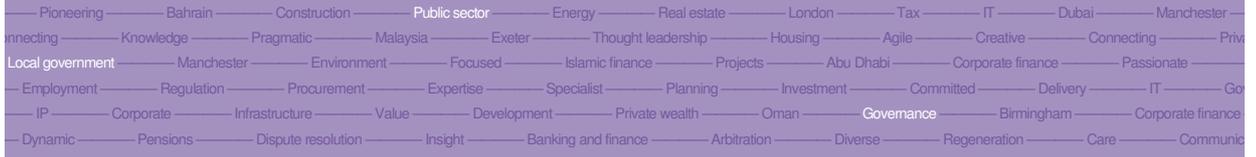


How to set up a successful mutual or social enterprise



The Government is committed to creating a greater role for social enterprises as well as mutuals, charities and co-operatives (often referred to as the "third sector") to deliver public services. As part of this commitment the Cabinet Office set up the Mutuals Support Programme, and to date over £1 million worth of professional support and advice has been procured for 30 live and developing mutuals.

Accordingly, many local authorities and other statutory bodies are progressing establishing social enterprises, co-operatives, charities and mutuals to deliver public services or are looking afresh at the third sector in terms of their commissioning strategies both to encourage diversity of provision by engaging with small and medium enterprises (SMEs) and to stimulate economic development in their local area.

What is a mutual?

The term "mutual" is used in a variety of different ways and contexts which can often lead to confusion. For the purposes of this publication it is used as an umbrella term to describe an organisation whose primary purpose is to generate benefits for members. Members of a mutual may consist of employees, service users, communities, private sector or a combination of the above.

What sectors are suited for delivery by mutuals?

The government's Open Public Services White Paper highlighted the importance of diversifying service providers to improve standards and focus on Commissioned, Neighbourhood and Individual Services. All of these can be delivered by mutuals albeit using different models. Alternative ownership models include:

- Employee plus other stakeholder-owned organisation (the other stakeholder could be a private sector partner), which is most appropriate for Commissioned Services such as education (school improvement or school support services); children's centres and child care; housing and housing management; family support; welfare to

work services; regulatory services such as trading standards or environmental health; professional services such as town planning, audit and financial services or even, now Alternative Business Structures are permissible, legal services;

- Community ownership, which is most appropriate for Neighbourhood Services such as ownership and management of community facilities and community assets and leisure, culture and sport;
- Employee-owned, which tends to be most appropriate for community based, primary and preventative health services and social care – Individual Services.



Source: iStockphoto

Which model to choose?

There is a multitude of different legal models from which to choose. The most common tend to be:

- Company limited by shares – shares could be fully owned by a particular group i.e. employees or the shares could be owned by more than one group (a hybrid mutual);
- Industrial and Provident Society - this can either be a co-operative which conforms to co-operative principles or a community benefits society which is constitutionally committed to benefiting the community and staff and/or service users can be members;

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- Company limited by guarantee - usually not for profit and a common legal form for a registered charity or community interest company;
- Community interest company - a company limited by shares or guarantee where the assets are locked in for the benefit of the community;
- Management buy-out - where the existing management team form an entity, raise investment and take over the service;
- Charity - a trust or a company limited by guarantee which must have public benefit aims and activities which are wholly and exclusively charitable in nature (as of December 2012 it is possible to register as a Charitable Incorporated Organisation with the Charity Commission, which enjoys the benefits of a company without the burdens);
- Community Land Trusts – a corporate body established for the express purpose of furthering the social, economic and environmental interests of a local community.

Why set up a mutual?

Mutuals offer a way of delivering public services within a safe and accountable framework independent of the authority, whilst being perceived as maintaining a public sector ethos. There are also a number of other benefits including:

- Stakeholder participation with better engagement and cohesion particularly for "individual" services such as health, social care and education. Service users may feel more engaged and inclined to trust a mutual in comparison to a major contractor whose shares are traded on the stock market;
- Ability to raise investment to expand and generate independent revenue stream;
- Accountability to wider stakeholders, the community and their staff;
- Safeguarding of publicly funded assets for future public benefit;
- Diversity of supply base and the encouragement of SMEs;
- Robust corporate governance for delivery of efficient public services;
- Promoting employee engagement and developing participative management styles;
- Ability to enhance recruitment and retention of staff;
- Financial benefits to employees through shareholdings, profit-related bonuses and performance-related pay;
- Building consensus amongst members/ stakeholders;
- Competitive advantage in the market where the service commissioner wishes to satisfy Corporate

Social Responsibility objectives or demonstrate that it is doing so through its supply chain;

- As a vehicle to take up the Community Right to Challenge under the Localism Act; and
- If well established, independence, longevity and stability.

