



Summary of legal structures



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Below is an outline of the most common legal structures used within the social enterprise sector. The information provided should be used in conjunction with the considerations set out in our factsheets, 'Introduction to legal structures' and 'Frequently asked questions on legal structures.'

Voluntary Associations (also known as Community Groups or Unincorporated Associations)

When starting out, if you are uncertain about whether you want to be a social enterprise, a charity or a co-operative then a simple option is to start a voluntary association. These are usually created by people who have come together to further what the organisation has been set up to do.

Fundamentally this is a membership body with a very simple set of guidelines (the constitution) that sets out membership rights, how the management committee is elected and what the association's purpose is.

A voluntary association can start off with very few members and test the idea they have. With time the members can determine which direction to take in terms of legal structure.

A voluntary association is very easy to set up and equally easy to dissolve. The management committee, or board, acts on behalf of the members and delivers the organisations objectives or services. Voluntary associations can also generally apply for grants to get started or to continue their socially related work.

The downside of being a voluntary association is that it is not recognised as a legal entity under English law. So members of the management committee undertake all activities in their individual capacity on behalf of the members.

This means that the management committee members are then personally liable for any debts, legal actions etc affecting the association. A potentially risky position to be in!

Most voluntary associations when they reach a certain size, are on the point of taking on employees, or a lease, will decide that it is time to evolve into a legal structure that gives the management and the members' protection from personal liability.

Limited Liability Companies

Limited Liability Companies are commonly known as companies. These include:

- Companies Limited by Shares - CLS
- Companies Limited by Guarantee - CLG
- Community Interest Companies Limited by Guarantee – CIC CLG
- Community Interest Companies Limited by Shares – CIC CLS
- Many charities are a CLG with a charity registration

Companies are the most common form of commercial and social enterprise businesses.

English law recognises companies as separate legal entities from the owners of the company. So a company can enter into contracts, employ people, trade, borrow money etc in its own name, as if it were a human being. What a company can do, how one can become a member, and how directors are elected is outlined in a set of documents – the Memorandum and Articles of Association (Mem & Arts). These documents are to be reduced soon to just the Articles, due to a change in law. Remember that all companies offer directors limited liability, unless they have acted fraudulently or have been deliberately trading with the knowledge that the company is insolvent.

Companies Limited by Shares

Many people are surprised that some social enterprises are set up as companies limited by shares, given that this is normally a legal structure associated with commercial businesses.

In this structure a company offers shares that give profit sharing and voting rights to an investor or founder. Voting rights are proportional to the percentage of shares owned.

However, some social enterprises do choose this legal structure for its flexibility and ability to attract investment, as outlined below.

Challenges

Companies with a share structure are usually profit distributing and can be owned and exclusively controlled by a small number of individuals. They are not able to apply for grants from grant making trusts or (usually) statutory authorities.

Because so much control can be exercised by one or a small number of share owners (who may also be the directors) there is often suspicion over the governance and transparency of social enterprises which operate under this structure. It can also be hard to convince others that you have genuine social aims. This can be overcome by strong and clear communication of your social values, reporting on your impact and profile within the sector – but it is not always easy.

Advantages

Companies with shares can grow through investment, i.e. selling more shares to finance growth. Companies with shares are not common within the social enterprise sector. This is for a variety of reasons:

- inability to attract grant funding
- perception that social aims may not be genuine
- tradition – most social enterprise support and development organisations only have experience with non-profit guarantee companies

However, this legal structure does have significant advantages:

- many social entrepreneurs like the flexibility this structure offers in terms of making quick decisions and not being governed by a board, which can at times be cumbersome in its decision making
- the ability to attract investment funding

There has recently been an increase in the number of entrants to the social enterprise movement from the commercial sector. The common perception is that they see social enterprise as a natural extension to ethical or environmental business. As such, the use of this legal structure in the social enterprise sector is likely to grow.

Companies Limited by Guarantee

This is the most common legal form for social enterprises in the UK. This non-profit company cannot issue shares or pay back dividends on investment. It can only use its profits or surplus to reinvest back into the organisation and its social work.

Advantages

A guarantee company is considered by grant making entities to have better governance, as voting rights are equal and there is no real ownership. The members effectively act as stewards of the company, and as they do not have a share in the profits and assets, they are expected to act in the best interest of the company and the community it serves. Quite often these types of companies have representative members from their communities or beneficiary groups on their board, which is considered good practice.

Disadvantages

As social enterprises grow and become profitable there is reluctance for grant making trusts to support them, in particular where support is sought either to achieve growth or to fund actions not directly supported by the trust. Though a guarantee company can borrow money, there is a limit to how much a bank will lend to any one organisation. The company is also unable to attract investors as it has no

shares to sell. These factors have often limited the growth of a number of ambitious social enterprises and there have been recent cases of successful companies seeking to change to a share structure to be able to attract investment in order to keep growing.

