



## Project overview

Since 2005, the Fraser Valley Centre for Social Enterprise (FVCSE) has been advocating for the creation of a separate business structure (or 'legal form') for social enterprise in Canada, inspired by the UK model, called a 'Community Interest Company' (or 'CIC'<sup>1</sup>). In May 2008, the US introduced their low-profit limited liability company (or 'L3C'<sup>2</sup>) for the same purpose.

Coast Capital Savings Credit Union has contributed to further the Canadian work, in a FVCSE-led project that runs to March 31, 2009. The project involves the exploration of possibilities for a new Canadian business form, engineered specifically for social enterprise. This would be an addition to existing business structures in Canada, which are sole proprietorships, partnerships, corporations, and cooperatives.

A separate legal structure for social enterprise in Canada could serve many purposes, including:

- The ability for the enterprise to **raise capital by issuing shares**;
- The ability for the **government to stimulate** social enterprise specifically, through incentives such as favourable tax treatment;
- Offering **clarity on limits of activity**;
- The freedom of establishing **legal ownership and governance among groups** with different legal structures themselves;
- The capacity of **private sector businesses now practicing 'more than Corporate Social Responsibility'** to further distinguish themselves from competition as authentic multiple bottom line enterprises;

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<sup>1</sup> Introduced in 2005.

<sup>2</sup> Passed in Vermont. Pending in Georgia, Michigan, Montana, Oregon, Minnesota and North Carolina. As of September 1<sup>st</sup>, 11 L3C's have been registered in Vermont, as per [www.youthtoday.org/publication/article.cfm?article\\_id=2220](http://www.youthtoday.org/publication/article.cfm?article_id=2220)

- The ability for the social enterprise sector to **track its impacts** (e.g. revenue generated, employment created, etc.), which will assist in attracting **funding to the sector** by government and others; and
- The introduction of a **'brand'** for social enterprise, a means for the public to more readily recognize multiple bottom line ventures, and a **platform for education around the benefits of procurement** of goods and services from social enterprises.

The deliverables for this project are:

1. Full analysis of features and benefits (in addition to shortcomings) of the CIC (UK) and L3C (US) models.
2. Creation of documents outlining features and benefits of proposed Canadian model.
3. Next steps action plan.

This paper represents the first deliverable listed above. Canadian implications will be discussed within the second deliverable.

Raison d'être: social enterprise legal forms

In the UK and the US, as well as in other countries exploring the introduction of a separate legal structure for social enterprise<sup>3</sup>, there is acknowledgement that social enterprise has no legal form of its own. Social entrepreneurs have been forced to choose among adopting ill-fitting charitable, non-profit, or traditional business forms.

While there are updated provisions for corporations (including the monumental shift to recognition of corporations as a legal 'person'), non-profit organizations and registered charities continue to be governed by outdated legislation<sup>4</sup> that restricts such elements as revenue streams and capital attraction.

To this point, social enterprises have endeavoured to work within existing legislative and regulatory frameworks, often with a sense of profound compromise. In this way, social enterprise has been constricted by rules intended for other times and circumstances.

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<sup>3</sup> In addition to Canada, these include Luxembourg, Singapore, and Sweden. As per email from Robert Lang (L3C Champion) 08.22.08.

<sup>4</sup> Charity law is based on the Statute of Elizabeth (1601), and old case law, including Pemsell's Case, 1891, which created the classic four heads of charity that distilled the Shakespearean prose of the 1601 Act. Similarly the Canada Corporations Act, under which federally incorporated non-profit organizations and charities are incorporated, has not been substantially updated since it was first enacted in 1917.

In the words of the Office of the CIC Regulator<sup>5</sup>, 'the Government wants to support the [social enterprise] sector by creating a modern and appropriate legal vehicle and to help raise their profile'.<sup>6</sup> Further, the CIC was formed to enable the locking of assets for community benefit without the need for charitable status<sup>7</sup>.

It must be stressed that the introduction of a new social enterprise form does not in any way threaten existing structures. It is intended to create added choice to the menu of structures already available.

States the CIC Regulator, 'the CIC will be a valuable addition to [existing] forms and [is] particularly suitable for those who wish to work within the relative freedom of the familiar limited company framework without either the private profit motive or charity status. They are more flexible than some other legal forms and there are a variety of capital structures available to meet the needs of members and the organization'.<sup>8</sup>

The L3C form is born from similar motives (although the L3C was designed with enabling new sources of capital attraction as the top priority).

