Building a Social Enterprise:

The Legal Landscape
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Author’s Notes

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Abbreviations

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Full Form</th>
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<tr>
<td>CCLG</td>
<td>Charitable Company Limited by Guarantee</td>
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<td>CIC</td>
<td>Community Interest Company</td>
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<tr>
<td>CIO</td>
<td>Charitable Incorporated Organisation</td>
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<tr>
<td>CLS</td>
<td>Company Limited by Shares</td>
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Introduction

The term “social enterprise” describes the purpose of a business, not its legal form. Given that it is not possible to register your startup legally as a social enterprise, how should you incorporate? As the sector develops, there are a number of legal structures that a startup can adopt. Depending on the specific choice, the implications regarding funding, taxation, and regulation vary significantly. The purpose of this report is to provide clarity regarding the legal options for social entrepreneurs who are seeking to build exciting and meaningful startups.

This report focuses on the most frequently used legal structures in the social enterprise space, and is written to be actionable rather than comprehensive\(^1\). Furthermore, our analysis is geared towards UK-based startups, however, we have included some examples of innovative social enterprises outside the UK, which adopted successful hybrid structures to achieve their social mission. We have also provided a brief overview of comparable legal structures in the US for anyone considering expanding their social enterprise overseas.

Belinda Bell (Programme Director, Social Incubator East):

‘Thinking about legal structure is a really important part of the startup process for social entrepreneurs and is an opportunity to really consider values, motivations and aspirations. Very often, social ventures walk this path alone.’

\(^1\) Full list of legal structures available to social enterprises: see table 1. https://www.gov.uk/set-up-a-social-enterprise
Should you incorporate?

As a social entrepreneur, the first choice you need to make regarding the legal form of your startup is whether to incorporate or remain unincorporated. If you choose to be unincorporated, this means that the business has no separate legal entity of its own. The risks and liabilities associated with running the business fall on the individuals who own and/or manage it. If you choose to remain unincorporated you could be a sole trader, a partnership or an unincorporated association. The advantages for being unincorporated include less regulation and lower taxation. This, however, might come at a cost: for example, the individuals running an unincorporated organisation will need to enter into legal commitments and contracts in their personal capacity. In the event of a claim for liability where the existing assets of the business are insufficient to cover outstanding debt and where the expenses associated with meeting the claim are not covered by insurance, individuals may be required to use their personal assets instead.

For these reasons, the majority of businesses choose to be incorporated. A separate legal identity can reduce the risk of personal liability in running a business, presents a clearer ownership structure and facilitates raising funds by increasing credibility for financial institutions and investors.

Nonprofit vs For-Profit Legal Structures

The next decision is whether your social enterprise is going to be a nonprofit, hybrid or for-profit venture. The terms charity, social enterprise, and nonprofit are frequently thrown around interchangeably in this sector, but legally these concepts differ greatly. There is also broader moral debate on whether social enterprises should be nonprofit or for-profit, and what really “counts” as a social enterprise. In our view, a social enterprise is characterized by its mission to maximize the impact on a community, society or country. Debates on whether or not a specific company fits this criterion is not what this report is about.

Instead, we want to help you consider which legal structure might best enable you to achieve your social goals. For this purpose, we argue that looking at social enterprise in a binary way does not reflect the broad spectrum of legal options available today. Where you fall on that spectrum should first and foremost be a strategic decision about you, your team, your values, and the path you want to take in the future. Below we'll provide you with valuable information to understand the legal, financial, and often such implications of opting for one structure as opposed to another.

![Figure 1: The spectrum of legal structures available to social enterprises in the United Kingdom.](image)
Charities

Charities are the clearest examples of strictly “non-profit” organisations, with most charities adopting the Charitable Company Limited by Guarantee (CCLG) structure. In order to set up a charity, an organisation will need to demonstrate three things:

1. Its activities fall within legally recognised charitable purposes, for example, the advancement of education.
2. Its activities benefit the general public or a sufficiently wide group of people.
3. Any private benefit to individuals or private bodies arising from the activities are minimal or incidental to the main charitable activities, (the public benefit test).

A CCLG is similar to a private company limited by shares but except that it cannot have a share capital, and therefore does not have shareholders. Instead, a CCLG has members, with their liability capped at the amount they agree to contribute or “guarantee” in the event of the charity’s winding up (usually a nominal figure such as £1 or £10). Charity members will have similar backstop powers to shareholders in a private company including, for example, the right to remove trustees and approve any amendments to the charity’s governing document. A CCLG is governed both by the Companies House and the Charity Commission, which results in dual filing requirements for documents.