A recent example is HCT Group, a well known community transport social enterprise based in Hackney, East London. Due to outstanding success and increased demand it reached a point where it needed to scale up its capacity. It had operated as a guarantee company, and a charity, until that point. However, it could no longer fund growth within this structure. Its solution was to establish a share company in order to attract ethical investors.

In all other respects a company limited by guarantee is exactly the same as a company limited by shares.

Community Interest Companies (CICs)

CICs were introduced in 2005 as a means of identifying companies which operate “with a Community Interest”. They are social enterprises by definition. CICs, like all limited companies, are regulated by Companies House but also by the CIC Regulator. With a few exceptions they are very similar to the other types of limited companies described above.

The introduction of CICs created the expectation that social enterprises operating under these new legal forms would have greater flexibility to raise money from a wider range of funding and finance sources. However, this has not proved to be the case. In fact, there are different kinds of CICs with certain types of funding available to some but not to others. This is explained below.

Existing companies can apply for CIC status or a CIC can be formed from scratch. The CIC has to be approved by the regulator and it has to supply an annual report stating what it has done to meet the community interest criteria.

CICs that are Companies Limited by Guarantee (guarantee companies)

A CIC that is a guarantee company has the prevention of profit and asset distribution (an asset lock) enshrined within the constitution. When a regular commercial company closes down for any reason, any assets remaining after liabilities are settled will go to the owners of the company. To counter this, an asset lock is a legal method that ensures the assets are distributed to other companies providing a community benefit, or to a charity, rather than to the owners. This makes sure that there is no financial benefit to the owners.

As a CIC limited by guarantee does not allow for profit and asset distribution it cannot attract investment or distribute profits. It can however attract grant funding. It is in fact a legal structure very similar to an ordinary company limited by guarantee.

Why choose to become a CIC that is a guarantee company?

Are there any advantages to being a CIC limited by guarantee as opposed to being an ordinary guarantee company? Below are some comparisons that will guide you between the two legal structures:

- Some people believe that being a CIC does differentiate you as a social enterprise. This form of recognition or branding may be of importance to you. For example, you may feel that as an ordinary guarantee company you will be perceived as a traditional non-profit organisation, rather than a more entrepreneurial social enterprise. However, this is anecdotal, and you should not make assumptions on how well the wider public and funders understand this new legal structure.
- Being a CIC means there is another layer of regulation that you have to deal with. However, it also means that someone external is checking that you fulfil your stated community interest, providing you with another level of legitimacy.
- Being a CIC does not provide any greater possibility of grant funding than if you were an ordinary guarantee company.
- The profile of CICs is likely to increase in the future though currently it is a structure little understood by the public or within statutory authorities and grant makers.

- Whereas an ordinary guarantee company can choose to convert into a charity, a CIC cannot do this.

CICs that are Companies Limited by Shares

There is second category of CIC – one that is limited by shares. This allows the company to sell shares and attract investors.

However, in order to protect the community benefit element there are various restrictions imposed on the functioning of this CIC:

- restrictions on the amount of dividend payable – this is considered to be a barrier in attracting investors
- restricted voting rights for the investors – this prevents the investor from being able to change the management, even if there are concerns around mismanagement
- restrictions on loan interest payable – restricting the ability to borrow money
- shares can only be sold back to the CIC at the purchase price – thus restricting the investor's ability to participate in any increase in market value of shares
- if the enterprise fails the investors lose their investment

All of these factors limit the interest in this structure from potential investors. On the other hand, this structure has been used to attract investors who are not seeking a high, or any, financial return. The attraction for them is the opportunity to invest 'ethically'.

In the near future it is likely that the CIC Regulator will make some changes to the CIC by shares structure in order to improve the rate of uptake.

Importantly, due to its profit distributing nature, organisations that operate within this structure have been unable to attract grants from grant making trusts and bodies. However, the structure is popular with charities that want a trading subsidiary. In this case the charity is the sole shareholder and receives all the profits of its trading subsidiary (for further information read our guide on Charity Trading).

Co-operatives (Industrial and Provident Societies)

The co-operative movement is recognised by many as the earliest legal form of social enterprise. Co-operatives are a form of incorporated entity. A co-operative is formed by a number of different people coming together to meet a common economic, social or cultural need. The people who are members of the co-operative own it and have voting rights to elect a committee to represent them and manage the co-operative.

A co-operative legal structure may be appropriate where there are a number of people coming together to create an organisation that will trade principally for the benefit of its members, but in a way that also benefits the wider community.

There are two forms of co-operative:

1. Society for the Benefit of the Community (commonly known as a BenComms) – set up to trade for the benefit of the community rather than its individual members.
2. Bona Fide Co-operative (commonly known as a Co-operative Society or co-operative) – traditionally set up to conduct business through member participation for mutual benefit.

