



## Selecting the right legal structure for a social enterprise

The intention of this factsheet is to provide general information, which can then be followed up with more in depth discussion to develop on specific individual business requirements.

It is very important to ensure that you select the right legal structure for your business. The type of legal structure adopted by a social enterprise is dependent on profit distribution, control of the enterprise and asset ownership.

### **How will the Profit be distributed?**

To assist with identifying the most appropriate legal structure, one of the key areas to determine is profit distribution.

Your answers to the following questions will guide you to specific structures:

- Will profit be distributed between an entrepreneur and shareholders?
- Will profit be retained by the enterprise to sustain its development and further its aims?
- Will profit be distributed amongst any members?
- Will profit be distributed for the benefit of community organisations and other social enterprises?

### **Who will Control the Enterprise?**

To assist with identifying the most appropriate legal structure, one of the key areas to determine is control of the enterprise. For a social enterprise it is expected that

beneficiaries representing the social aspect of the enterprise have some representation towards the development and growth of the business.

- Will a membership be established where members nominate directors/trustees to make decisions on their behalf?
- Will the enterprise not have a membership but a select number of directors/trustees to oversee the enterprise?
- How much control will the entrepreneur or manager on a day-to-day basis require or want or need?
- Will the directors/trustees require remuneration from the start or at some time in the future?
- Will the enterprise be representative of its beneficiaries at board level?
- Will the enterprise be governed by shareholders who have a financial and / or social interest in the enterprise?

**TIP** – Establish whether you envisage members having a stake in the enterprise.

### **What happens to the Assets?**

To assist with identifying the most appropriate legal structure, one of the key areas to understand is what happens to the assets. For some social enterprise structures it is expected that asset lock provision is required.

Under the asset lock provisions, assets and profits must be permanently retained within the community interest company (CIC), and used solely for community benefit or transferred to another organisation which itself has an asset lock, such as a charity, or to another CIC. Other legal structures can include this provision within the Articles of Association.

Will the assets be owned and retained for the benefit of the community?

Who will you nominate to receive your assets? Named or open?

**TIP** – Consider initial/pre-start capital provision of equipment – donations or at cost – and who initially owns them?

**TIP** – Gain clarity and understanding of asset ownership – ‘belonging’ or ‘loaned’ to the enterprise.

### **Legal Structures for Social Enterprise**

i) Company Limited by Guarantee (CLG) - the most popular structure for a social enterprise

This is generally the simplest form whereby directors may be paid, however, these directors/trustees will often be in the minority, with the majority of directors being unpaid and volunteering their time and

skills. In general, directors/trustees are usually not paid to fulfil Directors' duties, however they can be paid as employees but it is recommended that they stay as the minority.

- Liability is limited to the "guarantee" of usually £1
- There may be a membership where members vote in representative members as director/trustees on the board or no membership where the members are the directors/trustees on the board. A 75 percent majority is required by the directors/trustees on key decisions including appointing new directors/trustees to the board
- Rules are set out in the Articles of Association specifically for this type of company. The rules define the trading and social objectives of the company, the limited liability guarantee for directors/trustees and that profits / surpluses will not be distributed to directors/trustees but remain within the company. The rules also identify the voting rights of the directors/trustees and how this relates to the membership
- Members can be either individual members or an 'organisation' member
- The company is governed by the Companies Acts
- Assets can be locked but would need drafting in the Articles of Association
- May register as a charity providing it meets the Charity Commission's criteria. If they are a charity with company limited by guarantee status they are often described as charitable companies
- Only one director required by law. However, in general, the enterprise requires a minimum of three directors, with 2 out of 3 being unrelated to be eligible for support from some funders

## ii) Company Limited by Shares (CLS) – not used very often

In general terms, the CLS structure is where directors of the company have the opportunity to be shareholders that have a financial investment in the company.

The shareholders own part of the company. To differentiate the social enterprise structure from a commercial company limited by shares, the majority of shares are held by organisations or members from the third sector (e.g. social enterprises, charities, and voluntary or community organisations).

Employees may have shares but this is slightly complicated as usually they are unable to directly benefit from payment of dividends. A trust fund or non-financial means are usually the alternative to providing this benefit.

