



Strategy Unit

Private Action, Public Benefit: Organisational forms for social enterprise

This is a background discussion paper produced in support of the main consultation paper “Private Action, Public Benefit”. It is not a statement of Government policy.

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Strategy Unit Voluntary Sector Review: **Organisational Forms for Social Enterprise**

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Part 1: Introduction

Social enterprises can be characterised as organisations which trade for a social purpose. This section looks at the definition of social enterprise in more detail, and explains how they fit with business, government and the voluntary sector, and what the benefits of these enterprises are to various stakeholder groups

1.1 This paper looks at the legal and regulatory framework for social enterprise in the UK. It considers the wide variety of organisational forms taken by social entrepreneurs, and identifies the barriers they may face in setting up and running their organisation. The paper has a particular focus on legal forms, and on how these could be reformed to provide a more supportive framework, but also considers issues to do with regulation and support.

What is social enterprise?

“Trying to define a Social Enterprise can be like trying to define an elephant - very difficult and not much point, because you certainly know one when you see one” – Social Enterprise London website

1.2 Social enterprises take an enormous number of different ownership and governance structures, and have a very wide range of objectives. In the broadest possible terms, we can think of social enterprises as *organisations which trade for a social purpose*. The sector is best illustrated by examples: the case study work which we commissioned as part of our work¹ gives a good range of the type of organisations we are looking at. These are described in **Appendix A**.

1.3 The phrase which is commonly used in the US, “nonprofit”, or the similar phrase “not-for-profit”, to some extent carry the undesirable message that organisations are not aiming to make a surplus – whereas they are aiming to do precisely this, but this is in order to fulfil their social purpose. However, the phrase “not-for-profit” does capture the essence of the social enterprise sector – that social enterprises are not operating for the purposes of making a profit in itself, but instead for social purposes.

1.4 Alternative working definitions have been developed. Two examples follow: one governmental (the Social Enterprise Unit in the DTI), and the other sectoral (Social Enterprise London).

1.5 The **DTI’s definition**² is:

“A social enterprise is defined as a business with primarily social objectives whose surpluses are reinvested for that purpose in the business or in the community (rather than being driven by the need to deliver profit to owners and shareholders). There is no single model, but social enterprises include co-operatives, mutuals, employee owned businesses and private companies limited by guarantee. They are seen as having the potential to play a key role in

¹ “Organisational case studies of alternative organisational forms”: Report to the Strategy Unit, by University College London and the New Economics Foundation

² Provisional

delivery of public services and generating wealth and improving life in disadvantaged communities.”

Social Enterprise London³ define the sector as follows:

“Social Enterprises are businesses that trade in the market in order to fulfil social aims. They bring people and communities together for economic development and social gain”

The boundaries between social enterprises and business, charities and government

1.6 Most social enterprises see themselves primarily as businesses, in that both models emphasise the importance of trading in order to build long-term sustainability. However, whilst businesses trade for the purpose of creating profit, social enterprises operate for a social purpose – profit (or surplus) is only a means to that end.

1.7 As companies become increasingly aware of corporate social responsibility issues, the boundaries between social enterprise and business may start to blur. For instance, the fairtrade organisation Day Chocolate Company (see Appendix A) is a company limited by shares, which plans to distribute profits to its shareholders when it starts to make them. However, it has broad social aims (paying farmers a decent price for their cocoa; promoting fair trade in the industry and amongst consumers); the Ghanaian farmers’ co-operative which produces the cocoa are shareholders with a major stake in governance; and all the other shareholders are driven by ethical purposes (e.g. Twin Trading, the Body Shop, Comic Relief). Can profit distribution be compatible with the notion of social enterprise?

1.8 The relationship between charities and social enterprises is an interesting one. Many social enterprises see themselves as distinct from charities, as charities have traditionally relied on donations and grants. However, as charities have become more commercial and entrepreneurial, many now consider themselves to be part of the social enterprise sector. For instance, the Apex Leicester Project, which provides support and training to disadvantaged unemployed people, see themselves very much as a social enterprise, but are a registered charity. The Charity Commission’s decision to recognise as charitable organisations involved with urban and rural regeneration may lead many other social enterprises in this area to apply for charitable status.

1.9 And like businesses and charities, many social enterprises are involved in delivering public services, having a contractual relationship with central and local government.

The advantages of social enterprise

1.10 The social enterprise model has advantages for a range of stakeholder groups. As these advantages are increasingly recognised, growth in the sector is likely to be promoted.

1.11 From the point of view of the different stakeholders, the advantages can be identified as:

³ From the SEL website

Government:

- **Building social capital.** The user involvement element of some social enterprises could be invaluable in building social capital (defined as the collective value of social networks, such as their impact on trust and co-operation), particularly in the case of organisations working in deprived areas. Involvement in running local organisations could help to promote feelings of citizenship.
- **Wealth creation.** Social enterprises offer a new way of creating wealth and enhancing productivity. Research has shown, for instance, that employee-governed organisations enjoy higher productivity than the norm. They may also operate in areas which commercial businesses would not, so increasing the overall level of economic activity.
- **An alternative way of delivering public services.** Many social enterprises are already involved in public service delivery, and have shown that they can be locally responsive and a source of innovation.

Users / Consumers:

- **Investors' needs are not the top priority for social enterprises.** The primary purpose of profit-making companies is to make a good return for their investors. This delivery of good quality goods or services is only a way to achieve this goal, not an aim in itself. Shareholder pressures can also lead to a short-term approach, whilst for effective service delivery a long-term outlook is needed. Social enterprises, in contrast, have no conflict of interest between delivering good services and pleasing investors – since investors are not receiving a profit-related return. This is a characteristic shared by the charitable and public sectors.
- **Non-profit-distribution can be a guard against abuse of market failure or market power.** Where there is market failure (e.g. when consumers find it difficult to judge the quality of the good or service they are receiving), or market power (e.g. monopoly provision), profit-making firms will always have an incentive to exploit their position to increase profits at the expense of users, by increasing prices or cutting back on service quality. Social enterprises do not have this incentive, as their sole aim is the provision of the good or service.
- **There is a growing demand for more responsible business practices, which social enterprises are meeting.** Fairtrade organisations are a good example of how social enterprises are growing up in industries which were traditionally dominated by profit-making firms (e.g. coffee production) in response to consumer demand. This demand could also be met by profit-making companies; but is met more effectively by social enterprises, who can put the social purpose first and use their profits to further this purpose.

