

Paper for Swindon Music Service (“the Service”)

1. Introduction

- 1.1 The purpose of this paper is to give some broad guidance on the legal aspects of the Service transferring to an entity which is independent of the local authority, including options for structures and what would be involved in the transfer process, and in particular:
 - 1.1.1 consider and compare the following two legal structures that would be suitable for establishing an independent entity to run Swindon Music Service and lead Make Music Swindon (the borough’s music hub), focusing on:
 - (a) a charity, either a charitable company limited by guarantee (CLG) or a charitable incorporated organisation (CIO); and
 - (b) a Community Interest Company limited by guarantee (CIC);
 - 1.1.2 outline the process and timescales for establishing a charity or a CIC;
 - 1.1.3 if a charity, outline the extent to which the charity can carry out trading activities and whether a separate trading subsidiary might need to be established.
 - 1.1.4 outline the process for transferring the staff, contracts, assets and liabilities of the Service to an independent charity or CIC; and the other legal agreements that may need to be put in place; and
 - 1.1.5 give you an idea of the potential legal costs of the above work, if BWB were to provide independent legal advice to the Service.
- 1.2 It is currently envisaged that the independent entity would be operative in 2018.
- 1.3 Whilst this paper does consider how Make Music Swindon could be involved in the governance structure of the new entity, it does not look at its current or future structure and potential options. If you would like us to look into this further, please let us know.

Music Services in General

- 1.4 In this paper, “Music Services” refers to the Services provided in Council areas to facilitate and offer musical opportunities to young people both in schools and through wider music education programmes.
- 1.5 Since 2012, Music Services have been part funded through Arts Council England (“ACE”) grants; and with the funding being given to lead partners of Music Education Hubs.
- 1.6 As a result of the reduction in Council funding and the new funding/hub structure, many Music Services are considering establishing (or have already established) an independent structure to take forward all or part of their Music Services.

- 1.7 This is part of a wider landscape in which many local authorities are “spinning out” their services (such as fire services, health related services, library services, adult education services, Music Service, etc.) to independent charities and social enterprises. We have assisted many such services (including several Music Services) on their spinning out journey.
- 1.8 From our experience the most popular legal structure for new independent entities running Music Services and receiving the transfer of service from the Council is an incorporated charitable structure, either a charitable CLG or a CIO, with a commercial trading arm to pursue commercial activities (if necessary). However, other legal structures could be appropriate, such as a community interest company limited by share or by guarantee, a company limited by guarantee with no charitable status, a co-operative or community benefit societies, and a commercial company limited by shares.
- 1.9 Most of the Music Services we have advised or spoken to have also reached the conclusion to establish themselves as a charity (either a charitable CLG or a CIO) or a community interest company. This paper focuses on these options although I have included at Schedule 1 a summary of other legal forms for information purposes. If you would like any further advice on these other legal structures, please let me know.

2. Comparison of a charity (charitable CLG and CIO) and a CIC

As indicated above, the most appropriate legal forms for a Music Service are a charitable company limited by guarantee (Charitable CLG), a charitable incorporated organisation (CIO) or a community interest company (CIC). The table below summarises the key features of the two charitable legal forms (Charitable CLG and CIO) and the CIC:

Feature	Charitable CLG or CIO registered with Charity Commission for England and Wales	Community Interest Company (CIC) registered with the CIC Regulator
Legal Entity and registration process	<p>Will require creation of:</p> <ul style="list-style-type: none"> (For CLG) a new charitable company limited by guarantee registered at Companies House. It then needs to be registered as a charity with the Charity Commission for England & Wales. This is a separate registration process from the Companies House registration; (For CIO) a new charitable incorporated organisation registered with the Charity Commission. <p>Ongoing annual reporting, administration and company/secretarial support required for the charitable CLG or CIO.</p>	<p>Will require creation of a new company limited by guarantee registered at Companies House and with the CIC Regulator. The Companies House and CIC Regulator both assess the application, but this is done as part of the same application process.</p> <p>Ongoing annual reporting, administration and company secretarial support required for the company.</p>

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Establishment Requirements and Steps	<p>The following steps must be taken to establish the charity:</p> <ul style="list-style-type: none"> • Identify trustees (recommended good practice minimum 3 but it would be normal to have between 4-9 for this kind of entity). • (For CLG) prepare draft Articles and incorporate Company (by registration) at Companies House – this is a relatively straightforward application process. • (For CIO) prepare constitution for CIO. • Develop list of activities/business plan. • Completion and submission of Charity Commission application. The Charity Commission is likely to scrutinise the application and may ask questions about the charity's activities, its public benefit and relationship with the Council, etc. • Total registration process from submission of application to the Charity Commission (including, for CLG option, incorporation at Companies House) usually takes from between 2-6 months depending on the urgency and complexity. It is possible (in exceptional circumstances) to expedite Charity Commission applications in special circumstances for a quicker registration. 	<p>The following steps must take place:</p> <ul style="list-style-type: none"> • Identify Directors (no minimum, but it would be normal to have between 4-9 for this kind of entity). • Prepare draft Articles and CIC 36 form on which brief detail is given about the CIC's purpose and future activities. Must be able to show the CIC's activities will "benefit the community". It should be relatively straightforward for the proposed Music Services vehicle to satisfy this test. • Incorporate Company (register company) at Companies House. The application will also be considered by the CIC Regulator. It is unlikely the CIC Regulator will ask any questions about the CIC application and will pass the CIC for registration as a CIC. • Total registration process from submission of application usually takes from between 3-6 weeks.
Regulators?	<p>Companies House (for CLG) and Charity Commission.</p> <p>(For CLG) Companies House is a light-touch regulator. It is necessary to file information with Companies House but it is unlikely to scrutinise the Charity's activities.</p> <p>The Charity Commission has</p>	<p>Companies House and CIC Regulator.</p> <p>Companies House is a light-touch regulator. It is necessary to file information with Companies House but it is unlikely to scrutinise the CIC's activities.</p> <p>The CIC Regulator is also relatively light touch but has some powers of</p>