N.B: It is recommended that legal advice must be sought to ensure this not only suits the ethos of the organisation but is set up correctly within law. Due to the potential complexity of this share option it would require additional consideration and further clarification, prior to incorporation, due to potential tax implications for employees receiving dividends and regarding shares held on trust.

- Liability is limited to the amount of the share the shareholder holds
- Rules are set out in the Articles of Association specifically for this type of company. The rules define the liability of the shareholders, how the shares are distributed, if any shares are locked or have the ability to be sold and / or transferred and when dividends will be paid out. The rules also identify the voting rights of the shareholders
- The company is governed by Companies Acts
- Assets can be locked but would need bespoke drafting in the Articles of Association.
- May register as a charity providing it meets the strict criteria of the Charity Commission.
- Only one director required by law. However, in general, the enterprise requires a minimum of three directors, with 2 out of 3 being unrelated to be eligible for support from some funders

### iii) Community Interest Company Limited by Guarantee (CIC CLG)

This company is incorporated as a Company Limited by Guarantee but with a CIC overlay. The company applies to the CIC Regulator to register as a CIC although it is still required to go through Companies House as part of the initial administration process.

- The company must satisfy a Community Interest Test
- Membership and governance as with a Company Limited by Guarantee
- Not eligible for charity status unless it ceases to be a CIC and can then revert/change status providing it meets the Charity Commission's criteria
- Assets are locked which must be included in the Articles of Association
- CLG version of the CIC does not allow for share dividends to be paid – profit cannot be distributed, however, donations could be made to charities
- Only two directors minimum required by law. However, in general, the enterprise requires a minimum of three directors, with 2 out of 3 being unrelated to be eligible for support from some funders
- An annual Community Interest Report must be submitted to the CIC regulator stating how objectives have been met and detailing distribution of profit/surplus
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The added regulation ensures that the community benefits from the company's activities and assets.

### iv) Community Interest Company Limited by Shares (CIC CLS)

This company is incorporated as a Company Limited by Shares but with a CIC overlay. The company applies to the CIC Regulator to register as a CIC, although it is still required to go through Companies House as part of the initial administration process.

- The company must satisfy a Community Interest Test
- Profit distribution is subject to a cap, currently 35% maximum
- Membership and governance as with a Company
- Limited by Shares with liability limited to the amount of shares
- Not eligible for charity status unless it ceases to be a CIC and can then revert/change status – although could prove more difficult due to ‘ownership’
- Assets are locked which must be included in the Articles of Association
- Only two directors minimum required by law. However, in general, the enterprise requires a minimum of three directors, with 2 out of 3 being
- unrelated to be eligible for support from some funders
- An annual Community Interest Report must be submitted to the CIC regulator stating how objectives have been met and detailing distribution of profit/ surplus

Should the company cease to trade the assets revert to the organisation named in the Articles of Association.

**NB:** It is recommended that due to the potential complexity of this share option it would require additional legal consideration and further clarification, when creating the articles. Specifically for clarity on potential loss of initial investment and taking into account the asset lock beneficiaries, if the company ceases to trade.

The added regulation ensures that the community benefits from the company’s activities and assets.

#### v) Industrial Provident Society (IPS)

There are two categories in this structure; Community Benefit Societies and Bona Fide Co-operative societies. Both registered with the Registrar of Friendly Societies.

Societies for the benefit of the community (BenComs) are incorporated Industrial and Provident Societies (IPS) that are set up with exclusively charitable objectives to comply fully with charity law, and with restricted trading activities. These trade to benefit the broader community.

This is the only IPS model that is classed by funding organisations as a social enterprise.

- The rules are the “registered rules”
- The governing body is know as the “committee of management” rather than the board

- The committee of management are responsible to a wider membership. One member one vote regardless of size of shareholdings
- It is a share company with shares normally issued at £1 per share
- Membership can be individuals or organisations
- There needs to be minimum of three members
- The company is governed by the Industrial and Provident Societies Acts
- Liability is limited to the amount of the share the shareholder holds
- Assets can be locked but would require bespoke drafting in the rules which could be changed by members
- An IPS can be established as a charity, providing it has exclusive charitable objectives that are for public benefit, allowing it to raise capital through public grants and charitable trusts. If approved, it's known as an exempt charity and reports to the Financial Services Authority (FSA), not the charity commission
- The company's activities can benefit the members by trading (e.g. Using its facilities) rather than as a result of shareholdings
- Bona Fide Co-operatives are essentially democratic structures which are worker owned and controlled private enterprises that operate for the mutual benefit of their members. Co-operatives may or may not be a social enterprise, depending on their activities and how they distribute their profits