Staff:

- **Many social enterprises involve staff in governance.** Some social enterprises are wholly staff-governed; many others have staff representatives on their boards. This can have a significant effect on staff morale and productivity. Of course, many profit-making companies have similar arrangements. Charities, in contrast, are generally prohibited from having staff members on their boards of trustees, limiting the use of certain governance models.

Social Entrepreneurs / Philanthropists:

- **Social enterprises are a way of doing good, outside the constraints of charitable status.** Charitable status imposes certain restrictions which entrepreneurs may find it hard to work with, such as the requirement for a volunteer board of trustees, and the need to have objects which are wholly charitable. The social enterprise sector allows for much greater innovation and flexibility.

Part 2: Organisational form

Social enterprises have distinct requirements in terms of their organisational form. This section looks at what an organisational form is, describes the ways in which social enterprises are governed and financed, and discusses how they could be taken over or wound up.

2.1 Why do people set up organisations, rather than pursuing their goals as individuals? In principle, all types of business activity could be conducted through contracts between individuals. For example, one group of individuals could contract with another group to supply them with a particular good or service.

2.2 However, in practice, these networks of contracts are impossible to construct without excessive expense. The creation of an organisation with its own legal personality is a way of constructing these contractual relationships in a robust and relatively cost-effective way. It can also give owners limited liability, and give the organisation a life beyond the life of its founders.

2.3 Putting this in more practical terms, the main reasons why an organisational form is needed are:

To bring together a group of individuals in pursuing a task or mission (or a number of tasks and missions)

To ensure accountability to stakeholders

To mobilise resources and manage assets

2.4 In the case of social enterprises, each of these areas present distinct challenges:

Their mission falls between the charitable and the commercial, a “middle ground” which is, at present, poorly recognised.

Lines of accountability are less clear-cut than for the public or private sectors, but often succeed in involving a wide range of stakeholders

Financing options are usually limited to those which do not involve profit distribution, and some social enterprises, particularly smaller ones, suffer from poor recognition by funders

2.5 This section discusses the particular characteristics of social enterprises. It explains how they may be governed (and how accountable they are), and the financing options they face. It also talks about exit strategies – what happens if a social enterprise is taken over or wound up. Part 3 analyses how the current range of available legal forms fits these characteristics.

Governance and stakeholder accountability

2.6 Whilst the validity of the business model in providing appropriate incentives for managers is rarely questioned – despite many examples where these mechanisms have failed to operate - governance and incentive structures in the social enterprise sector are, at least in this country, poorly understood. There is no single clear line of accountability, meaning that structures have to be constructed with care if they are to work.

2.7 However, many social enterprises have succeeded in establishing structures which actually have advantages over both private and public organisations in terms of stakeholder involvement, staff and management morale and incentives, and accountability. Their primary line of accountability is to staff and/or users, rather than to the owners of capital – which is an important distinction from mainstream businesses.

2.8 There are a wide range of possible governance models. What is appropriate for any particular organisation will vary according to a number of factors, including size, stakeholder interest, the degree of government control and the goals of those running the organisations. Individual social enterprises should have the flexibility to choose the form that suits them best; this is not an area where government or the legal system should be prescriptive.

2.9 Some of the most well-used models of governance include:

- *User-owned (or consumer-owned) mutuals.* This structure eliminates the conflict of interest between making a profit for owners, and providing high quality goods or services to users, since the two groups are the same. It can also help to build social capital by getting communities involved in running local services. However, the form can suffer from member apathy, particularly in large organisations.
- *Staff-owned mutuals.* These are organisations which are owned by staff at all levels (rather than, for instance, law partnerships, which are owned only by senior staff). They can deliver high levels of staff motivation; and there is evidence⁴ that organisations where staff have a role in governance significantly outperform the average. However, they are subject to the risk that the self-interest of staff may outweigh the interests of users.
- *Multistakeholder controlled organisations.* This model formally involves a range of stakeholders in controlling the organisation. An example would be an organisation which allows both staff and users to be members and to have board representatives. This is a good way of drawing in all stakeholders, but there is a danger that conflicts may prevent quick decision-making⁵.
- *Representative member models.* These models recognise that, particularly for large organisations, full mutual membership may be unwieldy. Instead, a number of members are chosen who are representative of a range of

⁴ “The Employee Ownership Index, made up of UK companies with more than 10 per cent of their capital held by employees other than directors, has outperformed the FTSE all-share index over the past decade. A £100 investment in the EOI in 1992 would be worth £370 today, while the same investment in the all-share index would be worth £186” – Financial Times, 27 November 2001

⁵ To counter this, some have suggested “dual boards”, where a stakeholder-composed Board would set overall strategy, and a second executive Board would deal with day-to-day management.

stakeholders, and who have overall control of the organisation. This has the advantages of stakeholder involvement without the disadvantages of having to keep a large membership informed and involved; however, there may be difficulties in ensuring that the members are truly representative, particularly as selection processes may not be democratic.

- *Two-tier board structures.* These structures are designed to address the problem that boards made up of stakeholders can be unwieldy. Instead, the board is made up of executives, and a separate second-tier Steering Group, Advisory Council or similar is set up, made up of stakeholders. The main board is more involved in the day-to-day running of the organisation, whilst the second-tier board meets less regularly and influences direction and strategy (and may, for instance, make its views publicly available).
- *Oligarchy models.* In oligarchy models, there is no membership structure (the directors are the only members). Whilst this makes for simplicity, directors can be self-selecting and lines of accountability may be unclear.