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	wider powers of scrutiny and regulation into the charity's affairs and conduct of the trustees including to investigate trustees, remove trustees, appoint new trustees, and appoint a Receiver; and it is necessary for the Charity Commission to consent to (for example) certain changes to the charity's constitution.	scrutiny, eg. to investigate and appoint and dismiss Directors.
CIC Regulator's powers	No.	Yes – the CIC Regulator has more limited regulatory power than the Charity Commission.
Ongoing reporting and administration	(For CLG) Annual Accounts and Annual Return filed with Companies House and Charity Commission. (For CIO) Annual Accounts and Annual Return filed with the Charity Commission only. The Accounts and Annual Return are in the public domain. There are detailed ongoing administrative requirements in operating a CLG or CIO including board meetings, record-keeping, public benefit reporting, etc.	Annual Accounts and Annual Return filed with Companies House and CIC Regulator, and are in the public domain. There are detailed ongoing administrative requirements in operating a CIC including board meetings and record-keeping. These requirements are less onerous than operating a charitable company.
Rules on Conflicts of Interest	The trustees must comply with Charity Commission guidance on managing their conflicts of interest with the Charity. CLGs must also comply with company law.	The directors must comply with company law on managing their conflicts of interest with the company.
Control and autonomy	The charity will ultimately be run by trustees under a duty to act in the best interests of the charity in accordance with its charitable purposes. The staff team will report to the trustees.	The CIC directors will be under a duty to act in the best interests of the CIC members, in accordance with its specified community benefit purposes. The staff team will report to the directors.
Payment of directors/ trustees	The general rule is that charity trustees cannot be paid for their role as trustees or be employees of the Charity. There are exceptions to this rule. For example, it may be possible for the person employed as Chief	Directors of a CIC can be employees and can be paid for their role as directors.

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	<p>Executive of the Charity to be a trustee, but we would need to apply for special consent from the Charity Commission as part of the application process which could delay and complicate the application. (There is also no guarantee the Commission would agree to this request.)</p> <p>This general rule preventing payment of trustees/employees as trustees means that the people running the service will need to give control of the service to a group of voluntary trustees. They may be invited or encouraged to attend and speak at board meetings but will not be entitled to vote.</p> <p>The charity constitution will allow trustees to be paid for services (eg. consultancy/financial/artistic services) provided to the charity on a freelance basis.</p>	
Reputation	Charities enjoy a kudos/credibility – as they must exclusively further charitable (non commercial) objects, and the public, staff and stakeholders may be more likely to “trust” the activities of a registered charity.	The CIC benefits from the “social enterprise” brand. However, for many members of the public, this is not as widely recognised as the charity brand.
Tax	<p>Charities enjoy a range of charitable tax reliefs that are not available to CICs including:</p> <ul style="list-style-type: none"> • No corporation tax on profits generated from charitable trading. • Gift Aid (UK tax payers can obtain tax relief and donations to the charity are increased by 20%). • Inheritance tax relief. • Stamp duty land tax relief. • Business rates relief on premises occupied. 	There are no specific tax reliefs for CICs although it may be possible to get some business rates relief on premises (depending on the Council)
Funding	Most trusts, foundations, government funding sources will	Many, but not all, trusts, foundations, government funding sources will accept applications

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	accept applications from charities.	from CICs. However, some trusts and foundations or local authorities may find it easier to fund, or only accept applications from, charities.
Trading	In the main, charities can trade only in furtherance of their charitable objects (although up to 25% of income up to a maximum of £50,000 can be carried out by the charity. Above this amount the charity would need to set up a wholly owned subsidiary.	It is easier for a CIC to carry out most trading activities. It needs to show that the trading furthers the general community benefit of the CIC. There is a relatively low threshold to satisfy this.
BWB legal costs	<p>It typically costs £5,000 - £7,000 (excluding VAT) to establish a charitable CLG or a CIO. For this kind of charity where there is a Council relationship, costs may be towards or above the higher end as the Charity Commission usually has questions about the relationship. Please note it will also increase costs if you would like us to negotiate with the Charity Commission that the Chief Executive and/or a staff representative should be on the trustee board.</p> <p>It typically costs between £1,500 to £2,000 plus VAT to establish a trading subsidiary, which would include putting in place associated documentation such as a resource sharing agreement between the charity and the subsidiary.</p>	It typically costs between £2,000 - £3,500 (exclusive VAT) to establish a CIC.

Establishment of a charity – main advantages in comparison to CIC

- 2.1 Building on the information provided in the table above, we have identified below what we expect the main relevant advantages of establishing a charity in comparison with establishing a CIC for the Service.
 - 2.1.1 Charities must only carry out activities within this charitable purpose which therefore looks in the social mission of the service.
 - 2.1.2 Charity tax reliefs – see list above.
 - 2.1.3 Stakeholders, staff and members of the public are more likely to understand and trust the charity model.

- 2.1.4 Easier to raise funds from trusts, foundation, government as a charity (although CICs are often recognised as well).
- 2.1.5 Crucially, the Council may only wish to transfer the Service to a charity – this is not a legal requirement but depends on the view of the Council.

Establishment of a CIC – main advantages in comparison to charity

- 2.1.6 An unlimited number of employees of the CIC (including the Chief Executive) can serve on the board of directors (and be paid for doing so) and have ultimate control of the CIC. In a charity unless the constitution provides otherwise, they may attend and speak at board meetings but not vote. It is possible to have the chief executive and/or a staff representative on the board of trustees of a charity, but an argument will need to be made to the Charity Commission and there can never be a majority of employees on board of the charity.
- 2.1.7 The application process is quicker and easier.
- 2.1.8 It is cheaper to set up a CIC rather than a charity.
- 2.1.9 The CIC Regulator is more light touch than the Charity Commission as a regulator.
- 2.2 If the charity route is preferred, there is a further choice of legal form to be made. Charitable CLGs and CIOs are both incorporated legal forms, having their own legal personality and ability to enter into legal relationships (for example, with staff, suppliers and the general public) in their own name. Both forms have a two-tier structure of trustees (also known as company directors in a CLG) and members. Both forms also offer limited liability status. This means that, in most situations, the incorporated organisation itself will be responsible for the organisation's debts or for any other liabilities that might arise from its legal relationships. It will generally be the case that, except in relatively rare circumstances, if the organisation does not have the funds to meet those debts and liabilities, it will become insolvent but the members and trustees/directors will be protected from personal liability.
- 2.3 However there are some advantages and disadvantages of each:

