



**Law
Commission**
Reforming the law

Background Paper: Legal Forms for Social Enterprise (June 2017)

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Chapter 1: Introduction

- 1.1 This background paper looks at the legal forms which social enterprises can take. A wide range of possible structures provides flexibility but creates complexity as each is subject to different legal and regulatory regimes.
- 1.2 In this paper, “social enterprise” means a business with a social, charitable or community-based purpose whose surpluses are principally reinvested for that purpose. They are subject to rules and restrictions as to their activities and use of profits. A social enterprise is distinct from a commercial business which has been set up principally to make a profit and provide returns to shareholders.

SCOPE OF THIS PAPER

- 1.3 Social enterprises can take a wide variety of legal forms, providing choice and flexibility. For example, a social enterprise may wish to ensure that all its assets (including profits) are used only for its social purpose. It can do this by adopting a legal form which includes a full restriction on the use of its assets. Alternatively, if a social enterprise wishes to be able to provide some returns to investors, it can adopt a legal form which permits the issue of shares and the payment of dividends. This paper aims to provide an introduction to the range of social enterprise forms and the legal rules which apply to them.
- 1.4 We begin by looking at forms suitable for smaller social enterprises and move on to look at incorporated forms and those with limited liability which are more suitable for larger social enterprises.

LEGAL FORMS AND CHARACTERISTICS DISCUSSED IN THIS PAPER

Legal forms of social enterprises

- 1.5 This paper discusses the following legal forms that can be taken by social enterprises:
 - (1) Unincorporated associations;
 - (2) Trusts;
 - (3) Charitable incorporated organisations (CIOs);
 - (4) Companies limited by guarantee;
 - (5) Community interest companies (CICs); and
 - (6) Registered societies (co-operative societies and community benefit societies).

Contrast with companies limited by shares

- 1.6 This paper does not consider in detail companies limited by shares. Companies limited by shares do have the potential to have social impact. For example, a “mission-led business”¹ is a commercial business set up to make a profit and provide returns to shareholders while also fulfilling a social mission or purpose. However, these companies are distinct from social enterprises: they have been established to make a profit to provide returns to shareholders rather than to reinvest in their social, charitable or community based purpose.
- 1.7 This paper occasionally refers to companies limited by shares in order to contrast investment in social enterprises with investment in traditional companies.

Characteristics of legal forms of social enterprises

1.8 For each legal form, we consider the following characteristics:

- (1) **Whether it is incorporated and therefore has separate legal personality from its members**

Legal personality enables an enterprise to enter into contracts, such as loan agreements. We think that limited liability is essential as the individuals running the enterprise are likely to be reluctant to incur personal liability under contracts entered into on behalf of the enterprise.

- (2) **Whether it can grant fixed and floating charges and mortgages on land as security for loans**

Where a social enterprise is unable to grant security, in the form of fixed and floating charges and mortgages on land, this may limit the amount that a lender is willing to lend to it. In turn, this may affect a social enterprise’s ability to raise finance through debt and also limit the returns available to investors.

- (3) **Whether it can provide a return on shares or debt financing**

As well as receiving donations and grant funding, a social enterprise may be able to raise funding by issuing shares or by borrowing. An investor who has provided funding may be able to get a financial return from a social enterprise by:

- (a) Providing debt financing to the social enterprise and receiving interest; or
- (b) Investing in shares issued by the social enterprise.

The different legal forms available to social enterprises put greater or fewer restrictions on the uses to which the assets (including profits) of an enterprise

¹ There is no legal definition of a “mission-led business”; this is a term used in the government-commissioned Independent Advisory Panel Report, *Mission-Led Business: On a Mission in the UK Economy* (2016). Available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/574694/Advisory_Panel_Report_-_Mission-led_Business.pdf.

can be put. Such restrictions can prevent or limit the ability of the enterprise to distribute profits to members or provide a return on capital invested.

- 1.9 Appendix 1 to this paper sets out a quick reference table summarising the different characteristics for each legal form discussed in this paper.

CHARITIES

- 1.10 A charity is an organisation which exists for exclusively charitable purposes and may take a number of different legal forms. It is a legal status rather than a legal form.
- 1.11 Some social enterprises are operated as charities. Charities have a significant impact on everyday life. The sector is responsible for important services and provides support for many different causes.² In April 2017, the Charity Commission for England and Wales reported that there were 183,304 registered charities in England and Wales.³
- 1.12 If a social enterprise is operated as a charity, this affects the legal form that the social enterprise can take and its ability to provide a return to investors.
- 1.13 The four main types of legal form adopted by charities are:
- (1) unincorporated association;
 - (2) trust;
 - (3) charitable incorporated organisation (CIO); and
 - (4) charitable company limited by guarantee.
- 1.14 A charity cannot be set up as a co-operative society or a community interest company and is usually not set up as a company limited by shares.
- 1.15 A social enterprise which is registered as a charity is subject to charity law which requires, among other things, that it be established only for charitable purposes.⁴ A charity cannot use assets or profits for any purpose other than the pursuit of its charitable purpose.⁵

² See for example <http://www.theguardian.com/voluntary-sector-network/2016/may/20/10-public-services-run-charities>.

³ Charity Commission, *Charities in England and Wales – 30 September 2016 (updated daily)*. Available at <http://apps.charitycommission.gov.uk/Showcharity/RegisterOfCharities/SectorData/SectorOverview.aspx>.

⁴ Section 1(1) of the Charities Act 2011 defines a “charity” as an institution that is established for charitable purposes only. A charitable purpose is one which falls under one of the thirteen categories listed in section 3(1) and is for the public benefit as defined in section 4 of the Charities Act 2011.

⁵ Activities other than in pursuit of its charitable objects which involve risk to a charity’s assets must be undertaken by a separate trading company. See Charity Commission, *Guidance: Trustees trading and tax: how charities may lawfully trade* (February 2016). Available at <https://www.gov.uk/government/publications/trustees-trading-and-tax-how-charities-may-lawfully-trade-cc35/trustees-trading-and-tax-how-charities-may-lawfully-trade>.

1.16 Charities are subject to regulation by the Charity Commission and a charity will be required to register with the Charity Commission unless it:

- (1) is an exempt charity;⁶
- (2) is an excepted charity with an annual income of £100,000 or less;⁷ or
- (3) has an annual income of £5,000 or less.⁸

CIOs must register regardless of their income level.

1.17 In the following chapters we highlight where a social enterprise set up in a particular legal form may be subject to additional rules if it is a charity.

⁶ Charities Act 2011, ss 30(1), 30(2)(a), 22 and Schedule 3. Exempt charities are listed in Schedule 3 to the Charities Act 2011. These include: national museums and galleries and registered providers of social housing.

⁷ Charities Act 2011, ss 30(1), 30(2)(b) and 30(2)(c). The Charity Commission gives the following examples of charities that may be excepted charities: churches and chapels of Christian denominations, charities that provide school premises, Scout and Guide groups and armed forces charitable service funds the. For further details of excepted charities see Charities (Exception from Registration) (Amendment) Regulations 2014. See Charity Commission, *Excepted Charities* (June 2013). Available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/587387/Excepted_charities.pdf.

⁸ Charities Act 2011, s 30(2).

Chapter 2: Unincorporated associations

INTRODUCTION

- 2.1 An unincorporated association is the easiest, quickest and cheapest way for a group to establish itself. This structure is particularly suitable for small community groups.
- 2.2 An unincorporated association should:
- (1) consist of two or more persons with a common non-business purpose;
 - (2) have contractual relations between those persons;
 - (3) be governed by rules; and
 - (4) be non-temporary.⁹

HOW ARE UNINCORPORATED ASSOCIATIONS SET UP?

- 2.3 Unincorporated associations are set up through a contract between their members and governed by a simple constitution or association rules. There are no legal requirements for these to be written down. However, in practice in order to avoid disputes, a contract in writing is often preferable to an oral agreement.
- 2.4 If the association's aims are wholly charitable, it may have to be registered with the Charity Commission as a charity.¹⁰ A model constitution is available from the Charity Commission for an unincorporated association that wishes to register as a charity.¹¹

REGULATION AND REPORTING REQUIREMENTS

- 2.5 Non-charitable unincorporated associations are currently unregulated and have no central regulator. No central register for unincorporated associations exists, nor are there any statutory requirements that dictate how they are to be managed.
- 2.6 By contrast, unincorporated associations registered as charities are separately regulated by the Charity Commission and are subject to charity law.¹²

⁹ There is no statutory definition for an unincorporated association, but a number of definitions appear in the case law. The most well-known definition comes from Lawton LJ in *Conservative and Unionist Central Office v Burrell* [1982] WLR 522, who defined the entity as:

two or more persons bound together for one or more common purposes, not being business purposes, by mutual undertakings each having mutual duties and obligations, in an organisation which has rules which identify in whom control of it and its funds rests and on what terms and which can be joined or left at will.

¹⁰ See para 1.16 for further details.

¹¹ Charity Commission, *Model constitution for an unincorporated charity* (November 2013). Available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/586359/GD3.pdf.

¹² See para 1.15 for further details.