2.10 For many organisations, user (or staff) involvement may be desirable in theory, but hard to achieve in practice. Governance structures should take into account the risk of apathy. Alternatives to full involvement in governance may therefore be considered. For instance, where there is a reasonable belief that member apathy is likely, alternative methods of user involvement could be used, such as regular consultations or committees of users or staff; or having an appointment system for board members, but giving users the option to remove them through a vote.

Management incentives

2.11 Getting accountability structures right are the “stick” for managers, ensuring that bad performance will be corrected – a “carrot” is also needed to ensure that good performance by those running organisations, and those employed by them, is rewarded.

2.12 There is no reason why social enterprises should not pay competitive salaries. These could be supplemented with performance-related incentives, linked to success in meeting carefully chosen service indicators, which would be selected by the board and made public.

2.13 However, this has to be balanced against the fact that the credibility of social enterprises may be undermined if those running them have excessively high (“fat-cat”) salaries, or if surpluses appear to be distributed to staff through bonuses, rather than reinvested in the delivery of the goods or service. To counter this risk, organisations could choose to make senior executive salaries subject to approval by owners or members. The problem with this mechanism is that the general public is almost invariably opposed to high salaries, even if these are necessary to attract the right people. Attracting good management could therefore be made more difficult.

2.14 Alternatively, organisations or sectors could develop self-regulatory schemes for ensuring the public disclosure of salaries. Already, for instance, the housing sector publishes a survey of chief executives’ salaries.

Financing

Types of financing

2.15 There are a number of factors which can constrain the forms of finance accessible by social enterprises:

- If organisations use any type of finance where the return varies according to profits – such as conventional equity or venture capital finance - they need to ensure that this does not undermine their social purpose.
- Some forms of finance imply dilution of control (e.g. equity which carries voting rights; some types of venture philanthropy). This may be unacceptable to organisations with certain governance structures.
- Some legal forms impose restrictions on certain types of capital raising - e.g.. Industrial & Provident Societies have limits on the issuance of equity to members.
- The attitude of funders, and capital market conditions, may make some forms of finance excessively expensive or difficult to obtain.

2.16 The following types of finance can be used by social enterprises:

- *Debt*. This is likely to be the main source of financing for most small to medium size organisations. Loans could be secured either on assets, or on future income streams from the delivery of the service. Organisations which take unfamiliar legal forms are currently disadvantaged as few banks understand their business model. Bank financing can be expensive – particularly the overdraft route - and the personal guarantees usually forthcoming from proprietors of small businesses may be more difficult to obtain in social enterprise where the profit motive is absent. However there is a growing sector of Community Development Finance Institutions, who are able to lend at cheaper rates, and often do not demand security. Whilst specialist banks such as the Co-op Bank and Tridos Bank may be expected to be more likely to understand the needs of social enterprises, others, such as NatWest and Barclays, now have units dedicated to working with this sector.
- *Bond financing*. This would be suitable for medium to large sized organisations. An example of a recent successful issue is Citylife, a Sheffield-based regeneration organisation, which has raised money through zero-coupon bond issues in Sheffield and Newcastle. The US has a very sizeable bond market for nonprofits, though this is largely because it is tax-advantaged⁶.
- *Equity finance*. This form of finance has the advantage of transferring risk to shareholders from the organisation itself (see below); it also tends to be more easily available than other forms of finance, because of the size of the overall market. However, organisations must be careful not to allow shareholders to subvert the organisation's social purpose. If shares were saleable and had a market value, managers might start to run the organisation partly for the purpose of keeping the value high, rather than for the original social objective. Making shares non-transferrable (but redeemable at par) would solve this problem, although it might make raising capital harder. Preferential shares which do not carry voting rights are another option. Group structures may also be set up to ensure that equity holders never have a majority of the votes. In addition, organisations often wish to

⁶ Bonds are issued on behalf of nonprofits by municipalities; like all municipal bonds, interest on the bonds is exempt from federal income tax on bondholders.

limit the maximum dividend on the shares, or to set a fixed rate of return (e.g. investors in the Community Brewery Buyout, Cumbria case study receive a return no greater than 5% over the minimum lending rate).

- *Venture capital financing.* Traditional venture capital financing (which extracts a share of profits) may suit some social enterprises, but others are unlikely to be willing to allow venture capitalists to take an unlimited return. However, there are a small but growing number of trusts which are willing to put in funds at a fixed rate of interest, in return for a stake in governance. This may be a particularly good way of funding start-ups. This is a small but growing form of financing, of which there is currently limited awareness.
- *Grant financing.* Some social enterprises may have access to grant financing, which traditionally has been concentrated in the charity sector. Grants may be particularly useful in the start-up phase for some enterprises, before they are able to develop more commercial forms of finance.

2.17 Whilst social enterprises are currently somewhat disadvantaged compared with the public sector and mainstream business, there are reasons to believe that the situation will improve. The rapidly-growing ethical investment sector is a potential source of funds. Community Development Finance Institutions will be important for smaller-scale enterprises. And as awareness of the sector grows, so banks and other mainstream finance providers will start to build expertise and be more comfortable lending to these unusual business models – this is already starting to happen, for instance with NatWest’s Community Development Banking unit.

Risk implications of 100% debt financing

2.18 Social enterprises which do not use equity finance but are 100% debt financed (whether bond or bank loan) are inherently riskier than those financed by a combination of debt and equity. This is because companies must pay interest on bank loans and bonds, and eventually pay back the capital, or else face default. In contrast, companies can choose not to pay dividends to shareholders in bad years, and never have to repay the capital.

2.19 For low-risk businesses, such as some utilities, this may not be a serious problem. Subcontracting can transfer risks away from the organisation, leaving it with a relatively low level of residual risk. However, our case study research found that many social enterprises – particularly those where subcontracting is not appropriate - are keen to attract some kind of equity capital.