Benefits of a CLG over a CIO

- 2.3.1 The CIO is a relatively new and untested legal structure. It has existed for just over 2 years. As a result, there is still some uncertainty as to how CIOs will operate in practice and, as yet, there is no established legal framework to fall back on to resolve any future issues. In contrast, CLGs are tried and tested and there is a substantial framework of developed company law and precedents to fall back on.
- 2.3.2 Some financial institutions have indicated that they may be less willing to lend to CIOs. In particular, there has been concern about the absence of a Register of Charges for CIOs. Currently, for example, a bank setting up an overdraft facility for a CLG can register a charge at Companies House which gives the lender some limited protections. The fact that there is no Register of Charges for CIOs (and no personal liability on a loan for CIO trustees) may influence banks and other lenders not to make certain types of lending available to CIOs. In contrast, CLGs are much more familiar to funders and service providers and, as a result, borrowing might be easier. It is worth noting, though, that the concern about lending to CIOs will probably not apply to loans to fund purchases of property because the lender can register a charge at the Land Registry.

- 2.3.3 A CLG can be incorporated quickly, within 24 hours of submitting the documents to Companies House if necessary. A CLG has a legal personality from the point of incorporation and can enter into legal arrangements and begin to trade from that point, while the application to register with the Charity Commission is being considered. In comparison, a CIO only has legal personality once it is registered with the Charity Commission. This can take up to six months or longer during which time the organisation does not exist as a legal entity.
- 2.3.4 A member of a CIO has potentially fewer rights than a member of a CLG. For example, whereas members of a company have rights (conferred by the Companies Act 2006) to call a meeting, to vote by proxy, to call for a poll or to remove a charity trustee, a member of a CIO will have none of those rights unless the constitution expressly includes them. While it would be possible expressly to include them, if ensuring the rights of members is important to you, you might prefer the protections set out in statute that a CLG would provide.
- 2.3.5 In terms of decision making by members, a CIO is less flexible than a CLG. Although a CLG is subject to certain minimum requirements by the Companies Act, it does provide more flexibility for members' decision-making. For example, the CIO structure requires unanimity for some members' written resolutions, whereas the company structure requires at most 75% (and in some cases, a simple majority) of members voting in favour.
- 2.3.6 One consequence of the CIO's legal status being linked to registration is that if the Commission subsequently uses its powers to remove the charity from the register, the CIO ceases to exist entirely. Some organisations choose not to become a CIO because they do not want their legal status so closely linked to their status as a registered charity.
- 2.3.7 It is possible to convert a CLG into a CIO, if it is deemed to be a preferable form at some point in the future. However, it is not possible to convert a CIO into a CLG.

Benefits of a CIO over a CLG

- 2.3.8 A CIO is the only bespoke vehicle for charities and has been designed with charities in mind. In contrast, a CLG is a standard legal form (a company) that is then adapted for charities. One consequence of this is that, with a CLG, trustees have a dual role as both charity trustees and company directors, which some trustees can find confusing.
- 2.3.9 Registration as a CIO is a single operation, with one application resulting in both incorporation and charity registration. A CLG needs to be incorporated with Companies House and then registered with the Charities Commission.
- 2.3.10 For CIOs, there is just a single regulator – the Charity Commission. A CLG has two regulators – the Charity Commission and Companies House. This means that a CLG has to file two returns, while a CIO only has to file one. The amount of administration involved in operating a CLG, therefore, is greater than that involved in operating a CIO.
- 2.3.11 Unlike with filings at Companies House, there are currently no fines for failure to file accounts on time with the Charity Commission (but this may change in the future).
- 2.3.12 A CIO only has to comply with the Charities Acts and CIO regulations, whereas a CLG has to comply with company legislation. Again, this means that being a CLG requires a degree of additional administration and compliance procedures.

- 2.3.13 CIO constitutions can be drafted to allow for decisions at meetings without voting, ie. by consensus. A CLG would not be able to do this.
- 2.3.14 A CIO constitution can permit several things which a new CLG's constitution cannot. For example:
- (a) giving the Chair a casting vote at members' meetings; and
 - (b) stipulating that by becoming a member, each member is deemed to have consented to receive communications by email.
- 2.3.15 In contrast, the provisions for CLGs are more restrictive. The company must receive express consent from a member before it can communicate with him/her by email.
- 2.3.16 There is more privacy for the members of a CIO, since the register of members is not open to the public. The register of members for a CLG must be made available to the public at the registered office, on request.
- 2.3.17 A CIO can be set up without the need to show that £5,000 has been raised as there is no income threshold. In contrast, a CLG is generally required to demonstrate an income of more than £5,000 before it can register.
- 2.3.18 Members (and not just trustees) of a CIO have an express duty to exercise their rights in the interests of the charity, which assists to clarify their role in the governance of the organisation. It is not clear whether members of a CLG have the same duty.
- 2.4 There has been a move in the sector to register more and more charities as CIOs and, based on the limited information we have to date, in our view the CIO would be the preferred structure for the new entity.

Are there any drawbacks to being a charity?

Regulation and registration

- 2.5 Before choosing to be a charity it is worth noting some of the potential drawbacks.
- 2.5.1 ***Regulation and registration.*** As set out in the table above, all charities established in England are regulated by the Charity Commission. The Commission has considerable regulatory powers to investigate and scrutinise the actions of a charity and its trustees.
- 2.5.2 Once registered with the Charity Commission, the charity will need to file certain information with the Commission, and make certain disclosures to the public about its status. Registered charities are required to file their accounts and an annual report with the Charity Commission. In addition, changes to the trustees, constitution, or a "serious incident" (e.g. an incident of fraud), will trigger further filing requirements. As a company, filings of accounts and changes in officers will also need to be made at Companies House. While generally not considered to be unduly burdensome, these filing requirements incur administrative costs. They also bring with them a level of publicity on the activities and funding of the charity.
- 2.5.3 ***Duties of charity trustees and conflicts of interest.*** The new organisation would need to appoint a board of directors who will be the charity trustees. Charity trustees are subject to a

range of duties under charity law, the most important of which is to advance their charity's purposes. These include running their charity properly, acting reasonably and prudently, protecting the charity's assets and acting in the charity's interests at all times. More detail is available in the BWB publication "Duties of charity trustees" which is available here <http://www.bwbllp.com/knowledge/2015/05/08/duties-of-charity-trustees/>.