What are the powers to set up a mutual?

In the case of an employee-led mutual in which the local authority does not take an interest, then by and large, the powers issue should not arise. The local authority will wish to regulate the time and resource given to the employees to develop and launch the mutual, but that is largely restricted to HR issues and ought not impact upon the Council's powers. In the process for bidding for the authority's work, there may also be issues of conflict of interest to manage.

However, the attraction of the mutual in many cases for the local authority is as a vehicle in which it too can take an interest and where that is the case, as ever, it is important to identify the correct legal powers at the outset, not just to prevent challenge but also to ensure a sound basis for future investment where funding may be needed. Where that is the case, the Council will need to rely upon its trading powers.

Trading powers under section 95 Local Government Act 2003 and the Local Government (Best Value Authorities) (Power to Trade) (England) Order 2009 allow all English local authorities to trade in any of their ordinary functions apart from services which authorities are required by law to provide, such as front line education.

Before using the power, local authorities must consider and approve a business case and any trading activity must be carried out through a company in which the authority has a legal interest. Detailed guidance on using the power is set out in the 2003 ODPM Guidance on the General Power for Local Authorities to Trade in Function Related Activities through a Company, as updated by the 2007 Addendum issued by the Department for Communities and Local Government.

The advantage of trading powers is that they can be used to make a profit thus generating revenue for local authorities through share dividends and creating value through share ownership.

A number of local authorities are also looking at trading companies as a way of addressing the increasing impact of personal budgets (for example in adult social services) or increased local autonomy (for example, academies, free schools and community-based budgeting). As take-up of local choice increases, there is a risk that local authorities will find themselves running in-house services for a reducing client base which will lead to those services "withering on the vine"

because the power to provide such services will be lost once the budget is in the hands of the user or devolved locally. Promoting a local authority trading company which is able to compete for business is a positive way of preserving local employment and retaining citizen-focused, high quality services for the benefit of the community.

Alternatively, English local authorities may wish to look at the power of general competence introduced by the Localism Act 2011 to authorise setting up the new entity, perhaps supplemented by the best value duty in Section 3 of the Local Government Act 1999.

Do we have to procure a mutual?

This will depend on what the local authority intends to procure from the mutual and how the new entity is set up. Where the local authority retains the power of decisive influence over the entity both in terms of ownership and of that entity carrying out the essential part of its activities for the authority, then it may fall within the Teckal exemption from the European Public Procurement Directive (such exemption is due to be formally codified in the updated Directive later this year). This will mean that the level of authority ownership and turnover attributable to customers other than the authority needs to be monitored on an on-going basis to ensure that the entity stays safely within the exemption.

Alternatively some "residual" services (such as education, health, leisure and legal services) listed within Schedule 3B of the Public Contracts Regulations 2006 (the Regulations) do not currently have to be procured through OJEU advertisement or formal competitive tendering provided there is a degree of transparency in the way in which the service contract is awarded to satisfy the authority's obligations under the European Treaty. This position will soon however alter given the proposed changes to the Regulations whereby the ability to use the residual services exemption will be significantly curtailed.

It should also be borne in mind that the new entity might itself have to comply with the public procurement rules if it is set up in such a way so as to constitute a "body governed by public law". This could make it cumbersome for the entity to procure sub-contractors when it is itself bidding for work.

Where the authority wishes to set up an entity which is both exempt under Teckal and is not a "body governed by a public law" careful consideration will be required.

There is also the option for authorities wishing to procure the private sector investor in a proposed mutual to establish an Institutionalised Public Private Partnership (or once the Regulations are updated use the new Innovation Partnership Procurement

Procedure). This has the benefit of allowing the authority to procure services from the new entity once the investment partner has been procured and the entity established.

What are the steps in setting up a mutual and how long does it take?