2.20 Those social enterprises which are mostly or completely debt financed may also look for an alternative way to cushion risk, such as building up a cash reserve. Social enterprises may, therefore, be relatively vulnerable to poor business conditions - particularly in their early years of operation, before any reserves have been built up.

*Cost of financing*⁷

⁷ This section is concerned external financing sources, such as banks, rather than income sources, such as income from trading or from government.

2.21 Many social enterprises will have to pay normal commercial rates for financing – and some may even find themselves paying slightly above the odds, as some funders may see them as relatively high risk because of their unusual business model.

2.22 However, some enterprises may be able to access funders which understand the business model, and are happy to accept lower rates of return to normal commercial rates, because they want to support this type of enterprise. A good example is social venture capital finance.

2.23 One factor which may reduce the cost of financing is the ability to secure any debt on future income streams. This is used very successfully in the housing association sector, where future streams of rental income are used to secure lending. However in other sectors, many financiers remain wary of this, and still prefer to lend on “bricks and mortar”.

2.24 A second factor is the ability of a social enterprise to subcontract some of its riskier functions to other organisations, so reducing its residual risk and increasing its creditworthiness.

Exit strategies

2.25 Social enterprises should not be insulated from the disciplines of the marketplace for corporate control. They should be able to merge or be taken over. And the possibility of failure in a competitive market should be accounted for by winding up procedures, receivership and bankruptcy in the normal commercial way.

2.26 However, mechanisms should be in place to ensure a smooth transfer of assets⁸ and continuity of service in all of these eventualities. In particular, it may be desirable for organisations to be able to lock in their assets for the public benefit – so that in the case of take-over by a for-profit organisation or of winding up, assets are transferred to another social enterprise with similar aims⁹. The “lock” could be attached to very specific objects – as it is for charities – or to the promotion of public or social benefit in general.

2.27 The US Revised Model Nonprofit Corporation Act (1987) provides some guiding principles on how takeovers, mergers and dissolution may work for nonprofit organisations, although the system would have to be adapted for a UK context. It states that any merger or dissolution would have to be agreed by the Board and, where there is a membership, by a vote of members. Merger or takeover with a for-profit company, or dissolution, would require assets to be distributed to another nonprofit. The system has been criticised, and these criticisms should be taken on board when designing a system for the UK.

⁸ This may mean the physical assets of the business, or the proceeds of their sale.

⁹ As is currently the case with charities.

Part 3: The current range of legal forms

Social enterprises need to find a legal structure which allows them, as closely as possible, to fulfil the requirements they have in terms of their chosen organisational form, particularly with regard to financing and governance. This section identifies a menu of desirable characteristics, and maps how well existing legal forms fit these characteristics. It goes on to describe how, for a variety of reasons, the current range of legal forms is not ideal for many social enterprises.

A menu of options for social enterprise legal forms

3.1 Drawing on the previous analysis, and our consultation and case studies, we can say that social enterprises are likely to look for a legal form which has most (and sometimes all) of the following characteristics:

- 1) Ability to trade, generate surplus and create wealth for social aims
- 2) Entrenchment of a non-profit-distributing nature (e.g. limits on forms of financing that involve profit distribution)
- 3) Assets to be devoted in perpetuity to public benefit objectives (protection against conversion into a for-profit)
- 4) Regulation which does not stifle innovative and entrepreneurial activity, but prevents abuse
- 5) Flexibility to implement a variety of governance structures, often with active stakeholder participation
- 6) Strong “public benefit” brand
- 7) Ability to access a range of forms of finance
- 8) Limited liability for members or shareholders¹⁰
- 9) Ability to merge or to be taken over
- 10) Capability for transition between forms

How well do current legal forms provide for this range of options?

3.2 A variety of forms can be adopted by existing social enterprises:

- Companies limited by guarantee
- Industrial & Provident Societies (which are split into Bona Fide Co-operative Societies (Co-ops) and Benefit of the Community Societies (Bencoms))
- Companies limited by shares
- Friendly Societies
- Limited liability partnership
- Bodies incorporated by Royal Charter
- Unincorporated associations

¹⁰ This may not be necessary for the smallest organisations.

3.3 **Appendix B** describes the main characteristics of each form. **Appendix C** maps the four legal forms which are most popular with social enterprises – the company limited by guarantee, the I&PS BenCom, the I&PS Bona Fide Co-op, and the unincorporated association – against the proposed menu of options for an ideal form. It shows that whilst current legal forms have some of the options desirable for social enterprises, there remain drawbacks.

3.4 The case study work which we commissioned also identified a number of wider problems which the choice of legal forms has caused for social enterprises (**Box A**).

Box A: Evidence of difficulties encountered in choosing a legal form

Bulwell Hall Community Garden Ltd, a housing estate-based garden project, is incorporated as a Company Limited by Guarantee. It would, however, have considered becoming an I&PS – but did not know enough about it at its creation to consider the option properly, despite taking advice. It found the whole process of developing its legal form very difficult.

Poptel, a co-operative Internet Service Provider, has encountered difficulties in finding a structure which is consistent with its social ethos but which allows it to be majority-owned by employees. It had to establish a new operating company as a company limited by shares, then used both a holding company and an Employee Benefit Trust to maintain employee co-operative control. It still cannot take advantage of current employee share scheme incentives. It is reluctant to become a company limited by shares, but fears that it may be pushed further in this direction.

The **Community Regeneration Organisation** is a company limited by guarantee, which does not currently have charitable status. It is concerned that there is no official recognition of its community benefit philosophy, and that this hampers its access to funds.

The Trojans Scheme, a community childcare initiative, has so far chosen not to incorporate, wanting to avoid the extra administration involved. However, it has found describing itself as a “not-for-profit community enterprise” time-consuming and very difficult to explain. Registering as a charity has to some extent solved this problem.

Coin Street Community Builders found it necessary to set up a complex group structure (including a company limited by guarantee, a friendly society, and some charities) to carry out all the activities it wanted to do, which has caused it problems in terms of paperwork and determining board membership of each entity.