This dual filling requirement has been recognized as potentially unnecessary burden and was discouraging some charities from incorporating, particularly small organisations. As a result, the Charities Act 2006 introduced a new legal structure: Charitable Incorporated Organisations (CIO). The CIO is a relatively new legal form for charities who would like to be incorporated but do not wish to become a company. The major advantage is that they are only governed by the Charity Commission. In 2014, 2,016 CIOs were registered, constituting 41.4% of all charity registrations in England and Wales.

Beyond CCLG and CIO, other types of charity structures include Trusts and Unincorporated Associations. Charitable Trusts are the most basic legal structure available to organisations and simply involve transferring property into the name of trustees with a requirement that the property be used for a particular charitable purpose. Similarly, an unincorporated association has no separate legal identity; typical examples of unincorporated associations include parent associations or local tennis clubs.

It is also possible for charities to establish trading subsidiaries which could adopt the legal structure of a company limited by shares. Trading subsidiaries can carry out non-charitable purpose trading thereby ensuring that the assets of the charity are protected from the commercial risk and tax implications of trading. Any trading profits of the subsidiary can then be passed on to the parent charity by way of Gift Aid (subject to the retention of sufficient working capital for the subsidiary).

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2 To understand more details regarding the advantages and disadvantages of CIOs: http://www2.deloitte.com/content/dam/Deloitte/uk/Documents/charities-not-for-profit/deloitte-uk-charity-charitable-incorporated-organisations.pdf
3 http://www.cvalive.org.uk/support-for-groups/resources/1510-15-04-15/
4 For details regarding VAT & taxation of the trading subsidiary: https://www.gov.uk/charities-and-trading
Case Study

Charity - DNAdigest

DNAdigest is a registered Charity working to promote and enable easier and more efficient sharing of genomic data for research. Techniques for characterising genetic diseases are already available but the sharing of data is not. DNAdigest promotes tools and best practices that secure the data while sharing the knowledge that can accelerate diagnoses and treatments for genetic diseases affecting millions of people worldwide. The activities of DNAdigest include i) Running hack days and workshops where best practices and tools for more efficient and ethical data sharing are identified and discussed, ii) Promoting existing mission-aligned initiatives, tools, and organisations by featuring them on the DNAdigest blog, newsletter and social media, iii) Researching the current challenges for data sharing and disseminating the research results. DNAdigest is also the origin of the social venture, Repositive, which builds and hosts open-source software and tools for data sharing supporting the mission of DNAdigest.

For Fiona Nielsen, CEO and Founder, it was important that the lead organisation be established as a registered charity: “we were looking to gain the trust of the relevant stakeholders, protect contributors´ personal data, and remain independent. The charitable model is great for mission alignment, but for raising funding for our software development activities we chose to spin out Repositive as a separate social venture”. The rapport between Repositive and DNAdigest is further entrenched in Repositive’s Articles of Association, ensuring that Repositive upholds its mission statement “to facilitate efficient and ethical data sharing for genomics research” and Repositive employees regularly volunteer to support DNAdigest activities. Fiona concludes that “in this way, having DNAdigest as a charity and Repositive as a limited company offers us the best of both worlds.”
In 2004, the government created a legal structure specifically tailored to the social enterprise sector – the Community Interest Company (CIC). A CIC can be either limited by shares or by guarantee and provides a more relaxed model than a CCLG. CICs can undertake activities that are not recognised as charitable within the strict legal sense but are still of benefit to the community. CICs are required by law to have provisions in their articles of association to enshrine their social purpose through an ‘asset lock’, which restricts the transfer of assets out of the CIC. For example, any transfer must be for full market value to ensure that the CIC retains the entire value of the assets. If this cannot be guaranteed, all assets must be passed on to another nominated nonprofit body. This provision is meant to ensure that the assets of the CIC continue to be used for the benefit of the community rather than being distributed to members (if limited by guarantee) or shareholders (if limited by shares).

For CICs that are limited by shares there is a further restriction on the distribution of profits by way of dividend, with a 35% maximum aggregate dividend cap. This means that dividend payments can only be taken from up to 35% of the CIC’s distributable profits, ensuring the remaining 65% are available for the company’s social activities. For all CICs (whether limited by guarantee or by shares) a cap exists on the interest payable where repayment of any debt finance is linked to the performance of the CIC. These circumstances are relatively rare but where such financing is used the CIC cannot make interest payments above 20%. It should be noted, however, that this provision does not apply to normal commercial lending.