2.5.4 Trustees are also under a duty to avoid, and properly manage, any conflicts of interest. There are strict rules and guidelines on how charities deal with conflicts of interest between a charity and its trustees. These extend to:

- (a) ensuring that if a trustee, or someone with a connection to a trustee, is to benefit financially from the Foundation, proper procedures would need to be followed; and
- (b) putting procedures in place to manage the situation where a trustee may have conflicting loyalties to the Foundation and another cause or organisation.

2.5.5 **Unpaid board.** As a general rule, charities must have an unpaid board which arguably creates an inefficient split between executive and non-executive, and meaning it is not possible to pay the latter.

2.5.6 **Restrictions on trading.** There are some restrictions on trading but these can be largely dealt with by establishing a trading subsidiary (see below).

Trading subsidiary

2.6 There are a number of activities which the Service intends to deliver which are more of a commercial nature and, going forward, this is an area that the charity will wish to develop further in order to diversify its sources of income.

2.7 Whilst there is no restriction on charities undertaking primary purpose trading, this being trade which is carried out by a charity in fulfilment of its main or primary purpose, trading which is non-primary purpose is restricted.

Some examples of these are set out below:

Primary purpose trading	Non-primary purpose trading
Provision of music education to young people and live music shows	Corporate team building
Instrument loans to schools	Running a cafe
Ticket sales for music performances	Catering or facilities management for corporate or private functions
Running a day nursery (assuming it is within the charity's objects)	

2.8 Charities are permitted to derive up to 25% of their turnover from non-primary purpose trading, subject to a maximum tax-exempt limit of £50,000. Above this threshold, the profits

of the trading activity would be liable for corporation tax (unless it fell within certain other tax exemptions). If this happens, the Trustees would be in breach of their duties because they would be acting outside the charity's purposes (in carrying out the trade) and because they would have allowed the tax liability to arise through not structuring the trading appropriately, they would be failing in their duty to safeguard the charity's assets.

- 2.9 If it is likely that this threshold will be exceeded, a subsidiary company should be established alongside the new organisation to undertake the trading activity. This is a very common structure for charities to use – most household name charities have a subsidiary trading company.
- 2.10 Typically a trading company is set up as a private company limited by shares in which the sole shareholder is the charity.
- 2.11 Since the trading company is not a charity, there are no restrictions on its ability to trade. Unlike a charity it is liable to corporation tax, but usually the profits which it makes are paid up to the parent charity under the gift aid scheme. This reduces the trading company's taxable profits – in many cases to zero, which means that it has no tax to pay. This enables the charity to undertake a trading activity, but via a mechanism that is tax efficient.
- 2.12 Whilst there can be an overlap between the boards of the charity and the trading company there should be at least two independent directors on the board of the trading company with the rest of board including some (but not all) of the charity's directors. This ensures that there is an independent element among the directors of the trading company and that there are some directors of the charity who are independent of the trading company and can properly evaluate the relationship between the charity and the trading company.
- 2.13 The charity would need to ensure it recovers the proper costs of any of its assets used by the trading company and this should include not only direct costs (e.g. staff salaries) but indirect costs as well (e.g. a proper proportion of overheads). This management charge should be structured so that the charity merely recovers its actual costs and does not make a profit, as the charity would be liable to tax on such profit and the activity would constitute a trade which the charity, as a charity, should not carry on.

3. The process of transferring out of Swindon Borough Council (“the Council”)

- 3.1 Transfers out of Council vary greatly depending on a number of factors including the specifics of the service that is transferring out and the role that the Council takes in the transfer.
- 3.2 It will be very helpful if the Council's legal team is involved in the transfer at an early stage, so we can discuss roles and responsibilities in the transfer and the process. **However, it is also important that at an early stage the board of the new entity receives independent legal advice on the transfer and potential risks.**
- 3.3 We have listed below an outline of a typical transfer and the issues that arise. However, please note that there may be different issues or not all of the below may apply to the Service. It is only once we have carried out the due diligence process below that we can obtain an accurate picture of the Service, the potential legal issues and likely timescales (and a more accurate estimate on the legal costs – see paragraph 7).

4. Outline of the process of a typical transfer out of Council

Initial scoping meeting

- 4.1 We usually find it is useful to have a scoping meeting with the Head of Service and other members of the team that will be working on the transfer. It is also helpful to meet the member of the Council's HR team that will be dealing with the transfer often also attends part of the meeting to discuss the staff and pensions issues. A representative from the finance department (which may be responsible for pensions) should attend, particular if there needs to be agreement on any ongoing funding or surpluses going across to the charity on transfer or any loan arrangements (for example, for working capital of the new organisation until such time as it has built up a level of reserves). If property is being leased to the charity by the Council a representative from the property department should also attend.
- 4.2 It is also preferable to have members of the Council's legal team involved in part of this meeting to discuss the transfer process and who will take responsibility for key tasks. (For example, whether the Council's legal team will produce the first draft of the legal agreements – as the Council may wish to use its own precedents.)

Establishment of the new entity

- 4.3 At the same time as the due diligence process is undertaken (see below), BWB will work with the Service to establish the new charity or CIC. As part of this process, it is necessary to decide the governance structure of the new entity. There are some key issues to consider:
- 4.3.1 **Number of trustees/directors of the new entity.** There should be a minimum of three, with five to eight recognised as an optimum number. It is not necessary to have all the trustees in place straight away but at least three are required before the charity application can be submitted.
- 4.3.2 **Composition of the Board.** In deciding on Board composition consideration should be given to the skills and expertise required for the Board and the how key stakeholders will be involved. You have identified key stakeholders as staff, schools and parents. Make Music Swindon is also a key stakeholder which could be included in the governance structure. For example, the Board could contain a member of staff elected by the wider staff group, a hub organisation representative, a local authority officer, a parent, a young person or a school representative and co-opted members with particular skills.

The focus should always be on ensuring there are sufficient skills on the Board for it to operate effectively such as financial, business, charity, educational experience on a Music Services board and avoiding a prescriptive board composition. You have already identified fundraising as a particular skill which is needed, alongside finance, legal and HR.