Robert Lang, who originally conceived the idea, describes the L3C as 'the integration of business and mission organized to operate in what we might call the low-profit zone... The L3C investment structure is designed to bring vast new pools of funds such as private investors, banking, insurance, pension, and foundation endowment investments to bear on problems normally only addressed by the non profit community and its limited resources'. The L3C features the flexibility (and form) of a private company, with the requirement that its purposes be charitable or educational.

The remainder of this paper explores both the UK and the US forms in greater detail.

Community Interest Companies – features and benefits

Social enterprises are defined in the (UK) Prime Minister's Strategy Report as 'organizations which, like mainstream businesses, trade in order to build long-

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<sup>5</sup> The CIC Regulator is a government-appointed 'light touch' regulator, who also exists to promote the CIC brand, and provide guidance in matters related to CIC's.

<sup>6</sup> [www.cicregulator.gov.uk/faq.shtml#three](http://www.cicregulator.gov.uk/faq.shtml#three)

<sup>7</sup> [www.cicregulator.gov.uk/faq.shtml#five](http://www.cicregulator.gov.uk/faq.shtml#five)

<sup>8</sup> Information and Guidance Notes; CIC Regulator Sara Burgess, [www.cicregulator.gov.uk/CIC%20guidance/Chapter%201%20-%20introduction/Chapter%201%20-%20August%202008%20\(version%203\).pdf](http://www.cicregulator.gov.uk/CIC%20guidance/Chapter%201%20-%20introduction/Chapter%201%20-%20August%202008%20(version%203).pdf) page 7.

term sustainability, but which operate for a social purpose and use their profits to this end<sup>9</sup>.

In 2005, the Community Interest Company (CIC) was introduced in England, Scotland, and Wales, specifically via legislative changes to the Companies Act 1985. CIC's came into being in Northern Ireland in 2007, via legislative changes to the Companies Order 1986.

Other than the special attributes detailed below, a CIC operates exactly as a traditional company (i.e. corporation). This means that it is a separate legal entity, can enter into agreements and contracts in its own right, and does not cease to exist when shareholder changes occur.

Within the first year of introduction, over 360 CIC's were formed within the UK. At time of writing, there are over 2,050 CIC's.

The CIC is essentially a 'not-for-profit company' (or profit-for-community company) that 'combines the pursuit of a social purpose with commercial activities'.

A charity must be established exclusively for charitable purposes (passing the 'public benefit test'), whereas a CIC can be established for any purpose that benefits the community.<sup>10</sup>

The CIC is simple and inexpensive<sup>11</sup> to incorporate, and features a low level of regulation. Its structure is that of a limited liability company<sup>12</sup>, and it can be formed 'new', or can be converted from existing business forms (e.g. a standard corporation can switch to a CIC).

Typically, those choosing the CIC form are individuals, businesses, those operating community-based projects, and community groups.

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<sup>9</sup> From For and Against the Community Interest Company, by Malcolm Lynch. January 2004.

<sup>10</sup> CIC Briefing Pack, [www.cicregulator.gov.uk/CIC%20guidance/Briefing%20Pack/CIC%20Briefing%20pack.pdf](http://www.cicregulator.gov.uk/CIC%20guidance/Briefing%20Pack/CIC%20Briefing%20pack.pdf), page 27.

<sup>11</sup> Forming a CIC costs £35. Conversion of an existing company costs £25.

<sup>12</sup> This can take the form of a company limited by guarantee, a private company limited by shares, or a public company limited by shares. Ibid., page 8. Companies limited by guarantee are British, Irish, and Australian organizational forms used in situations similar to societies in Canada – clubs, sports associations, charities. They do not have share capital, and members guarantee the payment of a small amount toward the costs of winding up the organization in the event of a shortfall on cessation of business. The liability of members is limited to the amount of the guarantee.

As corporations feature 'Limited' or 'Incorporated' at the end of their legal names, CIC's choose either 'CIC' or 'Community Interest Company' as their company suffix. In addition to the purpose of meeting legal naming requirements, the suffix is intended to immediately identify the venture as a social business to the financing and purchasing public.

The CIC's corporate form is viewed by the CIC Regulator as making it more familiar (than a charity form) to banks and other potential financiers, suggesting increased ease in accessing more traditional forms of business loans. Early reports are that this has not turned out to be the case.