In the public sector the typical time scale for establishing and transferring services to a new entity tends to be at least six months or longer. Such a period is needed to ensure proper staff engagement, proper options appraisals, market analysis, capital raising and negotiation.

Set up tends to involve the following:

Options Appraisal and Business Case – the options appraisal should also look at market conditions, who should have an ownership stake (for example, the authority, the staff, investors and/or service users) and whether the entity should be co-owned rather than owned entirely by employees.

The options appraisals stage will typically conclude with an agreement in principle between senior managers and elected members with regard to the time, effort and resources to be invested in detailed business planning.

Building a Viable Business – this needs to include a "SWOT" analysis of strengths, weaknesses, opportunities and threats, market research, a skills audit, cash flow analysis and securing finance.

Key questions to ask include:

- How will the entity secure the finance it needs?
- Will the finance come from a dowry contract with the current authority?
- How likely is it that the existing funding sources will continue?
- Will a "payment by results" contract be in place, and if so how will the entity meet its overheads in the meantime?
- Is it possible to secure finance from external sources such as banks, investors, joint ventures or from specialist funds and, if so, what security will they ask for and in what form (for example, personal guarantees or charges over property)?
- What demand is there likely to be from additional customers and how will the entity attract them?
- Who will the competitors be and what are their relative strengths and weaknesses?
- What will it cost to provide these services in the future and will the level of overheads allow the entity to provide the services at a competitive price?

- Will VAT and other forms of tax be charged, and, if so, how will this affect the costs of the services provided?

Procurement will usually involve the authority procuring either an investor in the new entity via an Institutionalised Public Private Partnership (or the Innovation Partnership Procedure once the Regulations are updated) or the contract for the service itself. If the former, staff will want to be involved in the selection and evaluation of the investor to ensure that they can work with them and share common goals. If the latter, the new entity will need to prepare and gear up for submission of a tender to the authority. One issue may be a relative lack of detailed financial data or performance track record which the new entity will be able to provide to the authority at prequalification questionnaire stage.

In either case, the authority will need to give detailed consideration to preventing conflicts of interest by using ethical barriers and appropriate protocols.

Due diligence

This will consist of a "health check" of the business to assess assets, risks and liabilities and enable appropriate action to be taken. This might lead to contracts being terminated, assets being disposed of or staff restructuring and is a helpful exercise as it should prevent the new entity being encumbered with excessive liabilities and risks which could otherwise lead it to fail or have cash flow difficulties in its early years.

What about the staff?

More than in any other form of service delivery, engaging with staff in an open and transparent way is one of the most critical success factors where a mutual is involved. Staff will understandably be concerned as to whether their existing terms and conditions will be maintained under the TUPE Regulations and how their pensions will be treated.

Staff will also be interested to understand how alternative forms of share ownership might be structured and how this may affect them in terms of potential tax liability.

Share schemes

To acquire the company, the employees have to end up with at least a majority of capital hence shares in some form - along with trusts – are the typical currency of employee ownership. Employees can acquire ownership in a company in a number of alternative ways:

- Employees can buy shares with their own money, at market value or at a discount;
- Employees can be given shares free of charge;

- Employees can be given share options i.e. a chance to acquire shares at a future date but at today's value, so if the value of the shares goes up, the employee makes a gain; or
- Indirect ownership whereby a trust, acting on behalf of all employees, can acquire company shares and retain a portion of them either indefinitely or pending distribution to staff.

All of these situations have tax implications. Some enable employees to get tax relief against the amount they invest.

How we can help

Trowers & Hamlins LLP have set up hundreds of mutual and employee-owned organisations including companies, Industrial and Provident Societies, CICs charities, trusts and LLPs.

We help local authorities develop strategies for alternative service delivery models by advising on council powers to set up and/or trade with new organisations and how to safely navigate the rules which apply, including EU procurement rules. This initial work forms part of the commercial and legal business case for a local authority's preferred solution.

We subsequently advise on any procurement and governance issues as well as the business transfer and services agreement which is required to document the commercial arrangement including the provision of service, transfer of assets, performance management, payment and exit arrangements.

Where projects involve mutuals or joint ventures, we also advise on available corporate models and the structuring of ownership and governance arrangements to satisfy the requirements of the stakeholders and current legislation including tax efficiencies.

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