Factsheet 6: Legal structures

6.1 Overview

It is highly advisable for any organisation planning to raise investment capital from the community to become a corporate entity by adopting a legal form that provides them with the scope and flexibility to achieve their ambitions.

There are three main legal forms that can be used for community investment purposes: Industrial and Provident Societies, Community Interest Companies and charities. Some organisations have used other legal forms, such as the public limited company or the company limited by guarantee, although these forms offer no special provisions to protect the interests of the community.

6.2 Industrial and Provident Societies

Industrial and Provident Societies (IPSs) are registered and regulated by the Financial Services Authority. In the last ten years, 34 of the 41 new organisations with community investment have chosen to use the IPS form. Like companies, IPSs are corporate bodies with limited liability status, but otherwise they are significantly different in form, and have four unique attributes which make them a highly effective vehicle for community investment. These unique attributes are:

> **Shareholder democracy**: IPSs work to the principle of one-member-one-vote, regardless of how much share capital a member holds, in contrast to companies, which operate to the principle of one-share-one-vote. Members of an IPS have the collective right to appoint and dismiss directors, accept or reject directors' recommendations, and to determine the affairs and rules of the society.
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> **Withdrawable share capital**: This is a special form of share capital that can be withdrawn by members, subject to the conditions laid down in the rules of the society. Unlike transferable share capital, where members must find a third party buyer if they want to sell their shares, members holding withdrawable share capital know that they can sell their shares back to the society. Societies can treat withdrawable share capital as equity as long as the rules of the society give the directors the right to refuse a request for withdrawal if this is deemed to be against the interests of the society. Societies can choose to issue

withdrawable shares, transferable shares or shares that are both withdrawable and transferable.

Limits on shareholdings: Individual members cannot have a shareholding in excess of £20,000 in any one IPS, although there is no limit on the shareholding of one IPS in another IPS. The limit on individual shareholdings is currently under review and is likely to be increased to £30,000 before the end of 2009.

Limit on share interest: The interest payable on shares must be limited to what is "necessary to obtain and retain enough capital to run the business".

There are two main types of IPS: bona-fide co-operative societies and community benefit societies. The main difference between these two types of IPS is their relationship with members.

Co-operative societies are run for the mutual benefit of members whose membership is based on their transactional relationship with the society, either as customers, employees or suppliers. In addition to the interest members receive on their share capital, members might also receive a dividend on their transactions with the society. The purpose of the dividend payment is to encourage financial prudence whilst ensuring the principal stakeholders are fairly treated. Members can decide at the end of the financial year to return part of any surplus to members, based on the scale of the members' transactions with the society.

Community benefit societies are run primarily for the benefit of the broader community, rather than just the members of the society. Membership is open to anyone who supports the objectives of the society. Community benefit societies can pay members interest on their share capital, but they cannot pay dividends to members on their transactions with the society.

There is one other major difference between a co-operative society and a community benefit society. Since 2006, community benefit societies have been able to install an asset lock in their rules which ensures that the assets of the society will permanently be used for the benefit of the community and cannot be distributed to members if the society is dissolved, amalgamated or converted into a company. This new regulation does not extend to co-operative societies. Co-operatives can convert into private companies, and distribute assets to members if a special resolution is passed in a ballot of members in which at least 50% of members participate, and the resolution is supported by at least 75% of those who vote.

The choice between registering as a co-operative society or as a community benefit society is relatively straightforward. Co-operative structures are most appropriate for organisations whose members have a transactional relationship with the organisation, as customers, suppliers or employees. Community benefit structures are more appropriate for organisations that aim to serve a broader community purpose and do not have a transactional relationship with their members.
IPSs are treated differently from companies, including Community Interest Companies, when they promote community investment in the form of withdrawable share capital. Withdrawable share capital is exempt from regulation by the Financial Services and Markets Act. There are also exemptions for withdrawable share capital from regulations covering the approval of financial promotions and compliance with the Money Laundering Regulations 2007. Community benefit societies are also exempt from some of the regulations when promoting transferable share capital. The regulation of financial promotions is covered in greater detail in Factsheet 4.

These exemptions make it far cheaper to use IPS legislation than company legislation, the only exception being registered charities, which are subject to the same exemptions as IPSs when issuing bonds.

6.3 Community Interest Companies

Community Interest Company (CIC) legislation, introduced in 2005, provided a new regulatory framework governing the three main forms of company: a company limited by shares, a company limited by guarantee, and a public limited company. CICs were introduced after the Financial Services and Markets Act was passed. There are no special exemptions for CICs from the regulations covering financial promotions.

Like any other company limited by guarantee, a CIC company limited by guarantee cannot issue shares, although it can promote the sale of bonds and offer membership as a separate consideration. There is provision for the creation of a CIC public limited company, but none have yet been established.

The government invested a lot of energy into enabling CICs to adopt a company limited by shares structure, which would allow equity investment by individuals, and at the same time protect the interests of communities. This was achieved through the following specific provisions:

> **An asset lock** preventing any residual assets in a CIC being distributed to members if a CIC is sold, dissolved or amalgamated

> **A double dividend cap** which prevents a CIC from distributing more than 35% of its profits to shareholders in any one year, and limits dividend rates to base rate plus 5%. Unused dividend allowances can be rolled forward to future years but the 35% cap on distributions in any one year cannot be exceeded.