3.5 Drawing on this analysis and evidence, together with our wider consultation, the main difficulties with faced by social enterprises can be identified as follows. It is important to note that some of these problems can and have been circumvented. However, they impose constraints on the growth of the social enterprise sector as a whole.

Lack of a robust lock on assets against conversion into a for-profit enterprise. None of the most popular forms for social enterprise has the feature of a legally binding lock on assets (for more detail see Appendix B). All can either be converted into a for-profit enterprise, or sold (with the proceeds being distributed

to members)¹¹. Industrial & Provident Societies may have to convert into a company first, but in practice this is not a substantial obstacle. Lawyers can word constitutions to minimise risk of conversion, but there is no guarantee in statute that this will not happen. The only way of guaranteeing that assets will be used for a purpose in perpetuity is for an organisation to get charitable status – which is often not possible, or indeed desirable, for social enterprises.

Solid protection can be put in place through sector-specific legislation – such as that governing housing associations – or through regulation. However, this can be cumbersome, and will not be appropriate for all types of organisation.

Many social enterprises have told us that the possibility that owners or members may eventually profit privately from the organisation can be a serious deterrent to funders.

The strength of the incentive to convert can be very strong where the personal financial benefits to members from the distribution of assets are high. Since we expect the social enterprise sector to grow, it is very important to put in place a system which ensures that there is no risk of leakage of assets in the future.

The idea of locking assets into a purpose in perpetuity for social enterprises – something which is currently only possible for charities – raises a number of issues, which are discussed in Chapter 5 of the main report.

Weakness of the brand. There is concern that whilst the charity form enjoys high public recognition and confidence in this country, social enterprises are poorly understood, both amongst the general public and amongst funders, customers, and indeed government. This was a strong conclusion of the case study work. This lack of a “brand” contributes to a number of other problems, including the difficulties some organisations face in getting appropriate financing.

A higher public profile would be very important to the sector – although it is possible that a unifying brand, like the charity brand, may be hard to apply to the diverse range of organisations which fall into the social enterprise category.

Difficulty in choosing an appropriate legal form. Organisations can find it difficult to choose a legal form which is appropriate for them. Much depends on the quality of any professional advice sought by the organisation. There are good support services, but these are often regionally-based and provision of information is therefore patchy.

Information about the I&PS, in particular, is hard to get; and there are only a small number of lawyers who are familiar with using the form. The distinction between BenComs and bona-fide co-operatives can be confusing, with many mutuals now setting up as BenComs, undermining the original distinction.

¹¹ Companies which are permitted to dispose of the “limited” suffix under Section 30 of the Companies Act have to transfer assets to a similar body on winding up. However, this is not watertight, and in practice can be avoided: see Appendix C.

The company limited by guarantee is better understood, though less well-known than the company limited by shares.

The system is also perceived as being excessively complex and confusing: any changes we make to legal forms should bear in mind the risk of adding further complications. Good support and advice services are important.

Problems in establishing some governance models within existing legal forms.

Some forms impose limits on the type of governance structures that organisations can adopt. Within the Industrial & Provident Society form, for instance, it is unclear whether it is possible to construct a model which gives different groups of members different rights (for instance, allowing staff alone to elect a staff board member)¹². Charitable status (which of course is a status not a legal form) does not generally permit staff to be on boards, and can impose limitations on the representation of users on boards.

Difficulties in obtaining finance. Despite some high-profile successes, many social enterprises still face difficulties in obtaining funding. Often, these are linked to the lack of understanding of the social enterprise business model, leading to concerns about the riskiness of the organisation. The fact that profit-related returns are usually not paid limits access to some cheaper forms of finance.

Many social enterprises apply for grants, as well as borrowing. However, organisations we spoke to during our case study find that some grantmakers will only recognise charities, because they do not understand the broader social economy sector, or because their rules forbid them from giving to any organisation which is not a registered charity.

Limitations on access to equity finance. As discussed in Part 2, access to equity finance can be very useful in reducing an organisation's risk profile. However, all of the most popular legal forms impose some limits on this form of finance. A company limited by guarantee cannot issue equity at all; an I&PS can issue equity to members, but with a limit on any individual holding of £20,000.

These problems have led some social enterprises to restructure themselves into a group structure which includes a company limited by shares. However, this can create a complex group structure, which is expensive and difficult to set up, can cause governance difficulties and can obscure understanding of the organisation.

Obstacles for smaller community organisations. Smaller, community-based organisations may not feel ready to incorporate, but they often find that as an unincorporated association, the lack of a legal identity causes difficulties, particularly in applying for funding.

If they do decide to incorporate, creating a Company Limited by Guarantee is relatively cheap; however, becoming an Industrial & Provident Society can be costly.

¹² This should be possible in principle, but has not yet happened in practice.

Costs of registration. Although CLG and I&PS are used by very similar organisations, they have two different regulators – Companies House and the Financial Services Authority. Companies House registration is cheap and fast, partly because it can be done by statutory declaration. Industrial & Society registration cannot be done through statutory declaration, and there is more to be checked than for company registration; the process is therefore inevitably lengthier. The extra complexity of I&PS registration, and the need for the FSA to recover its costs, also means that I&PS registration is more expensive.

The difficulty in updating Industrial & Provident Society legislation (any changes require primary legislation) has also been an obstacle to simplifying and modernising the form.

Social enterprises which also want charitable status face a separate registration process, which can be lengthy (although I&PSs currently apply to the Inland Revenue for charitable status, not the Charity Commission, which is generally a less onerous process).

Many social enterprises also face regulation as a consequence of the type of activities they carry out – for instance, credit unions have their own legislation and regulatory requirements.

Part 4: Policy Proposals

The main report sets out two major proposals for reforming the forms of incorporation for social enterprises.

4.1 Some of the problems currently faced by social enterprises, and identified in Part 3, are specifically caused by the fact that it is not possible to entrench certain characteristics within the legal forms themselves. In particular, legal forms cannot protect against conversion into a for-profit, or against the distribution of assets to owners.