LEGAL PERSONALITY

- 2.7 The term 'unincorporated' means that the association has no separate legal personality from its members. It can only enter into contracts through its members and not in its own right. Members do not have limited liability so are individually responsible for any debts or contractual liabilities under these contracts.
- 2.8 For this reason, an unincorporated association is not likely to be suitable for a social enterprise that wishes to enter into contractual agreements such as employing staff, raising finance, taking on leases or purchasing property.¹³

RETURNS TO INVESTORS

Shares and dividends

- 2.9 Unincorporated associations do not have shares, so cannot distribute profits to investors by way of a dividend. However, an unincorporated association can distribute income to its members to the extent permitted by its constitution or association rules.
- 2.10 An unincorporated association registered as a charity will not be able to provide a return to members or investors because it cannot use assets or profits for any purpose other than the pursuit of its charitable purpose.¹⁴

Debt financing and interest

- 2.11 As an unincorporated association does not have separate legal personality, it cannot borrow in its own name. It can only borrow money by way of a loan through its individual members in their own names. Members would then be personally liable for any obligations under these arrangements.
- 2.12 Members may be unwilling to incur personal liability on behalf of the unincorporated association. While investors would be able to lend to individual members (for the benefit of the unincorporated association), it is unlikely that members would be willing to borrow large amounts. This limits the amount that investors could invest and also their likely returns by way of interest. Financiers are also unlikely to be willing to advance large sums of money without incorporation or a more formal legal structure. As a result, the financing of unincorporated associations is generally through small grants rather than loans.

SECURED LOANS

- 2.13 An unincorporated association cannot own assets in its own name so therefore cannot grant security over its assets in the form of fixed and floating charges, or mortgages on land. It can only borrow money and grant security through its individual members in their own names. Members would then be personally liable for any obligations under these arrangements.

¹³ For further discussion, see *Tudor on Charities* (10th ed 2015) para 6-050.

¹⁴ See paragraph 1.15 for further details.

2.14 Members may be unwilling to incur personal liability for debts and grant security of their own property on behalf of the unincorporated association. This can limit an unincorporated association's ability to enter into secured loans.

CONCLUSION

2.15 The main benefit of the unincorporated association is that it is quick and easy to establish and not subject to any statutory rules governing formation. This is a clear benefit for smaller community groups. Although in general an unincorporated association does not need to be registered, it may be subject to registration if it is a charity.¹⁵

2.16 An unincorporated association can distribute income to its members if permitted to do so by its constitution or rules, unless it is a charity. It can also provide returns to investors via interest on debt financing.

2.17 However, the lack of legal personality means this form is only suitable for small community groups and charities. It is unsuitable for those requiring substantial investment other than by grants and donations.

¹⁵ See para 1.16 for further details.

Chapter 3: Trusts

INTRODUCTION

- 3.1 A trust is not a membership organisation as such; it is managed by a small group of individuals, known as trustees. Trustees act on behalf of the beneficiaries of the trust and are the legal owners of the trust property.¹⁶ A trust can be set up to manage money or property, including for a charitable purpose.

HOW ARE TRUSTS SET UP?

- 3.2 Trusts are established using a trust deed or instrument which identifies the trustees and the intended beneficiaries of the trust. The trust deed generally provides that assets cannot be used or sold to benefit anyone other than the beneficiaries identified.
- 3.3 If the trust is a charitable trust, the trust deed or instrument must identify, among other things, the charitable purpose. A model trust deed for charitable trusts is available from the Charity Commission.¹⁷
- 3.4 Charitable trusts are subject to charity law, requiring both a charitable purpose and a public benefit (the trust's purposes must benefit the public, or a section of the public and not merely a group of private individuals).¹⁸

REGULATION AND REPORTING REQUIREMENTS

- 3.5 Trusts are subject to trust law but have no central regulator. Nor does a central register for trusts exist.
- 3.6 Charitable trusts are subject to charity law and are regulated by the Charity Commission, with whom they may be required to register and are required to file annual reports. They may be required to register with the Charity Commission and are required to file annual reports with the Charity Commission.¹⁹

LEGAL PERSONALITY

- 3.7 A trust does not have a separate legal personality from its trustees. Therefore, it cannot enter into contracts in its own name and it must act through trustees.²⁰ It is trustees, not the trust, who enter into contracts with third parties.

¹⁶ *Lewin on Trusts* (19th ed 2015), paras 1-001 to 1-010.

¹⁷ Charity Commission, *Model Trust deed for a charitable trust* (November 2013). Available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/586357/GD2.pdf.

¹⁸ Charities Act 2011, ss 3 and 4.

¹⁹ See paragraph 1.16 for further details.

²⁰ *Lewin on Trusts* (19th ed 2015), para 21-011.

- 3.8 If a trustee enters into a contract in their capacity as a trustee, they are personally liable in contract to the other party for obligations under that contract.²¹ Trustees incur personal liability to third parties irrespective of whether they act in accordance with their duties and powers as trustees.²²
- 3.9 Where a trustee, acting within their powers, enters into a contract with financial obligations, for example a loan, trust funds are used to repay the loan and any interest. However, where the assets of the trust are insufficient to satisfy the obligations under the loan, the trustee would face personal liability in respect of the repayments and interest. Personal liability for trustees exists unless there is a clause in the contract with the third party limiting that liability.²³ For example, liability can be limited to the trust assets. However, clear and unambiguous words are needed to exclude a trustee's personal liability.²⁴
- 3.10 Subject to the terms of the trust, a trustee has a right of indemnity out of the trust fund in respect of liabilities, costs and expenses properly incurred in connection with the performance of duties and exercise of powers under the trust.²⁵ The right to an indemnity from the trust fund itself is limited.²⁶ It is, however, possible for trustees to purchase trustee indemnity insurance at their own cost.
- 3.11 Trustees also face personal liability for losses incurred by the trust where they act in breach of duty, negligently or fraudulently. Where loss is caused as a result of a trustee's breach of duty, the trustee will be required to make good that loss out of their own means. Trustees may also face tortious liability.²⁷

RETURNS TO INVESTORS

Shares and dividends

- 3.12 Trusts do not have shares so cannot distribute profits to investors via dividends.²⁸
- 3.13 Trusts are also unable to distribute profits to investors in other ways. Trustees must act in the best interests of the beneficiaries under the trust.²⁹ A trust can only benefit

²¹ See *Lewin on Trusts* (19th ed 2015), paras 21-010 to 21-011.

²² *Lewin on Trusts* (19th ed 2015), para 21-011.

²³ *Lewin on Trusts* (19th ed 2015), paras 21-010 to 21-011.

²⁴ *Lewin on Trusts* (19th ed 2015), paras 21-011 to 21-012. It is important to note that a trustee cannot exclude liability beyond the "irreducible core of obligations" owed by a trustee. It therefore cannot exclude the obligation to act in the best interests of the beneficiaries; see *Armitage v Nurse* [1997] EWCA Civ 1279.

²⁵ *Lewin on Trusts* (19th ed 2015), paras 21-003 to 21-010.

²⁶ First, the contract has to be one which is permitted by the trust instrument, expressly or by implication. Secondly, the transaction must not only be permitted but also prudent. Finally, a trustee is not entitled to reimbursement out of the trust fund in respect of a proper transaction if there has been a prior unremedied breach of trust; see *Lewin on Trusts* (19th ed 2015) paras 21-019 and 21-042; *Re Raybould* [1900] 1 Ch 199.

²⁷ *Lewin on Trusts* (19th ed 2015), para 21-018.

²⁸ *Lewin on Trusts* (19th ed 2015), paras 21-010 to 21-012.

²⁹ *Cowan v Scargill* [1985] Ch 270.

its beneficiaries – this removes the possibility of being able to use a trust to distribute profits to investors.

- 3.14 Trust deeds usually make particular provision for the direction of assets, and their proceeds, profits and surplus.³⁰ They may provide that assets cannot be sold to benefit anyone other than the beneficiaries cited in the trust deed.

Debt financing and interest

- 3.15 Trustees may borrow on behalf of the trust, providing the trust deed expressly gives them the power to do so.³¹ The starting point is that a trustee must exercise their powers in the best interests of the present and future beneficiaries of the trust.³² When the purpose of the trust is to provide financial benefits for the beneficiaries, as is usually the case, the best interests of the beneficiaries are normally their best financial interests. Further, trustees are under a duty to exercise skill and care in accordance with the statutory duty of care laid down by section 1 of the Trustee Act 2000. Trustees must take reasonable care in agreeing the level of interest payable to investors under the loan.
- 3.16 Subject to the terms of the trust deed, a trustee is entitled to be indemnified out of the trust property in respect of liabilities (including interest payments), costs and expenses the trustee properly incurred in connection with the performance of duties and the exercise of powers as trustee.³³ This would include paying any interest to investors where that loan had been properly incurred.³⁴

Charitable trusts

- 3.17 The assets and profits of a charitable trust must not be used for any purpose other than the pursuit of its charitable purposes.³⁵ Trustees of a charitable trust must ensure the charity's assets are only used to support or carry out the charitable purposes.³⁶

SECURED LOANS

- 3.18 Trustees are the legal owners of assets held on trust for the beneficiaries. Trustees may borrow on a secured basis (granting a charge over assets held on trust),

³⁰ Trustees must preserve and manage the trust property for the benefit of the beneficiaries. See *Lewin on Trusts* (19th ed 2015), para 34-050.