As another means to inject cash into the venture, a CIC can sell investment shares. Windfall payments to shareholders are not allowed. There is a dividend cap on returns on shareholder investment, for the purpose of ensuring that an adequate level of resources remain in the CIC, and/or flow to community benefit. CIC's limited by shares adopting statutory clauses in Schedule 2 of the Community Interest Company Regulations, 2005,<sup>13</sup> are only permitted to distribute dividends to other asset-locked bodies or 'otherwise for the benefit of the community'<sup>14</sup>. In this case, there is no dividend cap. CIC's limited by shares adopting statutory clauses in Schedule 3 of the Regulations are subject to the dividend cap. Unlike traditional companies (whose Directors can declare that a dividend be paid), the entire CIC membership must vote to declare dividend issuance. The dividend cap is set at 5% above the Bank of England's base lending rate (Canadian 'prime'), in terms of the paid up value of the share (this is called 'maximum dividend cap'). The CIC is prohibited from declaring a dividend total per year that exceeds 35% of the CIC's distributable profits (this is referred to as the 'aggregate dividend cap'). The CIC can carry forward any unused dividend capacity (that is, amounts falling below the maximum dividend cap), allowing it to declare higher dividends in future years, as long as that year's dividends do not exceed that year's aggregate dividend cap.

As is the case with the asset lock, the dividend caps as outlined by the CIC Regulator are 'maximums'. CIC's can set lower dividend caps within their Memorandum or Articles of Association.

In rare circumstances (i.e. when a loan is extended to the CIC whose repayment is linked directly to the CIC's financial performance), an interest cap of 4% above the Bank of England's base lending rate exists, or the contracted lending rate, whichever is less.

In cases of dissolution, assets flow to the community, not shareholders or other private interests. The asset lock is a key feature of the CIC. The CIC is prohibited

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<sup>13</sup> [www.opsi.gov.uk/si/si2005/20051788.htm](http://www.opsi.gov.uk/si/si2005/20051788.htm)

<sup>14</sup> CIC Briefing Pack, page 20.

from liquidating its assets at less than market value, unless they are being directed to another asset locked entity (including registered charities) or for community benefit. This is the minimum requirement: CIC's may adopt even tighter asset lock rules within their articles. This includes naming a specific asset locked body that would receive the assets in the event of dissolution. Assets are however, allowed to be depleted in order to satisfy debts incurred during the regular operation of the enterprise.

It should be noted that the light regulation and simple set-up<sup>15</sup> exist mainly due to the fact that the CIC is not a registered charity. The other side of this reality is the fact that net profits of CIC's are taxed at corporate rates. This is the main reason why charities don't convert to the CIC form, although they sometimes establish CIC's with charities as shareholders / owners; and flow assets / profits to the charity. The CIC then claims this donation as an expense, lessening its taxable profits<sup>16</sup>.

The 'community' being served can be place-based, or sectoral. It is generally expected that the community being served by the CIC is broader than the members of the CIC itself<sup>17</sup>. If the venture does not meet the 'community interest test' (that is, if the mandate of the enterprise does not operate out of community interest), then the CIC legal form cannot be conferred upon it. A brief *raison d'être*, called a Community Interest Statement, must be provided to the CIC Regulator, in order for a decision to be rendered vis-à-vis whether the CIC form can be used. This CI Statement must cover purpose for formation, intended activities, and beneficiaries of those activities. Political campaigning and self-benefit preclude the granting of CIC status.

Broad community accountability is built into the CIC framework via the requirement to file an annual CIC report<sup>18</sup> with respect to its operations and activities, which is filed on the public record. The main sections of this report are: activities, stakeholder consultation, Directors' remuneration, asset transfers other than for full consideration, and dividends / interest paid.

In too many cases, the non-profit / charity impediments to remuneration for service on Boards of Directors (and therefore playing a governance role) forces organization founders to choose between remuneration and governance. In the case of the CIC, founders and CEO's can serve on the Board, and Directors can

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<sup>15</sup> Templated Articles of Association are provided by the CIC Regulator.

<sup>16</sup> [www.hmrc.gov.uk/charities/donors/companies.htm](http://www.hmrc.gov.uk/charities/donors/companies.htm)

<sup>17</sup> CIC Briefing Pack, page 5.

<sup>18</sup> An example of a completed simplified report can be found here [www.cicregulator.gov.uk/guidance/CIC34EgSimplifiedReport.pdf](http://www.cicregulator.gov.uk/guidance/CIC34EgSimplifiedReport.pdf). A longer report must be completed if dividends or interest were paid out from the CIC.

receive reasonable remuneration. The CIC literature also notes this as a positive incentive to attract the most suitable people for management and Directorship positions<sup>19</sup>.

The CIC is allowed to provide goods or services at below market value to other CIC's, charitable organizations, or community-based organizations provided that this does not represent 'unfair competition'<sup>20</sup>.