4.2 Others, such as ease of access to finance and brand, are more generic issues, but might be significantly eased by the introduction of new legal forms which are specifically tailored to the needs of social enterprises.

4.3 The Strategy Unit review proposes two major reforms to the legal forms available to social enterprises, aimed at tackling these problems.

The Community Interest Company

4.4 Many social enterprises have chosen to incorporate as companies, limited either by share or by guarantee. However, the company form was set up purely with the needs of profit-making enterprises in mind. The Review therefore recommends the establishment of a Community Interest Company (“CIC”), drawing as appropriate on company law, but with certain additional constraints and features which make it suitable for use by small scale community-based not-for-profit organisations.

Characteristics of the CIC are discussed in Chapter 5 of the main report.

Organisations could choose to take the company limited by shares or guarantee form. . Registration as an ordinary company limited by guarantee would continue to be possible.

4.5 Views on the idea of a CIC are being sought as part of this review. If, as a result of this consultation, government is minded to carry the proposal forward, a technical consultation would then follow.

Reforming the Industrial & Provident Society

4.6 The existing I&PS structure has many advantages, embracing a wide variety of trading activities and model constitutions within its scope. The form allows activities for community benefit (e.g. housing) and mutual benefit (e.g. clubs and producer/consumer co-operatives) to be handled in a way which gives legal priority to groups normally external to a company structure. Whilst not very widely understood, the form is flexible and popular with organisations using it.

4.7 A number of proposed reforms are set out in the main report. Comments are welcome on the proposals during this consultation. Again, a technical consultation will also take place if initial consultation responses are positive.

Appendix A: Case studies

This is a list of the organisations which were looked at as part of the University College London / New Economics Foundation paper for the Strategy Unit Review. Some have been anonymised.

Day Chocolate Company, London - aims to put quality and affordable fair trade chocolate into the mainstream chocolate market, raise awareness of fair trade issues, be a catalyst for change in the mainstream markets and pay a fair trade price for cocoa. Day is a joint venture private shareholder company with one third of the ownership by Kaupa Kokoo, a farmers co-operative in Ghana, and the rest by Twin Trading (fair trade) and the Body Shop.

Poptel – the UK’s leading employee co-operative internet service provider, aims to enable organisations to work for positive social change and to help them achieve their goal by using up-to-date technologies. Employees are members of Soft Solution Ltd which has a 75% stake in Poptel Ltd, the operating company (a company limited by shares). Their collective shareholding is held in the Soft Solution Employee Benefit Trust.

Coin Street Community Builders – has a mission is to make the South bank a better place to live in, to work in and to visit. Activities include property development. The non housing developments are undertaken by CSCB (a company limited by guarantee), whilst housing is undertaken by Coin Street Secondary Housing Co-operative, a friendly society and a holding company for four fully mutual housing co-operatives. The group structure also includes a number of charitable trusts.

The Furniture Resource Centre provides a one stop furnishing service to registered social landlords throughout England and Wales. The FRC is a company limited by guarantee and a registered charity; the FRC group also includes Revive – a high street store and Bulky Bob’s a furniture collection and recycling company, and a new joint venture, The Cat’s Pyjamas, all companies limited by guarantee.

AnyBodyCan an emerging social firm is dedicated to challenging social and economic exclusion by supporting the development of enterprise and social entrepreneurship to enable the social and economic inclusion of disabled and otherwise disadvantaged people. A newly established membership organisation and company limited by guarantee, it holds a 30% stake in Katalyst, an events management company (CLS).

Leicester Housing Association, a housing and regeneration agency, is committed to providing homes and to developing highly innovative, holistic strategies for tackling social exclusion in the communities of the East Midlands and beyond. LHA itself is a registered social landlord and an industrial & provident society. It set up a separate organisation, TREES, to do some of its more innovative activities, to keep this activity distinct from the housing association (and avoid potential regulatory problems). TREES is a charitable Industrial & Provident Society which is the holding company for a number of wholly owned social enterprises, which are companies limited by shares.

A Community Regeneration Organisation, North West – develops sustainable employment, training and educational opportunities for the community and aims to encourage new economic and social investment into the area. It is a company limited by guarantee currently without charitable status since it is unclear if it meets Charity Commission rules. It has a multi-stakeholder board including the membership, supporter organisations and the sponsoring housing association. Funding is mostly grants with some earned income but would like to become self-sufficient.

A Community Brewery Buyout, Cumbria – aims to maintain an important local service and source of employment in the village after the owner manager of a small brewery wanted to retire. The brewery is an Industrial and Provident Society community co-operative with multiple shareholding – 58 members all invested an equal amount of £1500 that is redeemable (capped return) but not transferable. Financed through equity and small grants.

The Trojans Scheme, London – childcare provision and training and consultancy in childcare. The project is aiming to operate a franchise arrangement whereby different childcare projects are supported by a central facility, which provides market, in financial and legal administration and a clear framework to deliver the service. Currently they are ‘parented’ by Trustees who delegate authority to a Voluntary Management Committee. They are an unincorporated charity. Income from fees, grants and earned income.

Bulwell Hall Community Garden, Nottingham – provides training opportunities for the long-term unemployed, a community space, sells healthy produce and educates in healthy eating and living. They are a company limited by guarantee without charitable status and run along democratic lines. Members can only come from the local community to ensure local control. The organisation was ‘incubated’ by Nottingham City Council through service level agreements and aims to become self-financing.

Apex Leicester Project – provides advice, guidance, support and training for disadvantaged unemployed people, particularly ex-offenders. They are a registered charity and a company limited by guarantee but describe themselves as social entrepreneurs running a business which provides an excellent service. Much of their income is from service level agreements and contracts. They are developing fee income and considering building an asset base.

Kettering Community Leisure – aims to provide leisure services for the people of Kettering. It offers discounted rates to people who cannot afford services and cross-subsidises loss-making activities. The building assets are owned by the Kettering Borough Council and Kettering Community Leisure is a bencom (benefit of the community) industrial and provident society with charitable objects (but not exempt charitable status). Funded through earned income and a council grant.