The CIC structure provides a clear signal to investors that the enterprise operates for the benefit of the community, and that this social purpose is protected by appropriate regulation. A CIC may convert into a charity if it is already established as a CLG, or it may voluntarily dissolve – but once established it may not convert into a standard limited company.6

Case Study

CIC - Social Impact Lab (SIMLab) and FrontlineSMS

FrontlineSMS is a desktop software created to lower barriers to positive social change through the power of mobile technology. By leveraging basic tools already available to most organizations, including those in 'last-mile' settings — computers and low-cost modems/handsets - FrontlineSMS enables instantaneous two-way communication to any mobile phone. In 2003, the founder of FrontlineSMS, Ken Banks, witnessed how SMS was widely used in sub-Saharan Africa. He saw the opportunity of drawing on the widespread use of mobile phones in resource poor settings and launched the first prototype in 2005. FrontlineSMS was a pioneer in this field and one of the first platforms to help harness the power of mobile technology for social change. In terms of legal structure, Banks initially formed Social Impact Lab, a nonprofit 501 (c) 3 organisation in the United States to house US-based funding for the FrontlineSMS project. Later, a Community Interest Company (CIC) in the UK, was formed to house European-funded projects and consulting. The CIC form was attractive for its relatively simple company administration workload, combined with the commitment to a social mission.

Ken Banks, who now runs Means of Exchange and other projects under his kiwanja.net brand, pointed out some of the challenges currently faced by CICs. “More broadly, CICs seem to be poorly understood. Investors, other than genuine impact investors, can be put off by the various restrictions imposed, such as dividend caps. There is also currently no real established market place/FTSE equivalent for trading in CIC shares.” Despite these drawbacks, social enterprises such as SIMLab can benefit from adopting this type of hybrid legal structure. Particularly in terms of funding it might open doors that would otherwise have been shut. Banks continues: “on the plus side, CICs allow equity to be sold and investors to come in, as well as charitable donations.” FrontlineSMS was recently spun out of SIMLab in a management buy-out and is now privately owned by a US corporation. Both the CIC and the 501(c)(3) are thriving and continuing to deliver on their mission, supporting organizations all over the world to use inclusive technology for social change.
Company Limited by Shares (CLS)

A Company Limited by Shares (CLS) is the most common incorporated form for private sector businesses. Because of its flexibility, this type of legal structure holds great potential for different types of organisations including social enterprises. When incorporating a CLS, share capital is divided into shares of fixed amounts which are then issued to shareholders. The shareholders become the owners of the company. A CLS is not specifically designed for social enterprises like the CIC, but it can be adapted to companies that consider a commercial approach to be a key step in maximizing their social impact.

Some enterprises are openly for-profit and maintain their social mission by placing values and impact at the heart of their agenda. This has enabled social enterprises such as fair-trade fashion retailer, People Tree, or the producer of affordable solar energy solutions, d.light, to scale quickly and further their social causes.

Other enterprises choose the CLS structure while staying nonprofit. For this purpose, their social mission is written in their governing documents along with what they intend to do with their profits. One way to modify a CLS structure for social enterprises is voluntarily including an “asset lock” in the Articles of Association. This will prevent the distribution of assets (as in a CIC) and can be accompanied by a restriction or cap on the declaring of dividends. A full prohibition on dividends combined with an asset lock allows the CLS to effectively function as a nonprofit, while providing more flexibility than a CIC. There is also the possibility for the company to modify its articles and remove these restrictions in the future to access conventional equity investment (whereas, once a CIC has been established, it may not convert into a standard CLS). However, ethically it is important that clear legal requirements are established around how and when the conditions of an asset lock can be lifted, and honest communication with employees, funders, and stakeholders will be crucial if the decision is ever taken to shift from a nonprofit to for-profit structure.
Case Study

Nonprofit CLS – Simprints Technology

Simprints is a nonprofit tech company committed to improving the lives of the poor. Accurately linking people to their digital records is a critical bottleneck in the delivery of mobile services in healthcare, microfinance, and aid distribution. Simprints has developed a low-cost, rugged fingerprint scanner and an open-source Android application to instantly link patients to their health records. Using this technology, a community health worker can swipe a mother or child’s fingerprint and access their records in real-time on their phone, including next steps in their care such as vaccinations or medication. Their technology has been tested with over 120,000 fingerprints in the developing world and is currently being rolled out in clinical sites across Bangladesh reaching 22,000 mothers and children. To maximize its impact, Simprints has chosen a hybrid legal structure through a 100% ‘asset lock’ in their articles of association. This lock prevents dividends and the sale of equity outside of impact investment, and mandates that its assets go to a charity if the company ever winds up.