It should be borne in mind that Board members are not there to represent a particular group. Whilst they can help present the views of a particular stakeholder group and contribute their practical experience they must act in the best interests of the organisation when making decisions as members of the Board. Stakeholders can be engaged in other ways.

- 4.3.3 **Ownership of the new entity.** Each of the legal structures described above have a two tier structure. The directors/trustees oversee the organisation and are responsible for strategy

and are the ultimate line managers of those who undertake the day to day running of the company/CIO. The owners of the organisation are its members, who have ultimate control. Unlike shareholders, however, they do not, in any of the scenarios above, make any financial investment which would result in a financial return.

- 4.4 There are a myriad of governance arrangements possible. The following options, or variations of them, may be appropriate:

Option 1: A fully democratic structure with staff, schools, parents, hub organisations as members

- 4.5 The advantage of this option is that key stakeholders feel represented. One member, one vote is not a requirement of a charitable CLG or a CIC or a CIO so it would be possible to have weighted voting. However, if the membership grows significantly it can be both time consuming and costly to manage – for example, a members' register would need to be held and updated, and annual general meetings organised. Stakeholders may have no real interest being a company/CIO member which can lead to low turnout at members' meetings and more vocal/active members having a disproportionate voice. Additionally, having the staff (for example) as members could swing the balance of power too far in their direction; they could, for example, remove the board if they passed a decision by a majority of them as members. It may be possible to minimise the likelihood of this.
- 4.6 If this option was taken, some or all of the board would be elected by the members. It would also be possible for the board to appoint individuals who had particular skills or experience which the board considered desirable.

Option 2: A community partnership model with the hub organisations (and other stakeholders) as members

- 4.7 The advantage of this model is that it does not have as high an administrative cost of the fully democratic mode of option 1 but does allow provide representation for key stakeholders to feel represented. If the aim of the new entity was to integrate Make Music Swindon more fully into its structure this could be a way of doing so, giving these organisations ultimate ownership of the new entity. The disadvantage is that where there are conflicts of interest between members or even simply differences of opinion in the correct approach, the new entity may become immersed in exploring these differences rather than being able to respond effectively to challenges and opportunities. This could be a particular problem here if hub organisations are delivery partners to the new entity.
- 4.8 If this option was taken, each member would appoint an individual to the board. Again, it would also be possible for the board to appoint individuals who had particular skills or experience which the board considered desirable.

Option 3: An oligarchy model with a select group of individuals as members and trustees

- 4.9 In this model each individual appointed as a trustee/director is automatically appointed as a member. The individuals might first be selected by interested parties according to their skill and experience or by some other process. Further trustee/directors would be appointed by the existing board, again according to skill and experience. Provision could probably be made for the board to include the chief executive, a staff representative and other key

stakeholders such as the music hub and schools and/or the chief executive. This would therefore provide a greater balance in involvement of the various key stakeholders. The staff representative could be elected by the staff whilst the chief executive would be an ex officio position.

- 4.10 This model is simpler to manage and administer than options 1 and 2 and, to date, the majority of the music services we have established have been set up with this governance structure.
- 4.11 This structure on its own may not be considered as sufficiently inclusive of stakeholders but they can be involved in other ways, for example as 'associate members'. This would not give them the full legal rights of members but certain specific rights according to what is set out in the constitution. Another option would be to have one or more advisory committees which could be consulted and provide recommendations to the board. As you have already identified, there are other established mechanisms in place to represent stakeholders, such as Make Music Swindon and associated sub groups.
- 4.12 *Council involvement.* The Council may expect or want to have a representative on the new entity board. However, as it is unlikely to be providing the new entity with any funding, its case for representation on the board is weak and it could in any event maintain its connections with the new entity in other ways, such as continued involvement in Make Music Swindon. There are various legal implications of having a Council representative on the board of the new entity (and this can delay the Charity Commission registration process), so we would need to discuss further with you.
- 4.13 We generally **recommend option 3** for the governance structure as this provides a simple, lean and efficient governance structure but there may be specific circumstances which would mean that one of the other models is more appropriate.

Due diligence

- 4.14 After the initial scoping meeting, BWB will prepare a due diligence questionnaire for the Council asking it to provide further information about the transferring Service. The purpose of the questionnaire is to gain an accurate picture of the Service, the potential legal issues, the timescales for transfer and the risks to the new entity when accepting the transfer of Service. The due diligence questionnaire asks questions or for further information about the following:
- 4.14.1 **The contracts/grants** – that will transfer from the Council to the Service (for example, with ACE, suppliers, delivery partners, freelancers, schools (SLAs), loan agreements with parents, etc.) and whether these can be transferred to the new entity if the consent of the other parties is required.
- 4.14.2 **The staff** – who are the PAYE employees of the Service and who will transfer to the new entity under TUPE.
- 4.14.3 **The pension provision for staff** – and the extent to which the new entity will be required to match the pension provision of the transferring staff.
- 4.14.4 **Any freehold or leasehold land or other property arrangements** – that will transfer to the new entity. This could include premises hire agreements with schools.

- 4.14.5 **The other assets of the Service** – including the physical assets (such as musical instruments, storage units, music curriculum library materials, computers, AV and digital equipment, archives, computer records and databases) intellectual property (such as publications and branding, etc.) and funding commitments.
- 4.14.6 **The liabilities of the Service** – such as debts, disputes with employees and third parties, reputational issues, loans, etc.

Staff consultation process about the transfer and other TUPE requirements

- 4.15 For further information see Section 6 of this paper.

Staff restructure

- 4.16 For further information see Section 5 of this paper.

Negotiation of entry for the new entity into the relevant pension schemes

- 4.17 We will need to negotiate entry for the new entity to relevant pension schemes such as the Local Government Pension Scheme and the Teachers' Pension Scheme. For further information see paragraph 5 of this paper.

Negotiation of the transfer deed with the Council

- 4.18 To achieve the transfer, a transfer deed or agreement will need to be entered into between the Council and new entity. This document will include details of:
- 4.18.1 what is transferring to the new entity (using the information that has been collected as part of the due diligence exercise);
- 4.18.2 the obligations of the new entity (for example, to take responsibility for all the assets, contracts, staff and liabilities from the date of transfer); and
- 4.18.3 the obligations of the Council (for example, it may be possible to negotiate warranties with the Council under which they agree to be liable for any redundancy liability for the period the staff were employed by the Council).
- 4.19 The Council may want to base the transfer agreement on its own precedent. This may be based on previous transfers of services out of the Council, for example, academy transfers. In our experience, these often need considerable negotiation and/or amendment. In preference, we would start with our own precedent.