Glas Cymru – is a company limited by guarantee and describes itself as a not-for-profit private sector company set up to provide: ‘high quality water supply and sewerage services at least cost to the communities served by Welsh Water’. Glas Cymru owns Welsh Water and other subsidiaries. It is owned by ‘members’ who are appointed by the board from nominations made by an independent panel.

A City Charitable Care Company – a recently established charitable company limited by guarantee that provides care services to a large conurbation. The company comprises the former staff of the local authority direct service organisation.

Information Byway – provides IT access for people who would not otherwise have it and provide a learning resource in a rural area. They are a company limited by guarantee run on co-operative principles and without charitable status. They describe themselves as a social enterprise. Whilst they are currently virtually fully grant-financed they aim to create revenue from fees and income-generating activities.

Diverse Resources', mission is to improve the well-being and health of local communities by offering support and resources to people so that they can help themselves and includes a range of services to local people ranging from primary health care to generic welfare support. Based in Hulme, Diverse Resources is a company limited by guarantee with charitable status. Through Diverse Resources Consultancy (CLG), a number of trading companies (CLS) have been established.

Bootstrap Enterprises – focuses on regeneration and delivering customised training programmes. They started life offering recycling programmes and many initial projects are now stand-alone organisations. They have a building that has been developed into workspaces and a café. They are a company limited by guarantee and a registered charity with a trading subsidiary, which manages the office spaces and covenants surpluses back.

Lincoln Co-operative Society Ltd – provides a whole range of retail and property services to its 133,000 members and the community including food, travel agents, dairies, and car sales. They focus on the general market but hope to solve some social problems by providing service in local areas with few retail outlets. The Society is an Industrial and Provident Society with around 14 subsidiaries and associates which are a mixture of companies limited by shares and IPSs.

Ibstock Community Enterprises Ltd – is a multi-activity development trust that aims to restore local financial services, provide access to information and support, provide local community retail and help local organisations attract and access grant funding. It is a company limited by guarantee and describes itself as a community co-operative without charitable status.

Lincoln City Football Club Supporters Trust – is an industrial and provident society, which owns 50% of the shares in Lincoln City Football Club and therefore in effect controls the Club. The aim of the Trust is to open the club up to provide a better service for the community and make it easier for local groups to use the ground. The board of the Trust is made up of a whole range of community stakeholders including young people and the local authority.

The Big Issue– a high quality weekly current affairs magazine, sold by the homeless or vulnerably housed, with content that raises awareness of social and economic factors that can lead to homelessness and cause social exclusion. 'A for-profit social business assisting the homeless to help themselves'. The Big Issue is a company limited by shares that has regional branches that are companies limited by guarantee. There is also the Big Issue Foundation that is a registered charity.

Kidszip Ltd - an online children's literature website in seven languages commercialising downloadable stories and novels. It is a company limited by shares and seeks to engage authors of stories and a committed clientele. The surplus generated from this commercial activity is directed to charitable aims related to the welfare and education of children.

A Housing Association Group - an enterprise group headed by a large housing association and includes other smaller housing associations and a range of subsidiaries providing care and development services. The group includes both industrial & provident society and company limited by guarantee legal forms, some of which are charitable.

Appendix B: Description of legal forms

The **company limited by guarantee** (or more precisely, the company limited by guarantee without a share capital) is a corporate vehicle governed by company legislation and the common law governing companies. There are two main differences between the CLG and the company limited by shares:

- A CLG cannot raise money through equity financing because they do not have shares. Instead of buying a share, members agree to contribute a nominal figure (usually £1) in the event of the company winding up. Their liability is then limited to the amount of this guarantee.
- In general the members of a CLG do not acquire a transferable interest in the company. This means that their interest usually cannot be sold or transferred, for example on death.

As with companies limited by shares, the members have certain statutory rights. For example their agreement is needed to change the company's constitution and they have the right to dismiss a director (with a 50% majority). Directors are not liable for any losses unless they acted improperly. They are under a duty to act in the best interests of the company¹³.

The only part of the company legislation that relates to non-profit distributing organisations specifically is Section 30¹⁴, which allows them to dispense with the word limited in their company name. A CLG can only dispense with the word limited if it:

- has objects that promote 'commerce, art, science, education, religion, charity or any other profession'
- there is a requirement that profits and other income are applied to the promotion of the objects,
- payments of dividends to members is prohibited and
- all assets are applied to similar objects on winding up.

There is evidence that take-up of s30 is patchy and there are non-profit distributing companies who choose to retain the word 'limited' in their title.¹⁵

The **Industrial & Provident Society** is a corporate form, which carries limited liability. An I&PS has its own legal identity, and can hold property and conduct trade. I&PSs fall into two distinct (though not statutorily defined) categories: Benefit of the Community Societies (BenComs) and Bona Fide Co-operative Societies (Co-ops).

BenComs:

- can be registered where the business is to benefit the community other than its own members, and there are special reasons to register as an IPS rather than a company under the Companies Acts
- have a membership, members having nominal share capital
- cannot distribute profits to members

¹³ The DTI Company Law Review proposes to codify directors duties in statute

¹⁴ Section 30 of the Companies Act 1985

¹⁵ The Company Law Review is considering removing it for companies set up in the future, and also making it easier for s30 companies changing their constitution to allow for profit distribution

- cannot distribute assets to members on dissolution, but transfer them to a body with similar objectives or be used for similar purposes
- can be exempt charities.

Co-ops:

- conduct business through member participation for mutual benefit
- entail control by all members equally
- may allow distribution of profits to members

The **company limited by shares** is a structure that is tailor-made for profit-distributing, equity-financed organisations. However, group structures for social enterprises are often constructed to include a CLS, in order to lever in equity capital – this is carefully balanced against the need to avoid subverting the social purpose of the organisation. An example is the Big Issue. This form does suit some organisations, but this is not an ideal form for social enterprises as its very construction is based on profit distribution.