## Co-operatives

- The principles are internationally defined – judged on the legality of their actions by reference to Cooperative principles
- The Co-operative society structure is governed by the Companies Act
- Incorporated as an IPS (with the Financial Services Authority) or CLG (with Companies House)
- The governing body is known as the “committee of management” rather than the board
- The committee of management are responsible to a wider membership. One member one vote regardless of size of shareholdings
- It is a share company with shares normally issued at £1 per share
- Workers are usually shareholders and receive dividends at the end of each financial year based on profits
- Membership can be individuals or organisations
- There needs to be a minimum of three members
- Liability is limited to the amount of the share the shareholder holds
- Profit distribution is related to member contribution
- Assets can be locked but would require bespoke drafting in the rules which be changed by members
- The company's activities can benefit the members by trading (e.g. Using its facilities) rather than as a result of shareholdings
- The purpose of a Co-operative is that the company services its members' interests by trading with them or supplying them with goods or services
- Co-operatives cannot be established as charities

## vi) Unincorporated Associations

This form of organisation is quite informal where a group of people make their own rules for running the organisation and set these as a democratic constitution on behalf of any members the organisation may have.

These do not need to register with or be regulated by either Companies House or the Financial Services Authority.

Unincorporated associations may register as charities but would be required to adhere to charity law and submit annual returns to the Charity Commission.

Unincorporated associations have no separate legal identity which means that their members are personally liable for any debts incurred.

Although an unincorporated association can trade and carry on commercial activity, the organisation cannot own property. It may be able to set up a trust to legally hold ownership of a property and assets for the community.

This form of organisation is unlikely to offer a long-term solution (although it could be useful to test trading initially) if you are intending to sign contracts or expand the enterprise. You should consider incorporation if you intend to:

- Take on employees
- Raise finance, apply for grants etc
- Issue shares
- Enter into large contracts
- Take on a lease or buy freehold property

### **Information on Trusts**

A trust is a legal device which governs how assets given by an individual or organisation are to be used. Many organisations such as those involved in education, healthcare, providing advice and conservation, can be structured as trusts.

These are unincorporated bodies and do not distribute their profits. They are managed by trustees. Trustees do not benefit from the trusts, but act on behalf of the community for whose benefit it is set up. Trusts make their own governing rules and have no legal identity of their own.

Trusts have a trust deed which protects their social objectives. It lists the intended beneficiaries and the conditions under which the trust's assets may be used.

They can act as sister bodies to unincorporated associations.

Trusts do not meet the eligibility criteria for social enterprise as they are not established to trade.

### **Differences between a Charity and Social Enterprise**

The main difference between a charity and a social enterprise is the trading and income generation. Charities are governed by Charity Law maintained by the Charity Commission. The law limits the trading

activity of charities, which may restrict a charity's income generating activities. The primary trading purpose must be wholly understandable and clearly stated in the governing document. The level of trading is at the discretion of the Charity Commission on an individual basis.

A social enterprise can have charitable status if the purposes of the organisation are exclusively charitable and are for public benefit and if the directors are not working in it. Assets must always be used for the charitable purposes of the organisation. Any profit or surplus cannot be paid out to members of the charity.

A social enterprise without charitable status does not have the activity and trading restrictions of a charity. Some charities have established separate 'trading arms'

to be able to carry out trading activity beyond that allowed under Charity Law. There are publications from the Charities Commission which explains this more fully.

Where to go for further information

Contact us at [info@seeahead.co.uk](mailto:info@seeahead.co.uk)

[www.gov.uk](http://www.gov.uk)

[www.cicregulator.gov.uk](http://www.cicregulator.gov.uk)

[www.companieshouse.co.uk](http://www.companieshouse.co.uk)

[www.cooperatives-uk.coop](http://www.cooperatives-uk.coop)

[www.charity-commission.gov.uk](http://www.charity-commission.gov.uk)

[www.fsa.gov.uk/Pages/Doing/small\\_firms/MSR/Societies/](http://www.fsa.gov.uk/Pages/Doing/small_firms/MSR/Societies/)