### Community Interest Companies – emerging issues

The CIC legislation is currently undergoing revision by its original writer<sup>21</sup>, based on feedback from three years of experience, and from those operating CIC's.

The dividend cap is said to present barriers to investment, as many are unwilling to engage in risk investment with a below-market potential for payoff. A change is being considered to increase the maximum percentage of profits that a CIC can distribute to investors from 35% to perhaps 70%.

Similarly, the interest cap has been criticized as too restrictive, and the suggestion has been made that the maximum rate of return that an investor can reap on a CIC investment should be increased from 4% above the Bank of England's base lending rate to up to 20%.

There is also interest in changing the tax treatment of investments in CIC's to make them a more attractive investment. Currently, there exist tax incentives for charitable donations and investments in certain high risk entrepreneurial ventures, but not for CIC investments. Specific reform proposals include:

- Allowing CIC investors a tax write-off against their income tax at the basic rate of 20%.
- Reducing the rate of investor taxation to a maximum of 20% on income received from the CIC as opposed to the maximum of 40%.<sup>22</sup>

It may also be that the corporate-like CIC form presents barriers to accessing start-up grants.

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<sup>19</sup> CIC Briefing Pack, page 5.

<sup>20</sup> CIC Briefing Pack, page 19.

<sup>21</sup> Stephen Lloyd of Bates Wells & Braithwaite, Solicitors.

<sup>22</sup> Ibid.

The argument has also been made<sup>23</sup> that the difficulties encountered by new CIC's seeking business loans will be the same as new small businesses seeking (and failing) to secure small business loans. Lynch states that in the UK, the challenges that small businesses face in securing loans have been well-documented. Like small businesses, the new CIC would have no track record to demonstrate to financiers. The lack of access to grants could place new CIC's in a bind.

To date, there has been little uptake on brand, from the point of view of purchaser procurement of CIC goods and services. Reports from the UK are that there hasn't been a big enough budget for promoting the CIC brand<sup>24</sup>. Further, the CIC brand may be too narrow for social enterprise promotion, since it excludes charities trading under their own organizational banner ('charitable trading' is like 'related business' in Canada).

So far, there has been no systematic tracking of CIC impacts such as jobs created, and savings on the social safety net.

Low profit limited liability company – features and benefits<sup>25</sup>

The challenge put before the New York based Mannweiler Foundation was how to 'access the vast pools of market-driven wealth to make socially responsible investments in ... non profit areas'. Mannweiler CEO Robert Lang has spearheaded the creation of the low profit limited liability company (or L3C), signed into law by the Governor of Vermont in May 2008. Because limited liability companies (LLC's) are legal across the United States, once one state includes L3C's in their LLC laws (as Vermont has), L3C's are considered to be legal across the country.

Unlike the CIC, the L3C is not a new legal form. Rather, it is a variation of the LLC, an already-recognized form in the United States. Where new CIC owners have stated that they spend much time explaining the nuances of the CIC form to financiers and the general public, no such explanation is required with the L3C.

Robert Lang explains the form thus: 'The LLC is an extremely successful business form that combines the best features of a partnership with the best features of a corporation: liability protection, and the ability to sell itself in pieces'. Unlike a

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<sup>23</sup> Malcolm Lynch, page 4.

<sup>24</sup> From A CIC in the Teeth, by Nick Temple. July 2008. Quoting Jonathan Bland of the Social Enterprise Coalition, a UK membership-based consortia of social enterprises. See [www.socialenterprise.org.uk](http://www.socialenterprise.org.uk).

<sup>25</sup> Information on the L3C comes from the L3C overview, by Americans for Community Development. <http://americansforcommunitydevelopment.org/l3c.asp>

corporation, owners are called members (rather than shareholders). Instead of (corporate) bylaws, LLC's (and therefore, L3C's) act under an operating agreement.

The L3C can elect 'pass-through' status for taxation purposes with each member of the L3C being taxed according to their own tax situation based on the portion of the profits they receive (corporations would be taxed on L3C net profits at the corporate tax rate, individuals at the personal tax rate, charities at zero, etc.). Because of the flexibility of the operating agreement structure, each member can enjoy different powers and privileges. This would prove valuable in terms of hybrid ownership groups. Likewise, members can be passive or directly involved in management, as per the conditions of the operating agreement. Unlike a corporation, members (for instance, charities) can receive profits out of proportion to their investment portion.