Negotiation of other relevant contracts with the Council

- 4.20 It is likely there will need to be put in place other legal agreements with the Council at the same time as entering into the transfer deed. For example:
- 4.20.1 **Grant agreement** – the Council may agree to grant funds to the new entity for a period of time to use in furtherance of its activities. In addition, there may be an opportunity to negotiate some seed funding for the new entity, particularly as there will be a cost saving to the Council following the transfer (see 5.3 below). It may be necessary to look at State Aid issues if a grant agreement is entered into with the Council. (The State Aid regulatory

regime applies where a public body, such as a Council, provides assistance to an entity which has the potential to distort competition.)

- 4.20.2 **Services agreement** – the Council may wish to enter into a contract for services, for example, for the new entity to provide music educational services for payment from the Council. Again, we understand that this is unlikely. If a services agreement is entered into with the Council, the Council may need to conduct a public procurement process to comply with EU procurement legislation although there may also be legitimate ways of avoiding this.
- 4.20.3 **Lease agreement** – if the new entity is going to be using Council premises, lease agreement(s) will need to be entered into with the Council or transferred to the new entity. Noting that the premises will be a core community asset by delivering music services to the community and in order to maximise the potential for the charity to obtain grant funding, the lease terms should be acceptable to grant funders, for example by providing a 25 year term at a peppercorn rent with no forfeiture of the lease on insolvency.
- 4.20.4 **Licences granting consent** – if the new entity is being transferred or leased property that the Council occupies under a lease or if it intends to carry out new alterations to the premises, Licence(s) granting consent may be needed.
- 4.20.5 **Hire agreement** – if there are hire agreements currently with Schools for use of premises, new hire agreements will need to be negotiated to be granted to the new entity.
- 4.20.6 **Hub arrangements** - If it is intended that the new entity will be able to share the premises with or sublet other organisations, the lease will need to include flexibility allowing for this. This could be simply to allow sharing with and hiring to other music organisations and individuals providing the music lessons or similar services from the property. However, if a “community hub” is intended, wider wording will be needed in the draft lease. If the new entity is to be a charity and wishes to charge discounted rents to non-music charities, the objects of the charity will need to be drafted to ensure they are wide enough to cover this.
- 4.20.7 **Back office service agreement** – the new entity may consider buying back certain services from the Council, perhaps for a transitional period (for example, payroll, HR and/or IT). This arrangement would be set out in a back office service agreement.

5. Staffing Issues: restructuring

- 5.1 If it is proposed to change the staffing structure that exists within the Service pre-pre-transfer, and the main reason, or the only reason for making changes is the spin-out, resulting dismissals may well be automatically unfair. It will be important to consider the circumstances carefully, in order to assess the potential risks – it is certainly not inevitable that all dismissals will always be automatically unfair (for instance where the reason for any proposed changes is unrelated to the spin-out). There may also be alternative approaches that could be followed, such as conducting a pre-spin-out consultation exercise with the aim of simplifying any post-transfer changes. This is a legally complex area and specific advice will be needed.
- 5.2 It may well worth considering whether it is possible to negotiate some additional funding from the Council to help cover restructuring costs, especially if undertaking the restructure will represents a cost saving to the Council.

- 5.3 If any changes to the staffing structure are proposed or anticipated 'in connection with' the transfer, these will be 'measures' and will need to be notified to the representatives of affected employees.

6. Staffing Issues: TUPE, contractual arrangements and pensions

- 6.1 In a transfer situation the Transfer of Undertakings (Protection of Employment) Regulations 2006 are likely to apply. These Regulations are essentially aimed at giving employees protection and will operate (unless an employee disagrees) to transfer an employee's contract of employment to the new entity, which will become the employer in place of the Council. The change in employer happens automatically, by operation of law, providing certain conditions are met relating (i) to the general situation and (ii) to particular employees.

The Council's obligations towards its existing employees

- 6.2 The Council needs to identify which of its employees will be 'Affected Employees'. It is assumed that the Council recognises a union (or unions) in respect of all those affected employees. If so, the union(s) will be the 'Appropriate Representative' for TUPE purposes. (If a union is not recognised in relation to some or all affected employees, it may be necessary to invite employees to elect representatives.) The Council has a duty to provide certain information (also prescribed by the TUPE Regulations) to the correct Appropriate Representative(s).
- 6.3 If the Council is itself proposing to undertake any significant changes to staff rules or contractual terms (known as "measures") in connection with the transfer, then it would also have a duty to consult with the Union about those measures. However, the Council does not have to consult about any measures proposed by the new entity; it only has to inform the relevant union about those measures.
- 6.4 The TUPE Regulations also set out certain obligations that the 'old' employer and 'new' employer have towards each other. These are dealt with below:

Obligations owed under TUPE by the Council to the new entity

- 6.5 The Council must provide "Employee Liability Information" to the new entity. The TUPE regulations set out a 'shopping list' of prescribed information about employees who will transfer. This obligation is a fairly limited one – the information prescribed by TUPE will not necessarily cover all the information that you would ideally want to know about the employees who will transfer to you. Additionally, the statutory timescale for the provision of this information is rather unhelpful, because the Council is entitled to wait until just 28 days before the transfer takes place before providing it. This is, in part, why we strongly recommend the Service undertakes a more detailed and timely due diligence exercise, which is essentially a much more in-depth information-gathering exercise which should allow you to get a fuller picture of all the potential liabilities, risks, exposures, etc. that the new entity is likely to face if and when it becomes the employer of the transferring employees.

Obligation under TUPE of the new entity to the Council

- 6.6 The new entity will have an obligation to inform the Council whether the new entity proposes to take any 'measures', in connection with the transfer, that will affect any transferring employees once they become employed by the new entity. The term "measure" is interpreted quite broadly.