³¹ *Re Suenson-Taylor's Settlement Trusts* [1974] 1 WLR 1280; *Lewin on Trusts* (19th ed 2015), para 36-120.

³² *Cowan v Scargill* [1985] Ch 270.

³³ *Re Grimthorpe* [1958] Ch 615 at 623.

³⁴ The power to borrow money must be expressly authorised by the terms of the trust deed and the trustee must comply with its statutory duty to exercise reasonable care.

³⁵ Charities can make a profit or surplus, but all the surplus funds have to be ploughed back into the charity and therefore cannot be used to pay investors. See The National Council for Voluntary Organisations (NCVO), "What does it mean to be a charity now?", p 1. Available at https://www.ncvo.org.uk/images/documents/about_us/media-centre/What-does-it-mean-to-be-a-charity-now.pdf. See also paragraph 1.15 for further details.

³⁶ Charity Commission, *The essential trustee: what you need to know, what you need to do* (CC3) (2015), section 7. Available at <https://www.gov.uk/government/publications/the-essential-trustee-what-you-need-to-know-cc3/the-essential-trustee-what-you-need-to-know-what-you-need-to-do#s7>; See also para 1.15 for further details.

providing the trust deed expressly gives them the power to do so.³⁷ However, in relation to land, trustees have the ability to deal with land as if they are the absolute owner, which includes taking out a mortgage.³⁸

3.19 Trustees of a charitable trust may only take out a mortgage or loan secured against charity land where written advice is obtained and the loan:

- (1) is needed and used for an activity that fits with the charity's purposes; and
- (2) has reasonable and affordable terms and repayments.³⁹

CONCLUSION

3.20 A trust is a relatively easy and cheap form to establish. The Charity Commission also provides a model constitution for charitable trusts which may be adopted.

3.21 A trust can provide a return to investors via interest on loans. However, a trust does not have separate legal personality, which means any contracts or liabilities are the responsibility of the trustees as individuals, rather than that of the trust itself. The lack of separate legal personality may impact on the ability of the trust to raise finance as trustees may be reluctant to incur personal liability for loans and financiers may be reluctant to lend larger amounts, in particular where loans are not fully secured against assets held by the trustees on behalf of beneficiaries.

3.22 A trust is also constrained in its ability to distribute profits to anyone other than its beneficiaries. Charitable trusts can only use their assets and profits in the pursuit of their charitable purpose.

³⁷ *Lewin on Trusts* (19th ed 2015), para 36-120.

³⁸ In relation to trustees of land see Trusts of Land and Appointment of Trustees Act 1996, s 6(1); in relation to non-land trustees see Trustees Act 2000, s 8.

³⁹ Charities Act 2011, s124.

Chapter 4: Charitable incorporated organisations (CIOs)

INTRODUCTION

4.1 A charitable incorporated organisation (CIO) is a new form of incorporated charity introduced as an alternative to the limited company.⁴⁰ It offers the benefits of incorporation without being subject to company regulation or dual registration with both the Charity Commission and Companies House.

HOW ARE CIOs SET UP?

4.2 In order to set up a CIO, it must be registered with the Charity Commission. All CIOs must register regardless of their income level. It is important to note that a CIO does not exist, in law, until it is registered.

4.3 In order to comply with Charity Commission requirements for registration, a CIO must have a governing document setting out certain information, including its charitable purposes, its powers (for example, its power to borrow money), who runs it and who can be a member.⁴¹ The Charity Commission has issued model constitutions which can either be used as templates or as a reference for CIOs to draft their own constitution.⁴² A CIO can adopt the foundation model, in which case the charity's trustees will be the only voting members and make all key decisions. Alternatively, a CIO can adopt the association model, in which voting membership is wider than just the charity's trustees.

4.4 The Government recently consulted on the draft Charitable Incorporated Organisation (Consequential Amendments) Regulations 2016.⁴³ These Regulations, if introduced, would allow charitable companies and community interest companies (CICs) to convert to a CIO should they wish to do so.⁴⁴ A summary of the consultation responses and the Government's response are yet to be published.

⁴⁰ The Charities Act 2006 first introduced the CIO legal form, and the statutory provisions now appear in the consolidated Charities Act 2011. The CIO status became available to charities in England and Wales on 4 March 2013 after the enactment of the Charitable Incorporated Organisations (General) Regulations 2012.

⁴¹ Charities Act 2011, s 206; Charitable Incorporated Organisations (General) Regulations 2012, part 3.

⁴² Charity Commission, *Model constitution for CIO with voting members other than its charity trustees* (August 2014) and *Model constitution for CIO whose only voting members are its charity trustees* (August 2014). Available at <https://www.gov.uk/government/publications/setting-up-a-charity-model-governing-documents>.

⁴³ The public consultation ran from 1 April 2016 to 10 June 2016.

⁴⁴ Cabinet Office, *Conversion to a Charitable Incorporated Organisation: consultation document* (April 2016). Available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/512916/20160322_CIOConversionConsultationDocumentFINAL.pdf.

REGULATION AND REPORTING REQUIREMENTS

- 4.5 CIOs must register with the Charity Commission and file annual accounts, trustees' reports and returns with the Charity Commission, regardless of their income level. At present, the Charity Commission does not charge a fee for filing reports or accounts.
- 4.6 A CIO does not need to register with or send returns to Companies House.

LEGAL PERSONALITY

- 4.7 A CIO has separate legal personality from its members. It can therefore enter into contracts in its own right and its members are not personally liable for the liabilities of the CIO.
- 4.8 An unincorporated charity which has grown over time is likely to benefit from incorporation as a CIO to facilitate entering into contracts and limiting the liability of its trustees.

RETURNS TO INVESTORS

- 4.9 A CIO is afforded a broad power to “do anything which is calculated to further its purposes or is conducive or incidental to doing so”, subject to any restrictions in its constitution.⁴⁵ As this broad power must be exercised to further the CIO's purpose, it cannot apply assets, profits or surplus to any other purpose than the specified charitable purpose.⁴⁶

Shares and dividends

- 4.10 A CIO does not have share capital and therefore cannot issue shares or provide a return to investors by way of dividends.

Debt financing and interest

- 4.11 A CIO can borrow in its own name, and provide returns to investors by way of interest on loans, subject to any restrictions in its constitution. However, charity trustees of a CIO are under a duty to exercise skill and care and exercise their powers in good faith to further the purposes of the CIO in accordance with their statutory duty of care in section 221 of the Charities Act 2011. In addition, Charity Commission guidance states that charity trustees as part of their essential duties should “ensure the charity can meet its financial obligations, particularly before agreeing to any contract or substantial borrowing”.⁴⁷ This extends to ensuring that the loan and its repayments are in the best interests of the charity. Charity trustees of a CIO must take reasonable

⁴⁵ Charities Act 2011, s 216.

⁴⁶ Section 1 of the Charities Act 2011 provides that an organisation can only be a charity if it “is established for charitable purposes only”. Accordingly, a charity must apply its property in the furtherance of its charitable purposes.

⁴⁷ Charity Commission, *Guidance: The essential trustee: what you need to know, what you need to do (CC3)* (2015). Available at <https://www.gov.uk/government/publications/the-essential-trustee-what-you-need-to-know-cc3/the-essential-trustee-what-you-need-to-know-what-you-need-to-do#s6>.

care in deciding whether to incur debt and when agreeing the level of interest payable to investors.

4.12 In relation to loans or mortgages secured against charity land, charity trustees of a CIO must obtain written advice and ensure the loan:

- (1) is needed and used for an activity that fits with the charity's purposes; and
- (2) has reasonable and affordable terms and repayments.⁴⁸

SECURED LOANS

4.13 A CIO is afforded a broad power to “do anything which is calculated to further its purposes or is conducive or incidental to doing so”, subject to any restrictions in its constitution.⁴⁹ A CIO can therefore borrow money on a secured basis and grant fixed and floating charges over its property as security for a loan, where this is calculated to further its purposes or is conducive or incidental to doing so and is not prohibited by its constitution.⁵⁰

4.14 Unlike Companies House, the Charity Commission does not keep a register of charges granted as security for a loan. Where CIOs grant mortgages over land, this will trigger registration with HM Land Registry.

4.15 The original proposal for the introduction of the CIO form envisaged that the Charity Commission would maintain and make publicly available information about charges over a CIO's property. However, it was later concluded that the costs to the Charity Commission of establishing and operating an electronic searchable register of charges for CIOs were not justifiable.⁵¹

4.16 In Lord Hodgson's review of the Charities Act 2006, it was stated that there were no plans to provide a web-based searchable register of charges over the property of CIOs.⁵² The Hodgson review, on the basis of the evidence it had received, decided it was not necessary for there to be a register for charges. It concluded that the only public register for charges over a CIO's property should be for those that trigger registration with HM Land Registry.

