

**CONFERENCE:
PUBLIC SECTOR MEETS THIRD SECTOR
A LEGAL PERSPECTIVE**

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BACKGROUND TO EXTERNALISATIONS IN SCOTLAND

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- KEY DRIVERS
- CHOICE OF LEGAL FORM
- KEY LEGAL ISSUES
- PUBLIC & THIRD SECTORS: INTRUSION OR CONVERGENCE?

- Perception that offshoot bodies:
 - are freed from bureaucratic clutter
 - have a clearer mission
 - give senior management more scope for innovation
 - are more agile in responding to new challenges
 - can create a fresh, empowered, and more responsive, culture throughout the organisation
- ...and thus contribute to higher quality service delivery without additional cost to the authority

- The presence of a board within an offshoot vehicle is seen as desirable - especially access to private sector skills and stakeholder representation
- Seen as safe haven against less palatable possibilities, especially contracting out to private sector
- Financial considerations:
 - savings (esp. rates and VAT)
 - opportunities to access external funding (grants, donations, commercial loans)
 - ability to build a more secure future for staff through entering wider markets
 - financial returns to the Council (or at least lower annual payments) through future expansion of the operations

- Part of wider shifts in the general local government environment, including:
 - modernisation agenda
 - drive for ongoing efficiency savings
 - emphasis on defined outputs
 - changing role of local authorities, focussing more on setting strategic direction
- Historic reservations/barriers have been weakened:
 - no longer uncharted territory
 - Scottish Government generally supportive
 - greater degree of pragmatism
 - availability of specialist technical support

- Three main types of legal entity:
 1. Company limited by shares
 2. Company limited by guarantee
 3. Limited liability partnership (LLP)
- Within model 2, three variants:
 - Charitable status
 - Community interest company (CIC) status
 - No special status
- May be a need for two or more entities:
 - Charitable company (CLG) and non-charitable subsidiary (CLS)
 - Two LLPs (one for Council contracts, one to compete in the market)

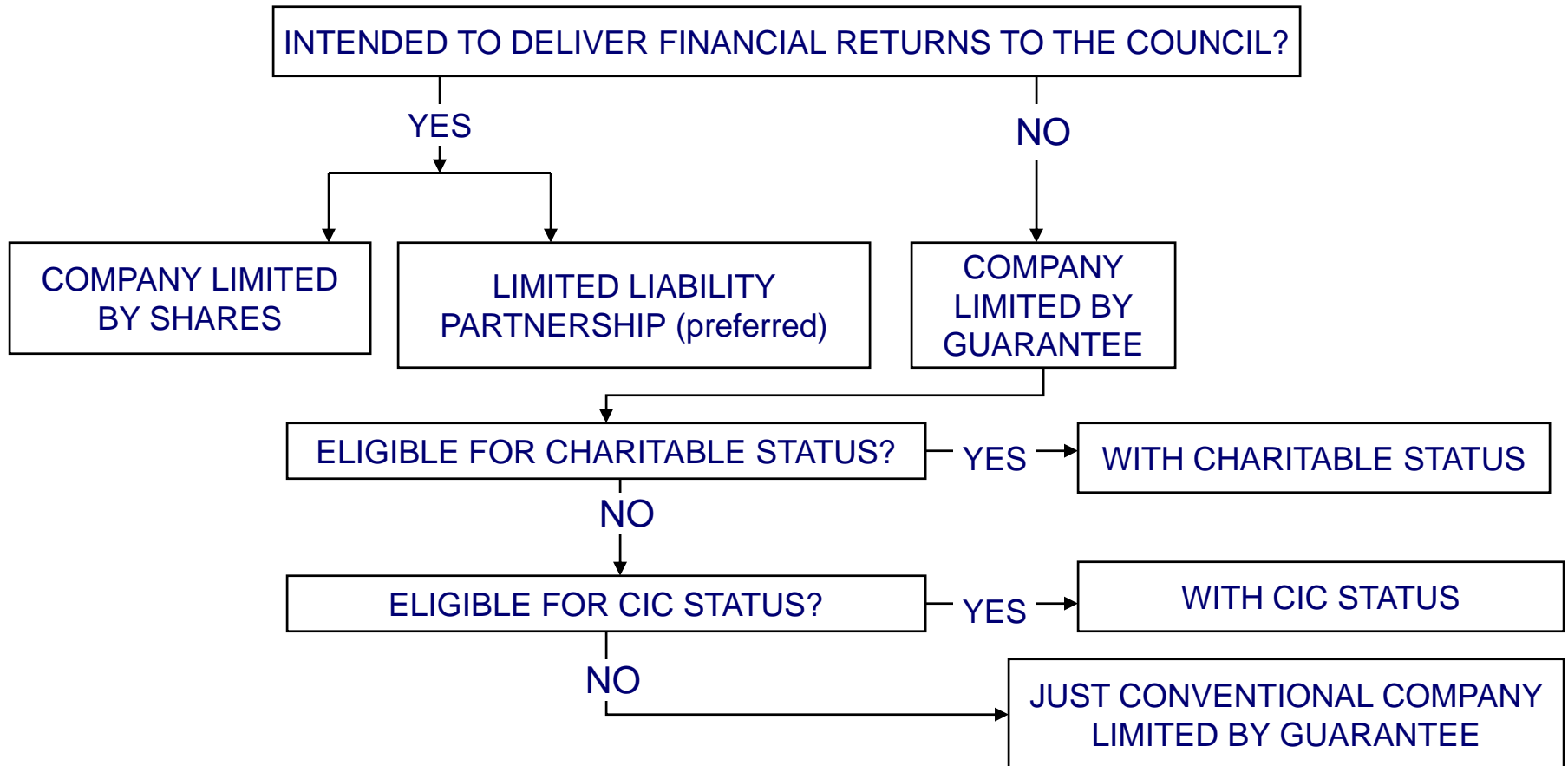
CHOICE OF LEGAL FORM (cont) Burness (b)