Additional arrangements between the Council and the new entity

- 6.7 You are probably aware that one of the main consequences of the TUPE Regulations is that, as well as transferring the employment of particular individuals to the new entity, the regulations will also operate to transfer any liabilities (except for criminal liabilities) relating to them or their employment. Anything done (or not done) by the Council in respect of an employee who transfers will be regarded as having been done (or not done) by the new entity, and the new entity will shoulder the liability for those actions (or omissions). That is why it is so important to understand what, if any, unwelcome baggage a transferring employee might bring with them, by undertaking a thorough due diligence process. The new entity is also likely to want to negotiate and draft into the transfer agreement some protection (such as warranties and indemnities) to try to ensure, so far as possible, that the Council has a contractual obligation to pick up the costs associated with any unwelcome and unexpected liabilities are picked up by the Council even if, as a matter of general law, the liability has transferred to the new entity.

Pensions Issues

- 6.8 Similar principles also apply to pension entitlements. We would strongly recommend that the new entity takes specialist pension advice (which we can assist you with obtaining) as it may potentially find itself liable for substantial pension liabilities, which could be extremely onerous. Some potential risks might include: having to make very generous payments if the new entity needed to make redundant long-service employees aged 55 or over; or if it needed to effect ill-health retirements; or in the event that a post-transfer actuarial assessment required the new entity to make significantly higher pension contributions in respect of participating employees than it had anticipated. There is also the potential for a significant pension funding shortfall to develop in future even if, at the time of the transfer, it appears that all pension funding is completely up to date. The potential risks and financial exposure for the new entity are likely to be dependent upon the number of employees, pension participation rates, and their age, health and salary profile, as well as on external factors, such as poor stock market performance, over which the new entity may have no control.
- 6.9 It is likely you would also wish to negotiate and have drafted into the transfer agreement, explicit provision and protection for a range of pension-related risks.
- 6.10 Although the TUPE Regulations themselves would not require you to continue to allow employees to participate in their existing scheme (whether that is the LGPS, the TPS or some other scheme) we would expect the Council to make it a contractual obligation that the new entity either allows existing employees to continue in the same scheme(s) or that it offers them alternative provision that is at least as good as their current scheme. Our experience is generally that most organisations choose to become a participating employer in the existing scheme(s) rather than set up alternative arrangements which can be prohibitively expensive. That is likely to require you to enter into a formal admissions agreement for the relevant scheme, in relation to which the new entity may need advice and assistance.

7. Legal costs for the transfer advice

- 7.1 It is very difficult for us to provide a costs estimate until we have held the initial scoping meeting and started on the due diligence process. This is because until we know what

involvement the Council legal team has, how much negotiation will take place between lawyers and the particular legal issues of the Service (for example, the number of purchases), it is difficult to predict costs. We would therefore want to provide you with a more accurate cost estimate after the initial meeting and when we have received initial responses to the due diligence questionnaire.

- 7.2 However, a transfer out of Council services of this size (including setting up the legal and governance structure and registering the charity) typically costs between £20,000 to £25,000 (exclusive of VAT) or higher where BWB takes on more of a project management role (excluding pensions, which can range from £5,000 to £7,000 (exclusive of VAT)), there is a lot of negotiation with the Council and/or significant/difficult legal issues arise (such as in relation to employees, pensions or properties).

Bates Wells Braithwaite

8 September 2017

Schedule 1 - Other legal forms

Note on legal forms and not for profit concepts

There are a myriad of legal forms available, the most appropriate for the service being a charitable company limited by guarantee or charitable incorporated organisation or possibly a community interest company. A detailed analysis of these forms is set out above. Some of the other legal forms available and not-for-profit concepts you may have come across are set out briefly below.

1. **Mutuals**

- 1.1 A traditional mutual is one that is owned by and run for the benefit of its members. An example of this in a legal form is the cooperative society model. However, this term is used more generally to apply to various practical forms of member/employee ownership and participation.
- 1.2 The new mutuals emerging in the public sector are generally not "mutuals" in the true sense of the word i.e. the business is not owned by and run for the benefit of members. However, they share similar characteristics to mutuals, as their businesses are directed towards delivering a collective benefit (in this case, improved public services), rather than maximising profits for shareholders.
- 1.3 The common denominator is some form of employee ownership/engagement, ranging from direct employee ownership of the entire business to some form of indirect ownership of a minority stake in the business. Commonly, there may a director on the board who is elected by the staff. However, public sector mutuals are about more than just employee ownership. There tends to be a requirement that, at the point the mutual is set up, the mutual is structured so that traditional private sector commercial motives (principally, seeking to make a profit) are either excluded or tempered by other motives, including those traditionally found in the public and third sectors. This can be achieved through the chosen legal form (charitable CLG, CIO, CIC, community benefit society).

2. **Social enterprise**

- 2.1 "*Social Enterprise*" is a descriptive term for an organisation dedicated to social purposes, on a sustainable business model. The Department of Trade and Industry says:

"social enterprises are businesses with primarily social objectives whose surpluses are principally reinvested for those purposes in the business or in the community, rather than being driven by the need to maximise profit by shareholders and owners"
- 2.2 This is a description not a legal definition. A charity can be a social enterprise if it has those described characteristics. A classic example might be a charity that in the course of a trade provides employment and skills training for beneficiaries and uses the profit from its trade to provide more employment and skills training for beneficiaries.
- 2.3 Not all charities can be social enterprises. A grant making trust, for example, does not trade and is not a business, therefore it is not a social enterprise.

- 2.4 Equally, not all social enterprises will be charities. Social enterprises do not have to satisfy the test for “what is a charity” and may not be established for exclusively charitable purposes for the public benefit.

3. **Limited liability partnership**

- 3.1 An LLP is statutorily defined as a legal vehicle used by two or more individual or corporate bodies to carry on a lawful business with a view to profit. The LLP legal form retains the organisational flexibility of a traditional “partnership” and is taxed as a partnership, but members have the benefit of limited liability.
- 3.2 The LLP is a one-tier structure, comprising a number of “members”, who are equivalent to the directors of a company. The rights and duties of members have to be given by agreement between them (and the LLP). These are usually set out in a master written agreement (the “LLP Agreement”). In the absence of an LLP agreement, there are default provisions under the Limited Liability Partnerships Act 2000.
- 3.3 Certain “designated members” have the same rights and duties as any other member but have extra responsibilities, such as signing the accounts on behalf of the members and delivering documents to the Registrar of Companies.