⁴⁸ Charities Act 2011, s 124.

⁴⁹ Charities Act 2011, s 216.

⁵⁰ The Charity Commission's two model CIO constitutions restate the broad statutory power and also include a short list of specific powers, including power to borrow and to charge all or any part of the CIO's property as security for a loan. Notes to the model CIO constitutions state that “It can... be helpful to state certain powers explicitly in the constitution. In particular, a stated power to borrow may reassure potential lenders.” For example, see Charity Commission Association Model Constitution, clauses 3, 4 and 5 and corresponding notes. Available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/562468/Association_Model_Constitution.pdf.

⁵¹ Lord Hodgson of Astley Abbotts, *Trusted and Independent: Giving charity back to charities – Review of the Charities Act 2006* (July 2012), p 120. Available at <https://www.gov.uk/government/consultations/charities-act-2006-review>.

⁵² Lord Hodgson of Astley Abbotts, *Trusted and Independent: Giving charity back to charities – Review of the Charities Act 2006* (July 2012), p 120.

- 4.17 Accordingly, a lender cannot easily know whether a CIO has granted security over any of its assets unless they are secured on land. As a result, lenders may be wary of CIOs, given their limited transparency compared to companies. This could make it more difficult to borrow, cause delays in arranging borrowing or preclude CIOs from getting funding altogether. The Hodgson review acknowledged that, in practice, the lack of a register of charges means that the CIO may not be an attractive form for those that routinely seek to borrow money against the security of the charity's property (such as larger charities).⁵³
- 4.18 Lord Hodgson suggested that organisations which outgrow the CIO form, through want of fixed or floating charges, should instead convert to a charitable company limited by guarantee.⁵⁴

CONCLUSION

- 4.19 A CIO must register with and report to the Charity Commission, filing accounts and an annual report. However, it does not have to register with Companies House. A CIO does not exist, in law, until it is registered. Unlike other charity registrations, where the regulator is asked to recognise an existing organisation, an application to register a CIO can only relate to a future organisation. This means that a CIO cannot be formed overnight as its existence is dependent on Charity Commission registration.⁵⁵
- 4.20 The CIO has separate legal personality and provides limited liability for its charity trustees and members. It may therefore be more appropriate for some organisations than the unincorporated association or trust form if they wish to enter into contracts, including debt financing.
- 4.21 A CIO does not have share capital and therefore cannot issue shares or provide a return to investors by way of dividends. It also cannot apply assets, profits or surplus to any other purpose than its specified charitable purpose. It can enter into debt financing and provide interest to investors, but is otherwise limited in its scope to provide returns to investors.
- 4.22 Unlike the Registrar of Companies, which maintains a register of company charges at Companies House, the Charity Commission does not keep a register of charges over CIO property. Only information about charges over land and interests in land held by a CIO is available from HM Land Registry. This may limit the usefulness of the CIO structure for larger charities with significant assets as there will not be public access to information about assets being used as security, and this may discourage potential lenders.

⁵³ Lord Hodgson of Astley Abbots, *Trusted and Independent: Giving charity back to charities – Review of the Charities Act 2006* (July 2012), p 120.

⁵⁴ We discuss companies limited by guarantee in Chapter 6.

⁵⁵ Institute of Chartered Accountants in England and Wales, *Charitable Incorporated Organisations: Issues for accountants* (December 2013). Available at <https://www.icaew.com/-/media/corporate/files/technical/charity-and-voluntary/law-and-regulation/charitable-incorporated-organisations-issues-for-accountants.ashx>.

Chapter 5: Community interest companies (CICs)

INTRODUCTION

5.1 The community interest company (CIC) is a relatively new form of company.⁵⁶ It was designed to provide a legal form for non-charitable social enterprises which aim to benefit the community or which are established with a social purpose, rather than purely to make a profit. A CIC cannot be a charity.⁵⁷

5.2 In March 2016, there were just over 11,000 CICs registered in England and Wales.⁵⁸

HOW ARE CICS SET UP?

5.3 CICs must be registered with Companies House and the Regulator of Community Interest Companies (the CIC Regulator).

5.4 The Companies Act 2006 sets out the requirements to be followed to register a company with Companies House.⁵⁹ These must also be followed to set up a CIC. Certain information and registration documents must be delivered to Companies House as part of the application for registration, including articles of association of the company, a statement of the company's proposed officers and a statement of the type of company it is to be and its intended principal business activities.⁶⁰

5.5 In addition, to set up a CIC the application sent to Companies House must also include a community interest statement which sets out the CIC's social purpose and the activities it will carry out to achieve it.⁶¹ This will be used by the CIC Regulator to decide the company's eligibility for CIC status.⁶²

5.6 Provided there are no issues raised by the CIC Regulator or Companies House, the CIC should be registered around two to three weeks from the application date. It is not yet possible to register a CIC electronically, so all applications must be submitted on paper by post.

⁵⁶ The CIC form was introduced in 2005 by the Companies (Audit, Investigations and Community Enterprise) Act 2004 and the Community Interest Company Regulations 2005.

⁵⁷ Companies (Audit, Investigations and Community Enterprise) Act 2004, s 35.

⁵⁸ Office of the Regulator of Community Interest Companies Annual Report 2015/2016 (2016), p 18. Available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/538040/cic-16-3-community-interest-companies-annual-report-2015-2016.pdf.

⁵⁹ Companies Act 2006, ss 7 to 13.

⁶⁰ Companies Act 2006, s 9.

⁶¹ Companies (Audit, Investigations and Community Enterprise) Act 2004, s 36; Community Interest Company Regulations 2005, regs 1 and 11.

⁶² See para 5.13 for further details.

CICs limited by shares or by guarantee

- 5.7 A CIC can be set up as limited by shares, limited by guarantee with a share capital or limited by guarantee without a share capital. The CIC's articles of association are required to contain certain information depending on whether they are limited by shares or by guarantee.⁶³ A CIC cannot rely on the model articles of association provided for by the Companies (Model Articles) Regulations 2008 as these do not comply with these requirements.
- 5.8 According to the CIC Regulator's Annual Report 2015 – 16, 77% of CICs in the UK are limited by guarantee and the remaining 23% are limited by shares.⁶⁴

The community interest statement and community interest test

- 5.9 In order to have CIC registration approved by the CIC Regulator, organisations must provide the CIC Regulator with evidence that they will satisfy the community interest test. A company satisfies the community interest test if a reasonable person might consider that its activities (or proposed activities) are carried on for the benefit of the community.⁶⁵
- 5.10 A "community" for the purposes of this test can include either the community, a section of the community or the population as a whole, or a definable sector or group of people either in the UK or elsewhere.⁶⁶ The test is whether a reasonable person might consider that the chosen recipients constitute a section of the community.⁶⁷
- 5.11 To enable the CIC Regulator to decide whether they will satisfy the test, applicants submit a community interest statement with their application for registration to Companies House. When the CIC Regulator considers whether a company will satisfy the test, it is taking a view about the likely course of its future activities, and what reasonable people might think of the CIC's actual or proposed activities. Once registered as a CIC, it must continue to satisfy the test for as long as it remains a CIC.
- 5.12 For the purposes of the community interest test, CICs cannot:
- (1) be politically motivated;⁶⁸ or
 - (2) be set up to serve an unduly restrictive group, that is, members of a particular body or the employees of a particular employer.⁶⁹

⁶³ Companies (Audit, Investigations and Community Enterprise) Act 2004 s 32; Community Interest Company Regulations 2005 regulations 7 and 8 and schedules 1, 2 and 3.

⁶⁴ Office of the Regulator of Community Interest Companies Annual Report 2015/2016 (2016), p 18.

⁶⁵ Companies (Audit, Investigations and Community Enterprise) Act 2004, s 35; Community Interest Company Regulations 2005, Part 2.

⁶⁶ Community Interest Company Regulations 2005, Part 2.

⁶⁷ Community Interest Company Regulations 2005 (as amended by the CIC (Amendment) Regulations 2009), reg 5.

⁶⁸ Community Interest Company Regulations 2005, reg 3.

⁶⁹ Community Interest Company Regulations 2005, regs 4 and 5.

REGULATION AND REPORTING REQUIREMENTS

- 5.13 CICs are currently regulated by the Office of the Regulator of Community Interest Companies (the CIC Regulator). The CIC Regulator decides whether an organisation is eligible to become a CIC and can take enforcement action if a CIC breaches CIC legislation.
- 5.14 The CIC Regulator has powers of investigation and audit which it can use to obtain necessary evidence to decide whether enforcement powers should be used.⁷⁰ It has wide-ranging enforcement powers, including the power to appoint or remove directors, appoint a manager and order the transfer of shares in a CIC. It can also present a petition to the court for the winding up of a CIC where it has formed the view that this is in the public interest.⁷¹ However, these enforcement powers are to be used only to the extent necessary to maintain confidence in CICs.⁷²
- 5.15 In its annual report, the CIC Regulator explicitly states that it adopts a “light touch” approach and uses its “powers of enforcement sparingly”.⁷³ There have been suggestions that the “light touch” approach of the regulator could be a cause for concern.⁷⁴ The CIC Regulator’s main concern is to ensure that a CIC continues to serve the community it was set up to benefit and that it is not operating in breach of the asset lock.⁷⁵
- 5.16 The CIC Regulator is small, employing a team of six who work for a part-time regulator.⁷⁶ They maintain a good working relationship with Companies House, sharing an office and some resources.
- 5.17 As with all companies, CICs are required to file annual accounts and returns with Companies House. In addition, a CIC has to file a community interest report annually with the CIC Regulator, which will explain how the CIC met the community interest test during that year and will, if applicable, give details of payments to directors and any dividends paid.