The main feature of L3C's is that they are accepted recipients of program-related investments (PRI's). These are loans, equity investments, guarantees, etc. made by American charitable foundations<sup>26</sup>, with the expectation of below-market (or zero) returns. It must be stressed that if these PRI's are returned back to the foundation, the grantor must reinvest the amount into another PRI or a grant within one year. In this way, PRI's live on via their potential to be returned and reinvested. This is clearly not the case with grants. A bonus feature is that PRI's count towards a foundation's 5% annual disbursement quota, even though the foundation stands a good chance of receiving the money back (through the loan repayment or sale of its equity investment).

'The managers of the L3C will have the freedom and flexibility of a for profit but with marching orders to ensure that they maintain their non profit souls.'

Prior to the formation of the L3C, there was no standard legal form to accept PRI's from foundations. This meant that foundations exploring the possibilities of making PRI's to potential recipients often went to the IRS to obtain a private letter ruling, which could take years to attain, with an attendant cost of tens of thousands of dollars: not a very efficient use of time and money. With the L3C structure standing by to receive PRI's, no IRS involvement would normally be required. It is hoped that the new streamlining of PRI flow will enable smaller foundations (which could not afford the previous IRS dealings) to move into consideration of PRI's as a means to increase impacts and make higher risk investments than are typically allowed in a foundation's traditional investment portfolio.

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<sup>26</sup> The investment power of Canadian foundation assets are dwarfed by that of American foundations, so it is unlikely that a Canadian incarnation of a social enterprise form would contain such a high stress on PRI's. Nevertheless, Canadian foundations are beginning to examine PRI possibilities, so it would prove helpful to have a structure standing by that can easily receive these loans.

Because the L3C can structure tranching (or layered) investments, some investments can receive below market (or zero) rates of returns (foundations, social responsible investors) while others can receive market rates of returns (traditional investors). Likewise, some investments (e.g. PRI's) can be given ownership interests that are subordinate to the other investments (e.g. traditional investors). This tranching structure enables the attraction of a greater mix of financial backers, broadening the variety and numbers of potential investors in social enterprise. The highest risk investment need not receive the highest rate of return.

In the case of procurement of goods and services offered by social enterprise, the vast majority of the general public often have a positive reaction to socially-based offerings, but seldom open their wallets solely because of this: the good or service has to be able to compete (on price and quality) with traditional businesses. So too, with investment. A socially-based mission will seldom attract investment if it is offering below-market returns. Tranching investments allow the L3C to offer competitive returns on investment.

#### L3C's – further commentary

The next steps in L3C development are a move to make them part of the LLC laws in more states and federal registration to add IRS recognition; development of a roster of L3C's in existence; and a requirement of registered L3C's to issue an annual social impact report. Additionally, there is discussion about attaching tax incentives, advocating for L3C's to be recipients of investments under the Community Reinvestment Act, and expanding the allowed use of L3Cs.

Unlike the CIC, the L3C has no asset lock and no dividend cap. Although branding is an objective, it has not been a priority to date. Robert Lang asserts that the impacts of the L3C activities in themselves will be the most effective means of building awareness and confidence in the legal form.

#### A Canadian opportunity

These UK and US innovations are timely and very helpful guides for Canada. The social economy and community enterprises in Canada are very similar to those in the UK and the US. They have developed in the same way, they have the same enormous potential, and, until now, they faced the same basic legal limitations. Canada now has before it an opportunity to draw the best attributes from both legal structures, to create new federal legislation to enable social enterprise to flourish.

The timing is right for these changes, not only because of the needs of Canada's social enterprises and the innovations elsewhere, but because some complementary legislative work has already been done.

In June of 2008, the federal government introduced Bill C-62, An Act respecting not-for-profit corporations and certain other corporations. This bill is to replace the Canada Corporations Act, which dates from 1917, and has not been significantly updated since then. If Bill C-62 becomes law, it will replace the current Act and will represent an improvement by every measure. It will streamline the incorporation process, modernize and clarify governance and financial accountability, and improve the federal government's administrative oversight role. It is a non-partisan, good housekeeping bill, very similar to Bill C-21, which died on the order paper in 2005.

A practical feature of Bill-62 is that there will be a three-year transition period during which entities incorporated under the current Act can apply for corporate status under Bill C-62. This transition period creates a convenient opportunity for the federal government to introduce another (social enterprise legal structure) bill that would complement and build upon the strengths of Bill C-62 while providing positive impacts on the financial sustainability of not-for-profit organizations engaged in social entrepreneurship.

We propose that federal legislation be created to enable the establishment of a new type of legal entity – Community Enterprise Companies – a hybrid of CIC's and L3C's.

A subsequent paper will outline suggested attributes of this new Canadian legal form.