Advantages

- 3.4 Tax transparency - an LLP is ‘tax transparent’, which means that the members of the LLP are taxed directly in their own capacity, rather than the LLP itself. This can be particularly attractive where there is a mix of charitable and non-charitable collaborators, since the distributed share of each member will be taxed, post-distribution, according to each member’s own tax status.
- 3.5 Limited liability - Despite being taxed like a traditional partnership, the LLP is a legal entity in its own right and the members benefit from the protections of limited liability. Members are liable in the winding up of an LLP up to the amount they have agreed (which can be nothing).
- 3.6 Structure - the structure of an LLP is simpler than that of a company, with only a single tier of ‘members’ (equivalent to a company’s directors).
- 3.7 Flexibility - There is much flexibility around how the LLP Agreement is drafted.
- 3.8 Privacy - The LLP Agreement does not have to be filed with Companies House.

Disadvantages

- 3.9 No ‘social enterprise’ status - There is no possibility of grant funding for an LLP, and certain ‘social enterprise’ targeted contracts may not be options. Although social enterprises can adapt the LLP form to their needs, in particular, by having protections for the social mission or commitments to ensure a certain percentage of profits is ploughed back into the LLP set out in the LLP Agreement, there is no guarantee that a potential funder/commissioner would see past the LLP form to appreciate this.

- 3.10 Accountability - accounts must be prepared in accordance with the relevant accounting rules and filed at Companies House. They must disclose the highest paid member's profits and the annual return must be completed. In addition, as for limited companies, there is certain information which must appear on the LLP's correspondence, such as the full name of the LLP, the place of registration, registered number, etc.

4. **Community benefit society models**

- 4.1 Co-operative societies and community benefit societies are bodies corporate (i.e. they have their own separate legal personality) with limited liability that are regulated by the Financial Conduct Authority ("FCA").
- 4.2 Like a company limited by guarantee, co-operative societies and community benefit societies both have a two tier structure of members and directors (often referred to as executive committee members).
- 4.3 Societies are registered with, and regulated by, the FCA, and are required to file accounts and a return with the FCA annually. Other matters which must be notified to the FCA are charges and changes of name or registered office. Changes to the rules do not take effect until registered with the FCA. There is an annual fee payable to the FCA ranging from £55 to £425 depending on value of assets.
- 4.4 Societies are not companies and are subject to the Cooperative and Community Benefit Societies Act 2014, rather than company law. Under that Act, a society may be registered if it exists "*for carrying on any industry, business or trade*" and if it satisfies the conditions for registration as either a co-operative society or a community benefit society.
- 4.5 Societies also have particular membership rules and limited restrictions arising from their regulation as such.
- 4.6 **Co-operative societies** - organisations run by and for the benefit of members, on the one member one vote principle and the International Co-operative Principles. A co-operative is the pure form of "*mutual*".
- 4.7 In order to be registered as a co-operative society under that Act, a society must show to the satisfaction of the FCA that it is a bona fide co-operative, its rules and activities reflecting the International Co-operative Alliances' Statement of Identity, Values and Principles ("the ICA Statement"). The ICA Statement contains statement of co-operative identity, which provides an internationally recognised definition of a co-operative and the values to which a co-operative should adhere. The definition states that a co-operative is an autonomous association of persons united voluntarily to meet their common economic, social, and cultural needs and aspirations through a jointly-owned and democratically-controlled enterprise with values of self-help, self-responsibility, democracy, equality, equity and solidarity.
- 4.8 The ICA Statement also contains a set of co-operative principles which constitute "guidelines" as to how co-operatives implement their identity and values in practice, which include a voluntary and open membership, democratic member control, member economic participation, autonomy and independence and concern for the community.

- 4.9 As co-operative society exists for the benefit of its members, allowing the members to receive dividends (often based on throughput) it is a profit distributing model and therefore might be unacceptable to the Service.
- 4.10 It should also be noted that as co-operative societies exist for the benefit of its members it cannot be charitable, except possibly in a case where a necessary condition of membership is to be within a class of charitable beneficiaries (for example, being a resident in financial need in an area of deprivation).
- 4.11 ***Community benefit societies***
- 4.12 A community benefit society is set up to benefit the broader community, rather than just its members.
- 4.13 A community benefit society can be charity and, at present, has the advantage that it would only need to be registered with the FCA rather than the Charity Commission. If the community benefit society has objects that are charitable in law, then it will be classed as an exempt charity and should be eligible for charitable tax breaks, if accepted as a charity by HMRC. In general, the FCA is less demanding as a regulator of charities than the Charity Commission. However, legislation has been passed, but is not yet in force, which would transfer responsibility for charitable community benefit societies from the FCA to the Charity Commission. The FCA has also recently become more onerous as a regulator of co-operatives and community benefit societies.
- 4.14 Typically, the rules of a community benefit society include a one member one vote principle, regardless of shareholding. Members can buy shares in the community limited benefit society up to £20,000. However, while community benefit societies can pay limited interest on member share capital, they cannot distribute profits to members and therefore it is unlikely to attract investors wanting a good return on their shares.
- 4.15 ***Advantages***
- (a) In general, the FCA is less demanding as a regulator of charities than the Charity Commission.
 - (b) Benefit from the advantages of incorporation whilst also having the reputational advantages of being a “co-operative” or a “community benefit society”.
 - (c) The inherently democratic nature of registered societies could be attractive as a cultural fit.
 - (d) Members can buy equity (shares) in the community benefit society, helping it raise funds, and limited interest can be paid out on shares, attracting members to buy equity.
- 4.16 ***Disadvantages***
- (a) Co-operatives and community benefit societies can be more costly to establish and administer than a company. In particular, there may be fewer professional advisers who will readily understand their legal and regulatory frameworks, which can make accessing professional support and funding more expensive. While there are

around 20,000 co-operatives and community benefit societies there are over 4 million companies.

- (b) The application process to register a charitable community benefit society with HMRC can be lengthier than for a CCLG.
- (c) In terms of transparency, it is more difficult for third parties to carry out due diligence on a cooperative or community benefit society as there is a cost attached to obtaining documents and it can take some time.