⁷⁰ Companies (Audit, Investigations and Community Enterprise) Act 2004, ss 42 and 43 and Schedule 7.

⁷¹ Companies (Audit, Investigations and Community Enterprise) Act 2004, ss 44 to 52.

⁷² Companies (Audit, Investigations and Community Enterprise) Act 2004, s 41(1).

⁷³ Office of the Regulator of Community Interest Companies Annual Report 2015/2016 (2016), p 16.

⁷⁴ We have heard from an individual who recently made a complaint to the CIC regulator who took issue with how the complaint was dealt with and had concerns relating to the light touch approach.

⁷⁵ Department for Business, Energy and Industrial Strategy, *Office of the Regulator of Community Interest Companies: Information and guidance notes, Chapter 11: The Regulator* (May 2016), para 11.1.4. Available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/605423/13-714-community-interest-companies-guidance-chapter-11-the-regulator.pdf.

⁷⁶ The team comprises 3 executive officers, 1 administrative officer, 1 team manager, 1 deputy regulator and 1 part time regulator.

LEGAL PERSONALITY

5.18 A CIC has separate legal personality and its members therefore benefit from limited liability. It can enter into agreements and incur debts in its own name, and it can hold, buy and sell land and property.

RETURNS TO INVESTORS

5.19 A CIC must be subject to an asset lock. The asset lock is designed to ensure that assets and their proceeds are retained and applied exclusively for the benefit of the community. Below we discuss a CIC's ability to provide returns to investors and how the asset lock applies in different circumstances.

Shares and dividends

5.20 A CIC limited by guarantee without share capital has no shareholders. It therefore cannot issue shares or provide a return to investors by way of dividends.

5.21 Where a CIC limited by shares or limited by guarantee with a share capital wishes to pay dividends to private investors, it must adopt the provisions in Schedule 3 to the Community Interest Company Regulations 2005 in its articles of association. However, any dividends are subject to a dividend cap.⁷⁷ With effect from 1 October 2014, a minimum of 65% of profits must be reinvested back into the company or used for the purpose it was set up to serve. This means that dividends are capped at a maximum of 35% of profits.⁷⁸

5.22 Alternatively, a CIC could adopt the provisions in Schedule 2 to the 2005 Regulations in its articles of association. This would allow it to pay dividends only to asset-locked bodies specified in its articles of association and other asset-locked bodies with the consent of the CIC Regulator. Dividends paid in this way are not subject to a cap.

5.23 An asset-locked body is:

- (1) another CIC, a charity or a community benefit society subject to a statutory asset lock; or
- (2) a body established outside the UK that is equivalent to either of those.⁷⁹

5.24 It is possible for a CIC to have an initial public offering (IPO) and become a public limited company, listed on a recognised stock exchange. This would increase the ability of investors to find buyers for their shares should they wish to sell them.

⁷⁷ Community Interest Company Regulations 2005, reg 22(1).

⁷⁸ Community Interest Company Regulations 2005, reg 22(1). See Office of the Regulator of Community Interest Companies, *Chapter 6: The Asset Lock* (May 2016), p 7. Available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/524154/14-1089-community-interest-companies-chapter-6-the-asset-lock.pdf.

⁷⁹ Community Interest Company Regulations 2005, reg 2; See para 7.33 for further details of community benefit societies and the statutory asset lock.

Redemption and repurchase of shares and reduction of capital

- 5.25 If permitted by its articles of association, a CIC may issue redeemable shares or purchase its own shares. However, this amounts to a distribution of assets and is therefore subject to the CIC's asset lock. Payments must be set at or below the paid up value of the shares, with no uplift for shareholders.⁸⁰
- 5.26 A CIC may also distribute assets by reducing its share capital, but only:
- (1) by reducing part of the value of shares that is not paid up; or
 - (2) by paying to members no more than the paid up value of their shares.⁸¹

Debt financing and interest

- 5.27 A CIC can take out loans in its own name. It can therefore provide a return to investors by way of interest on this debt financing.
- 5.28 Guidance from the CIC Regulator states that CICs can borrow at normal commercial rates of interest, based on the investors' assessment of risk and expected repayment term.⁸² Unduly high interest repayments would fall foul of CIC directors' duties under the Companies Act 2006 and the further duty of CIC directors to ensure that the company is run in a way that it will continue to satisfy the community interest test.⁸³ It would be difficult to show that high interest repayments could pass the community interest test. The CIC Regulator has powers to deal with excessive debt repayments where the regulator believes that the company is not satisfying the community interest test or there has been misconduct or mismanagement in the company falling short of fraud.⁸⁴
- 5.29 CICs, like other companies, may enter into loans which require them to pay a rate of interest which is linked to the performance of the company. This is known as "performance related interest" and for CICs is subject to a cap.
- 5.30 The cap has been changed three times since CICs were introduced in 2005. As the rate for a particular debt is fixed for the life of that debt, the relevant cap is based on the date on which the loan was entered into. For loan agreements entered into since 1 October 2014, the cap is set at 20%.

⁸⁰ Community Interest Company Regulations 2005, reg 24.

⁸¹ Community Interest Company Regulations 2005, reg 25.

⁸² Office of the Regulator of Community Interest Companies, *Chapter 7: Financing Community Interest Companies* (May 2016), p 8. Available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/605419/14-1090-community-interest-companies-chapter-7-financing-cics.pdf.

⁸³ Office of the Regulator of Community Interest Companies, *Chapter 9: Corporate governance* (May 2016), p 4. Available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/605421/13-712-community-interest-companies-guidance-chapter-9-corporate-governance.pdf.

⁸⁴ Companies (Audit, Investigations and Community Enterprise) Act 2004, ss 41 to 51.

The effect of the asset lock on winding up

- 5.31 Where assets remain after satisfaction of a CIC's liabilities on winding up, distribution to members is limited to the paid-up value of their shares.⁸⁵ This means that members cannot share in the residual assets beyond their paid-up capital.
- 5.32 Any residual assets are then to be distributed to the asset-locked body specified in the CIC's articles of association. Where the articles of association of the CIC do not specify an asset-locked body, or such body is not an appropriate recipient, the CIC Regulator shall direct what happens to the assets.

SECURED LOANS

- 5.33 A CIC can grant fixed and floating charges to lenders over its assets as security for a loan. These charges have to be registered at Companies House within 21 days. Potential lenders are then able to search the register to identify whether a CIC has granted security over any of its assets. Charges over land are also registered at HM Land Registry.
- 5.34 The asset lock⁸⁶ is not a bar to the CIC using its assets in the ordinary course of business to raise capital.

CONCLUSION

- 5.35 There is a lot of paperwork involved in the setting up and registration of CICs which might discourage smaller unincorporated enterprises from choosing to use the CIC form. The fact that it is not yet possible to register a CIC electronically may cause delays in the setting up of CICs. In addition, CICs are subject to ongoing reporting requirements and filing of annual reports with Companies House and oversight by the CIC Regulator.
- 5.36 The CIC form benefits from many features of a normal company such as separate legal personality, limited liability for its members and the ability to grant fixed and floating charges as security for loans. Security must be registered at Companies House. A CIC can provide returns to investors via interest on debt financing and, where it is limited by shares, it can provide returns via dividends.
- 5.37 The CIC form is suited to social enterprises that want to provide dividends but also protect the majority of profits to ensure they are reinvested for the enterprise's social purpose. However, social entrepreneurs whose main aim is to provide maximum returns to investors without being subject to an asset lock and dividend cap may choose to set up their business as a company limited by shares.

⁸⁵ Community Interest Company Regulations 2005, reg 23.

⁸⁶ See para 5.19 for further details.

Chapter 6: Companies limited by guarantee

INTRODUCTION

- 6.1 A social enterprise may be established as a company limited by guarantee. Companies limited by guarantee are usually formed for the purpose of carrying on business which is not intended to make a profit.⁸⁷
- 6.2 There are two types of company limited by guarantee under the Companies Act 2006: companies limited by guarantee not having a share capital and companies limited by guarantee having a share capital.⁸⁸ We only consider the first type since the second, hybrid, structure is rarely used in practice and it is no longer possible to register such companies.⁸⁹
- 6.3 A company has a separate legal personality from its shareholders⁹⁰ or members, and their liability is limited to the value of the shares they hold, or the guarantee they have given.⁹¹

CHARITABLE COMPANIES

- 6.4 It is possible for a charity to set itself up as a limited company. In 2015, there were just under 35,000 charitable companies registered in the UK.⁹²
- 6.5 Charitable companies are not the same as commercial companies. Unlike commercial companies (that is, companies set up to make a profit for their shareholders), a charitable company:
- (1) cannot distribute profits to its members or shareholders;
 - (2) is usually limited by guarantee, not by shares;
 - (3) can only apply its assets, profits and surplus exclusively to its charitable purposes; and
 - (4) must operate in the best interests of the charity, rather than in the best interests of its shareholders (or guarantors in the case of a company limited by guarantee).⁹³

⁸⁷ *Boyle & Birds', Company Law* (8th ed 2011), pp 90 to 91.