- Key issue: Is the offshoot intended to deliver financial returns to the Council?
- If YES, then the LLP model is now generally preferred to the company limited by shares model, on the basis of significant tax advantages
- If NO, then company limited by guarantee; and decision then based on:
 - Is charitable status available? - if so, go for it (rates relief, access to funding from foundations etc)
 - If charitable status is not available, is the CIC badge seen as helpful?
 - If charitable status is not available, and no special benefit in CIC badge, then go vanilla

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CHOICE OF LEGAL ENTITY – DECISION TREE

(assuming Council-controlled offshoot)

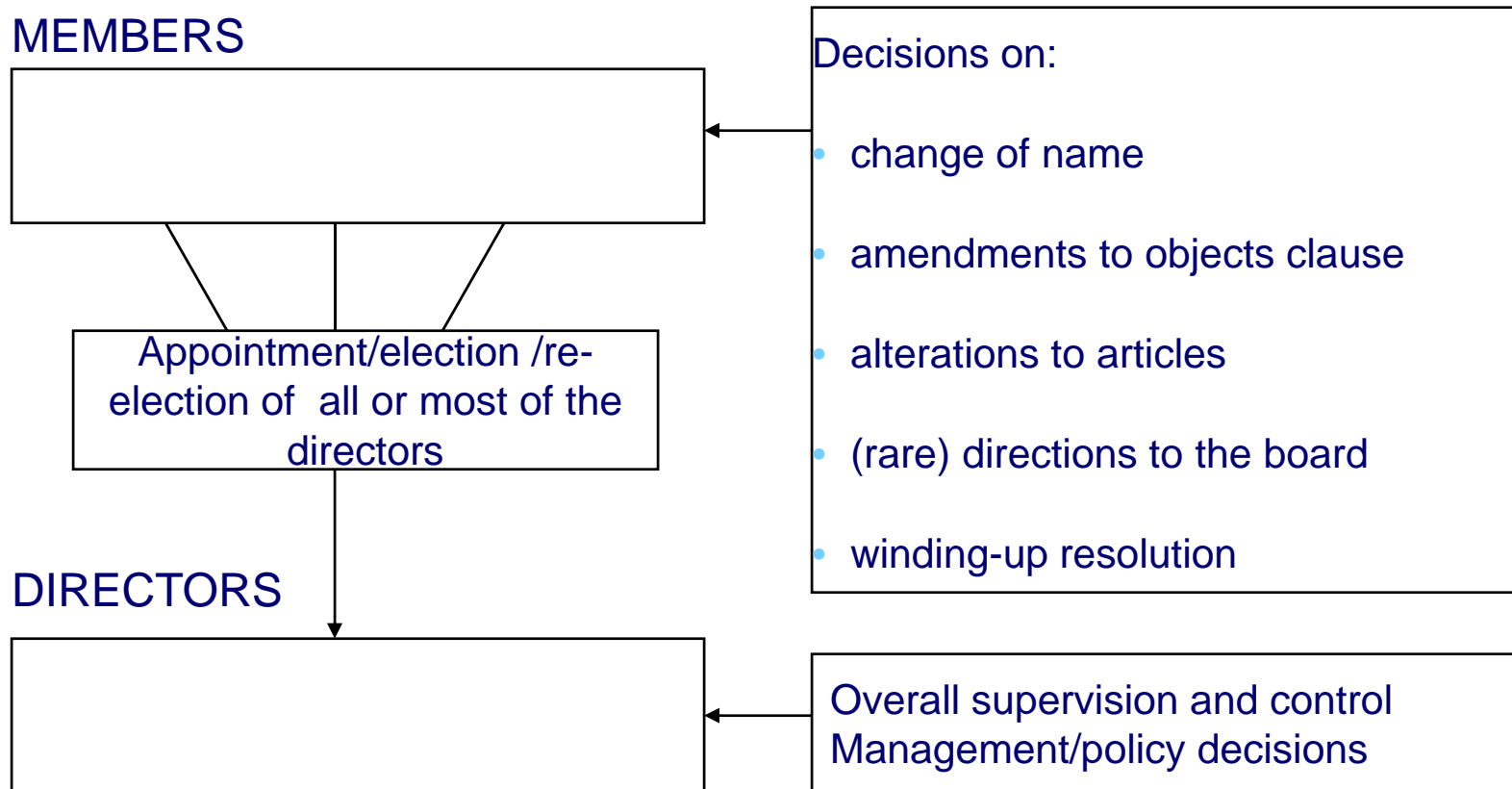


CHOICE OF LEGAL FORM (cont) Burness (b)

- A public sector offshoot using a ***company limited by guarantee model*** (LLP models and company limited by shares models are somewhat different) has a structure that closely mirrors a typical social enterprise....barring only the membership layer:
 - memorandum of association (objects, non-profit distributing clause, winding-up clause etc) – identical, or virtually identical
 - major part of the articles (conduct of board meetings, directors vacating office, directors' duties, appointment of office-bearers, code of conduct, appointment of subcommittees etc) – identical, or virtually identical

CHOICE OF LEGAL FORM (cont) Burness (b)