There is also a range of other regulatory requirements CICs must meet, which includes passing a community interest test and producing an annual community interest report.

In common with other private or public companies, CICs limited by shares can issue shares that are transferable or redeemable, but unlike IPSs, they cannot issue withdrawable shares. There is no upper limit to how much an individual or entity can invest in a CIC. Also, there is no provision for democratic membership rights in CICs limited by shares. The voting principle behind all companies limited by shares is one-share-one-vote, so it is possible for one large shareholder to own the majority of shares in a CIC and therefore have majority control.

Since the introduction of CICs regulations in 2005, over 2,500 CICs have been established, but only one CIC has, so far, used the form to raise community investment and there have been no examples of public limited company CICs. There may be a number of reasons why CICs are not used much for community investment purposes. The lack of exemption from regulation under the Financial Services and Markets Act is probably a major factor. Other factors may include the rigid controls on shareholder dividends, and concerns that a minority of shareholders could have majority control.

6.4 Charities

As a legal form, charities offer very limited scope for community investment. Charities can and do issue bonds, but they cannot issue share capital. Charities issuing bonds and other forms of debt, are exempt from regulation under the Financial Services and Markets Act.

Before embarking on raising capital through community bonds, charities should consider the impact this type of financial promotion may have on their voluntary fundraising activities. Encouraging donors to become investors might have a lasting impact on their relationship with the charity. The problem with bonds, and all other forms of debt, is that eventually the capital has to be repaid. This means that the charity has to behave like a business and generate sufficient profit to repay capital. The only alternative is for the charity to find donors willing to pay off its debts to bondholders. In this sense, bond finance can only ever be a temporary solution to the funding needs of charities.

6.5 Other legal forms

It is possible to use other legal forms for community investment. A number of organisations, including Cafédirect, have used the public limited company (plc) form. To register a public limited company it is necessary to have at least £50,000 as an initial investment in share capital. Any public offering of shares or bonds will have to be fully authorised, which is very expensive. Consequently, the plc form has only been used by organisations making larger initial public offerings of share capital, in the range of £1m to £10m.

Another problem with the plc form is its unsuitability for community investment. The plc form is designed for wealth-maximising businesses, and provides no legislative devices for protecting community interests. Even though it is possible to adapt the constitution of a plc to make it more community friendly, there is always the danger that some time in the future, members will decide to change the constitution and revert to wealth maximisation.

The same sorts of limitations apply to private companies limited by shares. Although private companies limited by shares are less expensive to establish and maintain than public limited companies, they still have to meet the same regulatory requirements concerning financial promotions. Companies limited by guarantee cannot issue share capital, but can issue bonds, subject to the same regulations governing financial promotions, unless the company is also a charity.

6.6 Choosing between legal forms

Determining the most appropriate legal form for an organisation will largely depend on its underlying purpose and objectives. For organisations pursuing charitable objects, and which are not overly reliant upon trade, then a charitable form is probably most appropriate, even though it will only be able to raise community investment in the form of bonds. For organisations that get most or all of their income through trade, and which also have clear community or social objectives, then either an IPS or CIC form will be most appropriate. Both these forms can be used to issue shares or bonds, and both forms support a profit-making business model.

The choice between the IPS and CIC forms depends on the relative merits of their special features to the organisation concerned. IPSs have four unique attributes: member democracy, withdrawable share capital, a limit on individual shareholdings, and a flexible limit on the interest paid on share capital. None of these features are available to CICs. However, all types of CIC have an asset lock, whereas only IPS community benefit societies have the scope to adopt this feature. CICs are generally cheaper to register and maintain as a legal form than IPSs. However, unlike IPSs, CICs are not exempt from regulation when offering shares or bonds to the public, adding significantly to the cost of raising capital this way. But maybe the evidence speaks for itself. Since 2005, when the CIC form was introduced, there have been 17 new community investment share offers. Only one of these share offers was by an organisation using the CIC form; the other 16 used the IPS form.

6.7 Converting from one form to another

For organisations that are already incorporated, but have adopted a form which is not the most appropriate for community investment purposes, then there are two options to consider: either to convert the organisation into a different form, or to establish a new legal entity.

The option of establishing a new entity has its attractions. It reduces the risks for the parent organisation. It allows the new organisation the scope to develop its own reputation and brand. The parent organisation can still be involved as a shareholder and part-owner of the new organisation. A potential drawback is that the parent organisation will not benefit from the consolidation of its current assets with the new investment. Also, potential investors might be more reluctant to invest in a new organisation, without a proven track record or any other financial reserves to draw on. The parent organisation might also be reluctant to share control of the new entity with community investors.

It is possible to convert most legal forms, from one form to another. Companies can be converted into IPSs, either as co-operatives or community benefit societies. IPSs can be converted into CICs, and co-operatives can be converted into private companies, although a special resolution is required. Private companies can be converted into CICs, but a company limited by guarantee cannot be converted into a company limited by shares, even if it becomes a CIC. This is because there are no provisions in company law to allow such a conversion to take place.

Following the introduction of CICs, it has been possible to convert charities into CICs with the permission of the Charity Commission. However, if the charity is also a company limited by guarantee, it will have to retain this guarantee format as a CIC. Both forms of IPS can be converted to a CIC, but there are no legal provisions to convert a CIC into an IPS, although the government is currently consulting on introducing regulations that would allow CICs to convert to IPS community benefit societies with an asset lock.