⁸⁸ Companies Act 2006, ss 3 and 5.

⁸⁹ Companies Act 1980, s 11; *Boyle & Birds' Company Law* (8th ed 2011), p 91.

⁹⁰ *Salomon v A Salomon & Co Ltd* [1896] UKHL 1; *Adams v Cape Industries plc* [1990] Ch 433.

⁹¹ Companies Act 2006, ss 3(2) and 3(3).

⁹² NCVO, UK Civil Society Almanac 2015/Big Picture. Available at <https://data.ncvo.org.uk/dataview/number-of-registered-charities-and-community-interest-companies-1960-2015/>.

⁹³ For further information see Charity Commission, *Guidance on charity types: how to choose a structure (CC2a)* (November 2014). Available at <https://www.gov.uk/guidance/charity-types-how-to-choose-a-structure>.

HOW ARE COMPANIES ESTABLISHED?

- 6.6 The Companies Act 2006 sets out the requirements to register a company with Companies House.⁹⁴ Certain information and registration documents must be delivered to Companies House as part of the application for registration, including the memorandum of association of the company, a statement of the company's proposed officers and a statement of the type of company it is to be and its intended principal business activities.⁹⁵
- 6.7 In respect of a company to be limited by guarantee, the application for registration must be accompanied by a statement of guarantee stating the amount that each member undertakes to contribute to the assets of the company if the company is wound up.⁹⁶

Charitable companies

- 6.8 Companies registered as charities have "charitable objects" in their articles of association. Charity law defines what purposes may be charitable, for example, relieving financial hardship or poverty.⁹⁷
- 6.9 As with all charities, the requirements of charitable purpose and public benefit in sections 3 and 4 of the Charities Act 2011 must be satisfied in order to register as a charity.⁹⁸

REGULATION AND REPORTING REQUIREMENTS

- 6.10 Companies are required to register with Companies House and produce accounts and file certain information (including annual returns) with Companies House.
- 6.11 Charitable companies are registered at both Companies House (as a company), and with the Charity Commission (as a charity). They are, therefore, governed by two separate legal regimes, and must comply with both.
- 6.12 For example, a charitable company must also file annual reports and returns with the Charity Commission.⁹⁹ This is a clear disadvantage of the charitable company form compared with the charitable incorporated organisation (CIO) form. The administrative burden is greater in charitable companies than in any other legal form for social enterprise.

⁹⁴ Companies Act 2006, ss 7 to 13.

⁹⁵ Companies Act 2006, s 9.

⁹⁶ Companies Act 2006, ss 9 and 11.

⁹⁷ Charities Act 2011, ss 3 and 4.

⁹⁸ See paragraph 1.15 for further details.

⁹⁹ Companies Act 2006, parts 15 and 24; Charities Act 2011, ch 4, part 8.

- 6.13 The dual submission of accounts and annual reports by charitable companies was recognised in the Hodgson review into the Charities Act 2006 as “an unnecessary and not inconsiderable burden”.¹⁰⁰

LEGAL PERSONALITY

- 6.14 A company has separate legal personality¹⁰¹ and can therefore own land and property, enter into contracts in its own name and is liable for its own debts and to perform contractual obligations.
- 6.15 Members of a company have limited liability for the company’s obligations. Where a company is limited by guarantee, a member will not be liable for an amount exceeding that stated in the statement of guarantee.
- 6.16 Incorporation only protects against contractual liability or tortious liability and provides no protection where charity trustees are in breach of their own duties. The charity’s trustees are the directors of the company for the purposes of the Charities Act 2011.¹⁰² They are therefore subject to directors’ duties under the Companies Act 2006.

RETURNS TO INVESTORS

Shares and dividends

- 6.17 Profits of a company limited by guarantee cannot be distributed to members by way of a dividend, like in a company limited by shares. This is because the company does not have share capital. Members will usually be involved in the company due to their commitment to the company’s objectives, rather than to benefit financially.
- 6.18 Further, section 37 of the Companies Act 2006 provides that any provision in the company’s articles of association or any resolution of the company purporting to give any person a right to participate in the profits of a company, otherwise than a member, is void. This means that a company limited by guarantee cannot distribute profits to third party investors, it may only distribute profits to members.

Debt financing and interest

- 6.19 Companies can borrow and provide returns to investors by way of interest on debt financing. The level of interest a company agrees to pay a lender is a commercial matter for the company, however, unduly high interest repayments would fall foul of the company’s directors’ duties under the Companies Act 2006.

Charitable companies

- 6.20 In relation to a charitable company, the Charity Commission requires that the articles of association contain a complete prohibition on distributing income, assets and profits to its members. The articles of association of a charitable company must also provide

¹⁰⁰ Lord Hodgson of Astley Abbots, *Trusted and Independent: Giving charity back to charities – Review of the Charities Act 2006* (July 2012), p 121.

¹⁰¹ *Salomon v A Salomon & Co Ltd* [1896] UKHL 1; *Adams v Cape Industries plc* [1990] Ch 433.

¹⁰² Charities Act 2011, s 177.

that any surplus in the event of a winding up be applied exclusively for charitable purposes. Charities cannot use profits for any other purpose than the pursuit of its charitable purpose.

SECURED LOANS

- 6.21 Companies have the ability to grant security, in the form of fixed and floating charges and mortgages over land and these must be registered at Companies House. This allows lenders and potential lenders to easily see whether assets of the company already stand as security for a loan. This may result in them agreeing to lend larger sums of money where they have comfort that the debt is secured against an otherwise unencumbered asset. Charges over land owned by the company are also registered at HM Land Registry.
- 6.22 A charitable company may grant a mortgage or take out a loan secured against the charity's land without Charity Commission approval as long as written advice is obtained and provided the loan:
- (1) is needed and used for an activity that fits with the charity's purposes; and
 - (2) has reasonable and affordable terms and repayments.¹⁰³

CONCLUSION

- 6.23 Companies limited by guarantee need to register with and report to Companies House, filing accounts and an annual report. A company may also have charitable aims and register with the Charity Commission. The main drawback to a charity of adopting a company form is dual registration. Charitable companies must make returns and submit accounts on an annual basis to both Companies House and the Charity Commission, and must also comply with both charity and company law.
- 6.24 The company form benefits from separate legal personality, limited liability for its members and, the ability to grant fixed and floating charges and mortgages over land as security for loans. Charges granted by companies must be registered at Companies House.
- 6.25 Companies limited by guarantee are able to provide a return to investors by way of interest on debt financing. They can also distribute profits to members where their articles of association permit them to do so, however, they do not have share capital and therefore cannot distribute profits to members by way of dividends. Charitable companies are unable to distribute profits to members otherwise than in accordance with their charitable purpose.

¹⁰³ Charities Act 2011, s 124; The Charity Commission, *Managing your charity* (September 2014). Available at <https://www.gov.uk/guidance/charity-land-and-property>.

Chapter 7: Registered societies – co-operative societies and community benefit societies

INTRODUCTION

- 7.1 Co-operative societies and community benefit societies (collectively known as “registered societies”) are membership organisations where funds can be raised through selling shares to members of the society.
- 7.2 Before 1 August 2014, all societies registered under the Industrial and Provident Societies Act 1965 (or its predecessors) were legally referred to as “industrial and provident societies”, whatever they called themselves. Societies set up as social clubs, working men’s clubs and friendly societies carrying out contracts of insurance were registered under the Friendly Societies Act 1974 or the Friendly Societies Act 1992. It is no longer possible to register a new society under those Acts.¹⁰⁴
- 7.3 From 1 August 2014, co-operative and community benefit societies are collectively known as “registered societies”. They are principally governed by the Co-operative and Community Benefit Societies Act 2014 which consolidated and updated 19th century legislation. Any new societies registered on or after 1 August 2014 must be referred to as either a co-operative society, or a community benefit society.
- 7.4 Co-operative societies and community benefit societies are two distinct legal forms. They are similar in nature but there are important differences. A key difference is that, a community benefit society exists primarily for the benefit of a community, and not its individual members. By contrast, a co-operative society aims to benefit its members. The impact of this and other features of these two legal forms are discussed in further detail below.
- 7.5 At present, there are over 8,220 societies registered under the Co-operative and Community Benefit Societies Act 2014 in the UK.¹⁰⁵ The following are examples of social enterprises which could take the form of a registered society:
- (1) housing associations and social housing providers;
 - (2) community energy societies. For example, groups for collective purchasing of heating oil, purchasing and installing of solar panels and collective switching of electricity or gas suppliers; and
 - (3) community stores, cafes and pubs.