COMPANY LIMITED BY GUARANTEE – LEVELS OF DECISION-MAKING



CHOICE OF LEGAL FORM (cont) Burness (b)

- Populating the “MEMBERS” box: -
 - first wave of leisure trusts had a membership reflecting wider stakeholders, not just the Council
 - no examples in Scotland (to date) of employee-controlled (co-op) models for externalisations
 - more recent externalisations involving a company limited by guarantee model have the Council as sole member (e.g. Culture and Sport Glasgow, Fife Sports and Leisure Trust)

CHOICE OF LEGAL FORM (cont) Burness (b)

- The membership, under company law:
 - takes decisions on constitutional changes
 - appoints/elects - and periodically re-appoints - the board (or the majority of the board)
- BUT:
 - constitutional changes are exceptional; and in virtually all cases are driven by the board even if formal voting is by the members
 - few mainstream social enterprises have a packed hall at the AGM (or at other GMs)
 - there are other mechanisms than board elections/re-elections to secure accountability
 - a number of major social enterprises follow selective, rather than democratic, procedures for appointment of board members - recognising the increasing requirement for high quality governance
- AND
 - key constraints/ controls at a practical level - for conventional social enterprises *and* offshoots - lie in the funding/services contracts..... so niceties of company law members' powers may not be key