Friendly societies are mutual organisations governed by rules, with the purpose of assisting members during sickness, unemployment or retirement. Some also provide life insurance. Their numbers have declined and only 9 were added to the register between 1995 and 1999.

The **limited liability partnership** is a new corporate legal form, which unlike standard partnerships carries limited liability. It is essentially a hybrid form combining the organisational flexibility and ease of formation of a partnership, with some of the characteristics of a company. It must be formed by at least two people 'for carrying on a lawful business with a view to profit' (s2(1)(a) Limited Liability Partnership Act 2000). The Act only came into force on 1 April 2001 and it remains to be seen whether any social enterprises will use the form, given its focus on profit making.

Bodies incorporated by Royal Charter, such as the Arts Council, are tailor-made for each organisation. This is not a form that would be used by a normal social enterprise.

Many small or new organisations are **unincorporated associations**. These are bodies governed by a constitution, but without a separate legal existence. Their basis is a contract between a group of individuals. The form is unregulated. Because members have personal and unlimited liability, this form is suited only to small organisations.

Appendix C: Profile of the CLG, I&PS and unincorporated association against the menu of characteristics for social enterprise¹⁶

Option	Company limited by guarantee	I&PS (BenCom)	I&PS (Coop)	Unincorporated Association
1. Ability to trade and generate surplus for social aims	Met. CLGs can trade in the same way as a company limited by shares.	Met.	Partly met. Co-ops can and do trade; this is for private member benefit but membership can be open to anyone.	Met. There are no restrictions on trading activity.
2. Non-profit-distribution	Partly met. Organisations can put a non-profit-distribution clause into their constitution; but this can be changed by a vote of members.	Met. BenComs are prohibited from distributing profits to members.	Not met. The Co-op can distribute profits to members via dividends, and to non-members subject to membership approval.	Partly met. The constitution may stipulate non-profit-distribution; but this can be changed.
3. Assets to be devoted in perpetuity to public benefit objectives	Not met. Section 30 registration (see Appendix C) requires such a clause in the constitution. However, the company can still be wound up and the assets transferred; and in practice, evidence from solicitors suggests that companies can remove themselves from the Section 30 constraints even without having to go through this process. Companies can use contracts to minimise the chances of conversion, but this cannot provide an absolute safeguard.	Not met. In theory, assets must be transferred to a body with similar purposes on dissolution. However, an I&PS can always convert into a company and then be sold, with assets distributed to members. Careful drafting can reduce the risk of this happening. Housing Associations and Credit Unions are safeguarded under separate legislation.	Not met. Subject to high voting thresholds, two membership ballots can resolve to demutualise and distribute assets to members.	Not met. Nothing in the legal form itself prevents assets being used for private benefit.
4. Regulation which does not stifle innovative and entrepreneurial activity	Met. CLG's are obliged by the Companies Act to provide certain information to Companies House.	Partly met. Formal regulation by the FSA is very light (although many I&PSs have multiple regulators); but registration as an I&PS costs more and takes longer than that for a company.	Partly met. Formal regulation is very light; but registration as an I&PS costs more and takes longer than that for a company.	Met. Unincorporated associations are not regulated.

¹⁶ This table makes the assumption that organisations are not charities.

5. Flexibility to implement a variety of governance structures	Met. The CLG form is highly flexible, and allows for a range of membership and board structures. The constitution can be changed by special resolution (75%) of the members	Partly met. Many different structures have been implemented. However, structures with different categories of membership are difficult, and have not yet been used in practice.	Not met. There are strict rules emphasising equality among membership; members elect officers.	Met. Highly flexible, however, the lack of specific legislation or regulation can makes any governance disputes hard to solve.
6. Strong brand	Partly met. Companies have a stronger brand than the I&PS, although the CLG is less well known than the traditional one limited by shares.	Not met. The I&PS is a poorly recognised form; terminology of Bencoms and Co-ops is often confused.	Not met. The I&PS is a poorly recognised form; terminology of Bencoms and Co-ops is often confused.	Partly met. The unincorporated association is recognised as useful for certain types of organisations where unlimited liability is not an issue.
7. Ability to access a range of forms of finance	Partly met. High-profile CLGs have successfully tapped the bond market; others have had varying success.	Partly met. The poor level of understanding amongst financiers hinders access to funds, except where strong assets and income flows are established.	Partly met. The poor level of understanding amongst financiers hinders access to funds.	Not met – lack of legal corporate personality likely to hinder raising finance.
8. Limited liability for members or shareholders	Met. Members' liability is limited to the amount of the guarantee (which is usually nominal).	Met.	Met.	Not met. Liability is personal and unlimited.
9. Ability to merge or be taken over	Partly met. No straightforward procedure. In principle, each member must agree to transfer their membership. However usually possible by transfer of assets to a new entity or by restructuring.	Partly met. Mergers between I&PSs are very straightforward, as are group and subsidiary structures. Mergers with other corporate forms are more complicated.	Partly met. Mergers between I&PSs are very straightforward, as are group and subsidiary structures. Mergers with other corporate forms are more complicated.	Partly met. Dependant on powers in constitution. Otherwise need unanimous consent of members
10. Capability for transition between forms	Met. It is normally necessary to have a winding-up procedure even for conversion into a company limited by shares, which can be administratively burdensome.	Partly met. The law is uncertain on whether BenComs can resolve to convert to a company lacking the original community benefit objectives or rules on distribution.	Partly met. Subject to high voting thresholds, two membership ballots can resolve to convert to company form.	Met. Nothing in the legal form itself prevents conversion to another form.
Concluding notes	A useful form. It has the advantages (and disadvantages) of being subject to companies legislation.	A useful and flexible, but poorly understood and dated form.	A restrictive form whose use is limited to certain types of organisation.	Does not meet many of the characteristics, but may still be appropriate for the smallest organisations.