Some of the ways co-operatives can be formed are:

- **Worker co-operative** - that is owned and controlled by its employees. They may manage the enterprise together collectively, or democratically elect a board of directors.
- **Co-operative consortium** – a co-operative formed by a number of independent businesses, organisations or individuals, which is owned and controlled by those members. They enhance their trade by joint activities such as publishing and marketing, or pool their resources for a joint enterprise.
- **Multi-stakeholder co-operative** – a co-operative that is owned and controlled by a variety of interested parties such as workers, users and the local community.

Co-ops share many features with companies, including the following:

- limited liability (the liability of members is limited to the amount of any unpaid share capital)
- a registered written constitution, set out in rules (rather than Mem & Arts)
- members who hold a share or shares
- directors to whom the power to manage the business is usually delegated by the members

Members can invest in a co-op up to £20,000. Other co-ops can invest more than that if they want to become members. Members have only one vote and enjoy a dividend distribution based on what is set out in the rules. On winding up, the members can recover their investment but do not have rights to the underlying assets.

In a BenComm members only hold a nominal amount of shares and there is no dividend distribution. This allows them to apply for grants. A number of social enterprises have chosen this form for their business because it allows the participation of a wide group of stakeholders and they can still access grants. A Bone Fide Co-operative cannot receive grants as it is by its nature trading for the benefit of its members, and it can distribute profits. All forms of co-operative can borrow money and are regulated by the Financial Services Authority (FSA).

Comparing the different legal structures

The table overleaf provides an overview of the key features of the legal structures discussed in this guide. Explanations are provided below (numbered references are in bold on the table). This is a guide only and for a more detailed explanation you should seek guidance from a professional support provider.

Explanations

1. Good practice is to have more than one guarantor or board member. If you are claiming community/ stakeholder representation than you need to demonstrate that you have a wider membership than just the founder. Funders tend to prefer at least five members (guarantors).
2. If you are the founder and want to be actively involved in the charity and get paid for your time then you cannot be a director (Trustee). By law, trustees of charities cannot be paid for being trustees. To be actively involved and get paid you would need to become the Chief Executive or part of the management team. However, ultimate responsibility for the charity would rest with the trustees. They would employ you and can dictate your pay and employment.
3. Even where the legal requirement is that only one officer is required (Companies Act); good governance practice recommends that there are at least three directors. This means that power and responsibility is shared and not vested in just one person. Grant funders are reluctant to fund organisations with just one director/trustee. Wider director involvement would support and complement claims of stakeholder representation and community involvement.
4. Additional directors could be non-executive, that is, they do not get involved in day-to-day activities of the enterprise, but oversee strategy and monitor the executive directors. So they would operate in much the same way as trustees. Usually in a social enterprise the non-executive directors contribute their time on a voluntary basis, i.e. they do not get paid.
5. By definition CICs are profit-making enterprises. Some people choose the CIC, Company Limited by Guarantee model to show they are a social enterprise aiming to generate profit, but do not wish to distribute these profits to directors. It is questionable whether the CIC model is appropriate for them. You could choose to be a company limited by guarantee that does not distribute profits.
6. You need to have shares to sell in order to receive an investment. Therefore companies limited by guarantee cannot receive investments.
7. Sometimes the word investment is used to show any form of monetary receipt e.g. grants or loans. This should not be confused with the true nature of investment, which is selling a stake in the company for money.

8. CICs that are Limited by Shares can distribute profits to external shareholders. The amount of distribution is restricted by law and any variances require the permission of the CIC Regulator.

	Limited Liability Companies				Industrial & Provident societies		
	Limited by		CIC				
	Shares	guarantee	shares	guarantee	Co Op	BenComm	Charity
Limited liability for members?	yes	yes	yes	yes	yes	yes	yes
Ownership by?	shares	guarantee (1)	shares	guarantee (1)	membership	membership	guarantee
Can directors be paid for their role as board members?	yes	yes	yes	yes	yes	yes	no (2)
Governance/ultimate responsibility	Board of directors	Board of directors	Board of directors	Board of directors	Management committee	Management committee	Trustees
How many directors or trustees? - legal requirement	1	1	1	1	3	3	1
How many directors or trustees? -- good governance recommendation (3)	3+	3+	3+	3+	3+	3+	3+
Established to make profit?	yes	possibly	yes	yes (4)	yes	no	no
Can receive grants?	no	yes	no	yes	yes	no	yes
Can receive investment?	yes	no (5)	yes	no	From members	no	no
Borrow money?	yes	yes	yes	yes	yes	yes	yes
Profit distribution?	yes	no	yes (6)	no	no	no	no

Further information

For further information on Co-operatives, visit:

www.cooperatives-uk.coop/

For further information on the Memorandum and Articles of association visit the Companies House website:

www.companieshouse.gov.uk

Read our guide on frequently asked questions for legal structures:

<http://www.blondon.com/socialenterprise/Frequently-asked-questions.html>

Read our guide on Charity Trading:

www.businesslink.gov.uk/london/socialenterprise/Charity-trading.html