Toby Norman, the Founder and CEO of Simprints, explains that “finding the right legal structure was difficult for us. Impact is at the heart of everything we do, but being a charity would have reduced our fundraising options considerably”. The challenge they faced was how to combine their social mission with a legal structure that allowed for impact investment in the future. “We chose to be a limited shares company with an asset lock as it seemed an innovative way to secure funds now with the option of attracting investors in the future. We focused on business grants to get us off the ground while committing to our social-impact focus through the asset lock”. Simprints has raised $1.2m in its first year alone and is moving to commercial manufacturing in 2016.
Case Study

For-profit CLS – d.light

d.light is a global social enterprise delivering affordable solar-powered solutions designed for the two billion people in the developing world without access to reliable energy. d.light provides distributed solar energy solutions for households and small businesses that are transforming the way people all over the world use and pay for energy. Through 10 field offices and four hubs in Africa, China, South Asia and the United States, d.light has sold over ten million solar light and power products in 62 countries, improving the lives of over 50 million people. d.light is dedicated to providing the most reliable, affordable and accessible solar lighting and power systems for the developing world and reaching 100 million people by 2020. d.light has arguably been one of the most successful for-profit social enterprise to date, taking full advantage of the financing channels available to private companies while maintaining a clear focus on their core social mission.

Ned Tozun, Founder and CEO of d.light, recounts how “we decided to set up d.light as a standard for-profit corporation. We always believed that we needed to create a financially sustainable and profitable model for renewable energy solutions that could leapfrog kerosene lanterns other off-grid energy alternatives”. As a result, d.light attracted investment from traditional impact investors such as the Acumen Fund and the Omidyar Network. Interestingly, established venture capital firms such as Nexus and Draper Fisher Jurvetson joined for second-stage investment rounds. Ned explains that “we believed that we would need to attract commercial capital in order to scale to reach hundreds of millions of people”. This diverse funding strategy, based on their for-profit legal structure, has enabled d.light to achieve its ambitious expansion targets, transforming the lives of 50 million people to date.
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**Table 1:** Depending on the choice of the legal structure, the implications regarding taxation, funding sources and regulations vary significantly.
Legal Structures in the US

In the United States there are several legal structures available to startups: Sole Proprietorships, Partnerships, Corporations, and Limited Liability Companies (LLC); there are also a number of legal structures specifically designed for social enterprises: Flexible Purpose Corporation, Low-Profit Limited Liability Company (L3C) and Benefit Corporations.

The L3C is a variant of an LLC, designed primarily to enable companies to access investment from tax-exempted sources such as private foundations. The Flexible Purpose Corporation, which has passed in California and Washington (where it is called the Social Purpose Corporation), requires boards and management to agree on one or more social and environmental purposes with shareholders, while providing additional protection against liability for directors and management. The Benefit Corporation or B-Corp is a corporate form passed in seven states and pending in four others that requires organisations to consider a designated social purpose and corresponding social impact alongside financial analysis in making strategic and tactical business decisions.

Needless to say, this overview is brief and far from conclusive. Our intention is to provide social enterprises incorporated in the UK with a quick introduction of the available options when considering moving or expanding to the US. Similar to the UK, the legal landscape has been changed in recent years to provide greater flexibility to social enterprises.

Over the past decade, the market for impact investment has gained a lot of traction in the US. This is mirrored in the sums already flowing into social enterprises by impact investment funds such as the Acumen Fund and Bamboo Finance. Despite making some progress, the market in the UK is still very young. For those social enterprises with an international outlook, aiming to help beneficiaries on a global level, exploring funding opportunities outside of the UK maybe an option. This will not, however, be appropriate for all types of social enterprises and should be considered carefully.
Next Steps

Starting a business is always difficult. For social enterprises, the task can seem even more challenging considering the number of legal options available when incorporating a social enterprise.

We hope this report has helped you by providing a concise and comprehensive overview of what is on offer. The key takeaway is that picking the right structure at the beginning is crucial: it will determine not only how your enterprise is perceived by the public, but also which type of funding you can access. Increasingly hybrid structures have shown themselves to be adaptive, flexible and scalable option and may be worthy of particular attention for those considering setting up a social enterprise.

Once you have considered all these options, it’s time to seek advice from experienced entrepreneurs, mentors and lawyers and “stress test” your proposed structure with them. While incorporating a new social enterprise can be an expensive endeavour a well-executed incorporation brings you the peace of mind to do what really matters: building a world-class social enterprise.

Good luck.

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