¹⁰⁴ There are around 1200 registered friendly societies; <https://www.fca.org.uk/firms/friendly-societies-introduction>.

¹⁰⁵ FCA Mutual Societies Register. Available at <https://mutuals.fsa.gov.uk/Search.aspx>.

HOW ARE REGISTERED SOCIETIES SET UP?

- 7.6 Co-operative societies and community benefit societies must be registered with the Financial Conduct Authority (FCA). Once registered, the society is incorporated with limited liability.
- 7.7 A company registered under the Companies Act 2006 may convert into a registered society.¹⁰⁶
- 7.8 FCA guidance explains that a registered society must meet certain conditions before it will be registered. These are discussed further below.
- 7.9 Registered societies are required to have an “objects rule”.¹⁰⁷ The “objects” describe and identify the purpose for which the society has been set up. An objects rule can be broad, but not so vague that it is meaningless in practice. The society only has power to act within its specified purpose.¹⁰⁸ Below we consider the objects rule as it relates to community benefit societies and co-operative societies respectively.

Community benefit societies

- 7.10 If a society applies to register with the FCA as a community benefit society then the condition it must meet is that it is conducting its business for the benefit of the community.¹⁰⁹
- 7.11 A community benefit society must carry on an “industry, business or trade” that is conducted for the benefit of the community.¹¹⁰ It may be wholly charitable or benevolent, but it does not have to be, as long as it is conducting its business exclusively for the benefit of the community.
- 7.12 Community benefit societies with exclusively charitable purposes are exempt from registration or regulation by the Charity Commission under the Charities Act 2011. They only need to be registered with the FCA.

Co-operative societies

- 7.13 If a society applies to register with the FCA as a co-operative society then the condition it must meet is that it is a bona fide co-operative society.¹¹¹ The phrase “bona fide co-operative society” is not defined in the Community Benefit Societies Act 2014, though section 2(3) of the Act states that:

¹⁰⁶ Co-operative and Community Benefit Act 2014, s 115.

¹⁰⁷ Co-operative and Community Benefit Societies Act 2014, ss 2(2)(c) and 14(2).

¹⁰⁸ *Halifax Building Society v Chamberlain Martin & Spurgeon* [1994]; Co-operative and Community Benefit Societies Act 2014, ss 43-49.

¹⁰⁹ Financial Conduct Authority, *Guidance on the FCA’s registration function under the Co-operative and Community Benefit Societies Act 2014* (November 2015), p 13.

¹¹⁰ Financial Conduct Authority, *Guidance on the FCA’s registration function under the Co-operative and Community Benefit Societies Act 2014* (November 2015), p 31.

¹¹¹ Financial Conduct Authority, *Guidance on the FCA’s registration function under the Co-operative and Community Benefit Societies Act 2014* (November 2015), p 13. Available at <https://www.fca.org.uk/publication/finalised-guidance/fq15-12.pdf>.

[a] co-operative society does not include a society that carries on, or intends to carry on, business with the object of making profits mainly for the payment of interest, dividends or bonuses on money invested or deposited with, or lent to, the society or any other person.

- 7.14 Co-operative societies are formed primarily to benefit their own members, who will participate in the primary business of the society. Co-operative societies cannot be charities since they exist solely to benefit their members. However, the main purpose of a co-operative society cannot be to generate financial returns for shareholders. In other words, it must not be set up solely with the “object” of generating and paying profits, and therefore its ability to provide financial returns is restricted.
- 7.15 The FCA, in its guidance, explains that the benefit gained by members of co-operative societies comes from their participation in the business, rather than financial returns. The society must explain the benefits of membership on registration with the FCA.¹¹²

REGULATION AND REPORTING REQUIREMENTS

- 7.16 The FCA is the registering authority for registered societies and has extensive powers. The FCA determines whether a society is complying with the Co-operative and Community Benefit Societies Act 2014. It does not regulate the business, financial stability or conduct of societies beyond this remit. Once registered these societies are included in the FCA’s Mutuals Public Register.
- 7.17 The FCA may cancel or suspend a society’s registration on several grounds. These include: failure to meet the co-operative or community benefit society conditions set out in the Co-operative and Community Benefit Societies Act 2014; wilful breach of any other provision of the legislation; existing for an illegal purpose or ceasing to exist; membership falling below the minimum number; obtaining registration by fraud or mistake; and request by the society to have its registration cancelled.¹¹³
- 7.18 The FCA also has the power to require registered societies to provide information or documents and may appoint an inspector to investigate the affairs of a society in certain circumstances.¹¹⁴ These powers are backed up with the sanction of prosecution. For example, failure to submit a return by the due date is a criminal offence punishable by a fine of up to £1,000 per offence.¹¹⁵
- 7.19 The FCA makes use of these powers.¹¹⁶ It maintains a list of prosecutions and cancellations, of which there are several each year. In 2015, the FCA cancelled seven registered societies for failure to submit annual returns/accounts on time and brought

¹¹² Financial Conduct Authority, *Guidance on the FCA’s registration function under the Co-operative and Community Benefit Societies Act 2014* (November 2015).

¹¹³ Co-operative and Community Benefit Societies Act 2014, s 5.

¹¹⁴ Financial Conduct Authority, *Guidance on the FCA’s registration function under the Co-operative and Community Benefit Societies Act 2014* (November 2015), p 72.

¹¹⁵ See: <https://www.fca.org.uk/firms/annual-returns-accounts-mutual-societies/prosecutions-cancellations>.

¹¹⁶ Financial Conduct Authority, *Guidance on the FCA’s registration function under the Co-operative and Community Benefit Societies Act 2014* (November 2015), p 74.

six prosecutions under the Co-operative and Community Benefit Societies Act 2014.¹¹⁷

- 7.20 A registered society's accounts must be published and filed with the Mutual Societies Register kept by the FCA. Accounts must also be audited. There are, however, exemptions from audit requirements for smaller societies.¹¹⁸
- 7.21 Housing associations and social housing providers which are registered societies are also regulated by the Homes and Community Agency under the Housing and Regeneration Act 2008.¹¹⁹
- 7.22 A registered society seeking to raise capital through an offer of shares is not subject to the financial promotion rules¹²⁰, providing such shares are non-transferable.¹²¹ This means that they can offer non-transferable society shares to the public without the need for the financial promotion to be approved by an FCA authorised person. Where a registered society wishes to issue "transferable" shares, the offer will fall within the financial promotions regime.¹²²

LEGAL PERSONALITY

- 7.23 Once registered with the FCA, a registered society is incorporated and has separate legal personality.¹²³ As a result, a registered society can contract in its own name and hold property and land.
- 7.24 Members have limited liability so are not liable for the debts, contracts or other liabilities incurred by the society. Members are only liable to the extent of any share capital they hold in the society, including the amount of any amount unpaid on share capital they hold.

¹¹⁷ See list of cancellations and prosecutions at: <https://www.fca.org.uk/firms/annual-returns-accounts-mutual-societies/prosecutions-cancellations>.

¹¹⁸ Financial Conduct Authority, *Guidance on the FCA's registration function under the Co-operative and Community Benefit Societies Act 2014* (November 2015), p 45.

¹¹⁹ The terms "social housing" and "registered provider" are defined in the Housing and Regeneration Act 2008. Section 68 defines social housing so as to include all low cost rentals (such as affordable rental properties) and low cost home ownership. A reference to a "provider of social housing" includes any landlords of low cost rental accommodation or home ownership properties. Registered providers include local authority landlords and private registered providers (such as not-for-profit housing associations and for-profit organisations).

¹²⁰ Any reference to the financial promotion rules is a reference to the restriction in section 21 of the Financial Services and Markets Act 2000. A financial promotion is any communication that invites or induces someone to invest in a particular investment. There is a requirement that those promotions are "approved" by an FCA authorised person.

¹²¹ Withdrawable shares which are non-transferable shares are not 'controlled investments' or 'specified investments' under the Financial Services and Markets Act 2000. The issue of non-transferable shares by a society registered under the 2014 Act is not therefore subject to FCA's financial promotions or conduct of business rules.

¹²² Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, art 76(2)(b). There, however, is an exemption from the Prospectus Rules for a community benefit society issuing "transferable securities" under the Financial Services and Markets Act 2000, s.85(5)(a) and Sch 11A, part 2.

¹²³ Co-operative and Community Benefit Societies Act 2014, s 3(3).

RETURNS TO INVESTORS

Shares and dividends

- 7.25 Registered societies are limited by shares and must have share capital. The rules of the society must fix the maximum shareholding any member may hold.¹²⁴
- 7.26 Registered societies may seek to retain control over who can become a member by issuing “withdrawable” shares. These are shares that can only be sold back to the society, and not to anyone else. For withdrawable shares, the current maximum amount of a holding is £100,000.¹²⁵ No statutory limit applies to non-withdrawable shares.
- 7.27 Registered societies can adopt a voluntary asset lock. An asset lock can be written into the rules of a registered society to prevent the distribution of profits to members. The purpose of the asset lock is to ensure that any retained profits cannot be appropriated for the benefit of private members and are used for the benefit of the community. Below we consider how asset locks apply to community benefit societies and co-operative societies respectively.
- 7.28 The ability of members of registered societies to sell their shares is limited. Guidance issued by the FCA explains that “a market in society shares allowing capital gains for members is normally inconsistent with registration as a society”.¹²⁶
- 7.29 Whether a registered society can pay dividends to its shareholders depends on its form. Below we consider the position in relation to co-operative societies and community benefit societies respectively.