CHOICE OF LEGAL FORM (cont) Burness (b)

- Charitable status or CIC status:
 - anchors the company in the non-profit distributing sector, through robust legal mechanisms
 - can assist in allaying political opposition
 - can reduce concerns among staff and/or the general public about creeping privatisation
 - (arguably) supports the social enterprise ethos
- Legal principles round charitable status and CIC status are identical for a public sector offshoot as for a mainstream social enterprise
- The duties imposed by charity law - including the duty to give priority to the interests of the charity, even if appointed by the Council - apply in full to directors of a charitable offshoot company
- Payments by the Council to the offshoot are normally based on a tightly drawn contract; usually:
 - more detailed in its requirements; and
 - more onerous in its obligations

than a similar services/funding contract for a mainstream social enterprise

Menu of technical legal issues:

- Vires (legal capacity)
- Restrictions on local authority commercial income
- Charitable status (if applicable)
- EU Procurement requirements
- State aid principles

And with interplay on:

- VAT issues
- Taxation issues
- Overall business/operating model

KEY LEGAL ISSUES (cont)

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- Need to tailor the corporate structure to reflect:
 - nature of organisation as profit-distributing or otherwise
 - intended balance at board level
 - principles of best practice as regards governance
- Contractual relationships with the Council set by:
 - Transfer Agreement
 - Services Agreement
 - Leases/licences of premises
 - Council Services Agreement
 - (potentially) array of other contracts
- Overall intent:
 - a robust, sustainable operation
 - sufficient stability in the overall framework to ensure the board is empowered; and that the board can plan ahead with confidence

PUBLIC & THIRD SECTORS: INTRUSION OR CONVERGENCE?

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- **Compare and contrast - as regards *legal* structure and wider *legal* framework :**
 - a conventional social enterprise running a community sports centre
 - an offshoot sports & leisure trust running a portfolio of sports centres
- Same legal entity - company limited by guarantee, with charitable status
- Same objects clause, so same mission
- Same bar on distribution of profits
- Same procedures for board meetings
- Same duties on directors under company and charity law
- Same standards of governance at board level
- Same requirements under company law and charity law

PUBLIC & THIRD SECTORS: INTRUSION OR CONVERGENCE? (cont)

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Comparison of conventional social enterprise with leisure trust (cont):

- (potentially) same set of obligations, defined outputs etc under the services contract/SLA with the Council
-so key controls lie under the services contract/SLA for both types of organisation

AND let's assume (devil's advocate!):

- the same board has been in place with the social enterprise for ten years; there is no encouragement for any new candidates
- no local people turn up to the AGM beyond the board themselves
- there is no public access to minutes of board meetings

PUBLIC & THIRD SECTORS: INTRUSION OR CONVERGENCE? (cont)

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Comparison of conventional social enterprise with leisure trust (cont):

while

- the leisure trust has substantial representation on its board from democratically-elected local councillors
- the non-council board members are recruited through a transparent process, based on an objective assessment by a nominations committee which works to an agreed skills matrix
- the leisure trust has very active local users groups in each community, and also thematic user groups focussed on young people, ethnic minorities etc - and the board is highly responsive to their views

Comparison of conventional social enterprise with leisure trust (cont):

- the leisure trust has representatives of sports interests, young people and other stakeholders on the board
- the leisure trust holds an annual public meeting to debate future strategy, which is well attended by a wide cross-section of the communities served by the trust
- minutes of all board meetings, and all significant strategy papers etc, are available for public access on the leisure trust's website
- the Council's powers as sole member of the company are exercised only after wide consultation

A LEGAL PERSPECTIVE – SUMMARY

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- The legal models for *non-profit distributing* offshoots are virtually identical to conventional social enterprises
- The legal overlay in relation to company law; and charity law or (if applicable) CIC status, is identical
- The contractual framework (as regards services contract/SLA) within which they operate is similar in nature

SO

- The key differences – as regards *legal* framework - relate to members' powers under company law and democratic accountability to members (particularly through election/re-election of directors)
- Those differences form a boundary - but a boundary which may be starting to blur.....