Community benefit societies

- 7.30 A community benefit society cannot use profits to pay dividends to members. The community benefit society’s rules must prohibit either profits or the society’s assets from being distributed to members.
- 7.31 However, community benefit societies can pay interest on share capital. The FCA clearly states in its guidance that any interest payable on share capital should be the lowest rate sufficient to obtain the necessary funds from members who are committing to further the society’s objects.¹²⁷ This is consistent with the FCA’s view that societies should primarily be inviting people to become members, with any requirement for capital being secondary (beyond the minimum required for membership).
- 7.32 The principle behind this restriction is that the primary motivation for purchasing shares in a society should be to support the purpose and objects of the enterprise.

¹²⁴ Co-operative and Community Benefit Societies Act 2014, s 14(7).

¹²⁵ Financial Conduct Authority, *Guidance on the FCA’s registration function under the Co-operative and Community Benefit Societies Act 2014* (November 2015), pp 34 to 35.

¹²⁶ Financial Conduct Authority, *Guidance on the FCA’s registration function under the Co-operative and Community Benefit Societies Act 2014* (November 2015), p 35.

¹²⁷ Financial Conduct Authority, *Guidance on the FCA’s registration function under the Co-operative and Community Benefit Societies Act 2014* (November 2015), p 34 to 37.

Financial motivation is considered at best secondary, and any return on capital is better understood as compensation rather than a reward for risk-taking.

- 7.33 Community benefit societies can choose to adopt a statutory asset lock in their rules in order to further protect the society's assets.¹²⁸ The FCA has the power to take enforcement action if a community benefit society breaches its statutory asset lock. This can take the form of a warning and enforcement notification, ordering restitution by officers and removal of officers.¹²⁹

Co-operative societies

- 7.34 Unlike a community benefit society, co-operative societies can use their profits to pay a dividend to members. Co-operative societies can also pay members a rate of interest on share capital invested.
- 7.35 However, the primary purpose of a co-operative society cannot be to generate financial returns to members. If paying interest or dividends on money invested is the primary purpose of the society then it will not be a "bona fide co-operative society" and the FCA will refuse to register it or cancel any existing registration.¹³⁰
- 7.36 Guidance issued by the FCA explains that the benefit gained by members of co-operative societies comes from their participation in the business, rather than from financial returns.¹³¹ Any dividend paid to a shareholder should be in proportion to their participation in the co-operative, not based on the funds invested in shares.¹³²
- 7.37 Co-operative societies may include a non-statutory asset lock in their rules.¹³³ This could set parameters for the amount of profit that can be distributed to members by way of dividends. The FCA would not have the same specific enforcement powers in relation to this asset lock as the statutory asset lock applying to community benefit societies. However, it would still have power to take enforcement action in the circumstances described in paragraphs 7.17 to 7.18.

Debt financing and interest

- 7.38 A registered society is free to negotiate whatever interest rates and debt repayment terms it chooses, as long as it complies with its own rules and condition for registration. It is treated by the FCA as a commercial decision of the society, albeit

¹²⁸ Community Benefit Societies (Restriction on Use of Assets) Regulations 2006, reg 3.

¹²⁹ Community Benefit Societies (Restriction on Use of Assets) Regulations 2006, regs 9, 10 and 11. For further discussion see, Financial Conduct Authority, *Guidance on the FCA's registration function under the Co-operative and Community Benefit Societies Act 2014* (November 2015), paras 3.28 to 3.30 and 9.28 to 9.30.

¹³⁰ Financial Conduct Authority, *Guidance on the FCA's registration function under the Co-operative and Community Benefit Societies Act 2014* (November 2015), p 26.

¹³¹ Financial Conduct Authority, *Guidance on the FCA's registration function under the Co-operative and Community Benefit Societies Act 2014* (November 2015).

¹³² Financial Conduct Authority, *Guidance on the FCA's registration function under the Co-operative and Community Benefit Societies Act 2014* (November 2015), p 27.

¹³³ For further discussion see, Financial Conduct Authority, *Guidance on the FCA's registration function under the Co-operative and Community Benefit Societies Act 2014* (November 2015), paras 3.28 to 3.30. Available at <https://www.fca.org.uk/publication/finalised-guidance/fg15-12.pdf>.

that if a society uses loans or similar methods to distribute profits, the FCA considers this an indicator that the society is not meeting its condition for registration.¹³⁴

- 7.39 Registered societies can offer bonds to the public without the need for the financial promotion to be approved by an FCA authorised person.¹³⁵

Charitable registered societies

- 7.40 A charity can take the form of a community benefit society, but cannot take the form of a co-operative society.

- 7.41 A charitable community benefit society cannot use assets or profits for any purpose other than the pursuit of its charitable purposes.¹³⁶ Charitable community benefit societies must restrict their use of assets to a greater extent than the statutory asset lock provided for by the 2006 Regulations.¹³⁷ This is because the statutory asset lock is not fully compliant with charity law as it does not restrict the use of residual assets exclusively for charitable purposes.

SECURED LOANS

- 7.42 Subject to its rules, a registered society may borrow on a secured basis, using both fixed and floating charges and mortgages over land. The rules must state the type of security that may be granted to lenders and the maximum amount that can be borrowed.

- 7.43 A registered society can register fixed or floating charges it has granted over its assets with the FCA.¹³⁸ Most secured creditors will insist on the registration of their charge with the FCA.

- 7.44 Registered charges are available for inspection on the FCA Mutual Societies Register, which will be of interest and reassurance to a society's creditors and potential lenders, and has a role in fixing the priority of charges over the society's property. Charges over land owned by the registered society are also registered at HM Land Registry.

- 7.45 The Bills of Sale Acts will not apply to the transaction if the relevant charge is registered with the FCA.¹³⁹

CONCLUSION

- 7.46 Registered societies benefit from separate legal personality so can enter into contracts in their own name and can give fixed and floating charges as security over

¹³⁴ Financial Conduct Authority, *Guidance on the FCA's registration function under the Co-operative and Community Benefit Societies Act 2014* (November 2015), p 40.

¹³⁵ Financial Services and Markets Act 2000 (Financial Promotion) Order 2005, s 35(b).

¹³⁶ See para 1.15 for further details.

¹³⁷ See para 7.33 for further details.

¹³⁸ Co-operative and Community Benefit Societies Act 2014, ss 59 to 64.

¹³⁹ Failure to register does not have any consequence except to bring the charge within the Bills of Sale Acts. For a further discussion, see A Burrows, *Principles of English Commercial Law* (2015), para 8.147; See *Re North Wales Produce and Supply Society* [1922] 2 Ch 340.

their assets. This, coupled with the fact that the financial promotion rules do not apply to them, means that the legal and regulatory regime assists in the societies' ability to raise debt finance.

- 7.47 Registered societies can provide a return to investors via interest on debt financing, as long as they comply with their own rules and the conditions of registration with the FCA.
- 7.48 Co-operative societies can pay interest and dividends on money invested, however, these activities cannot be the main purpose or "object" of the society and any return on capital is better understood as compensation rather than a reward for risk-taking.
- 7.49 Community benefit societies are not permitted to distribute profits, dividends or other surpluses to their members. They can pay interest on share capital, however, this should be at the lowest rate sufficient to obtain the necessary funds from members who are committing to further the society's objects.
- 7.50 Therefore, enterprises that wish to provide higher returns on investments to their members could not use the co-operative or community benefit society form.

Appendix 1: Table of legal forms for social enterprise

	Registered societies		Community interest companies (CICs)		Limited companies		Charitable Incorporated Organisation (CIO)	Trust	Unincorporated Association
	Cooperative Society	Community Benefit Society	CIC Limited by Shares	CIC Limited by Guarantee	Company Limited by Guarantee	Company Limited by Shares			
Does this form have limited liability?	✓	✓	✓	✓	✓	✓	✓	✗	✗
Is this form subject to a restriction on the use of assets?	Can adopt a voluntary asset lock	✓	✓	✓	Yes, but only if a charity	✗	✓	✓	Yes, but only if a charity
Can this form grant a fixed or floating charge over its assets?	✓	✓	✓	✓	✓	✓	✗	✗	✗
Can this form give a return on shares?	Yes, but cannot be the main purpose of the society	Yes, but only by way of interest on share capital	Yes, subject to a dividend cap	✗	✗	✓	✗	✗	✗
Can a charity use this form?	✗	✓	✗	✗	✓	Yes, but rare	✓	✓	✓
Can a non-charity use this form?	✓	✓	✓	✓	✓	✓	✗	✓	✓