Appendix B - Company Limited by Shares vs Company Limited by Guarantee Options Appraisal & Legal framework governing local authority controlled companies

Section 1: Company Limited by Shares vs Company Limited by Guarantee Options Appraisal

Option 1 - A company limited by shares (CLS): *A* type of company which most people (and the private sector) are familiar with. The corporate structure is tried and tested and is underpinned by an established body of law and practice.

Table 1.1 – A company limited by shares (CLS)

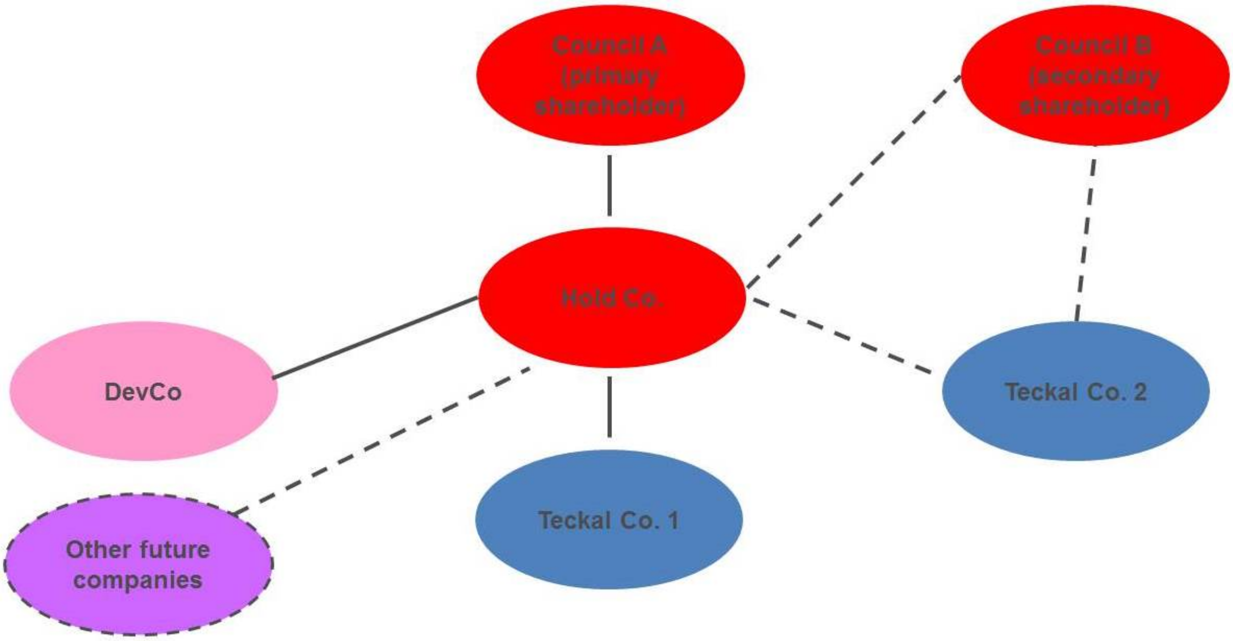
A company limited by shares (CLS)	
Key features	
1.1.1	A CLS can have very wide objects (unless these are limited in the company's articles);
1.1.2	A CLS is usually formed for the purpose of making and distributing profits to its shareholders;
1.1.3	As a separate legal entity a CLS can own and deal in assets, sue and be sued, and contract in its own right;
1.1.4	A CLS has limited liability. The circumstances in which shareholders could be held legally liable for a company's debts (beyond their unpaid capital contribution) are extremely limited. This means that the liability of the shareholders of the CLS would be limited and protected;
1.1.5	Shares can be held by the Council and the holding of shares is fluid and flexible. Shareholdings can change in order to take account of a change in circumstances and/or in accordance with the parties' requirements;
1.1.6	The shareholder agreement would set out the relationship between the Council and NewCo in more detail (see Section 5.8 of Cabinet Report);
1.1.7	In a CLS, the decision-making power of an organisation rests primarily with its board of directors, but some matters may be reserved to the shareholder(s);
1.1.8	A CLS is intended to generate a commercial profit and distribute profits, and it is the most suitable form of vehicle for this purpose;
1.1.9	The administration process of a CLS is primarily governed by the Companies Act 2006 and the company's articles of association. This will involve holding board and general meetings and preparation and submission of accounts. CLSs are registered at Companies House, but there is no ongoing regulation by Companies House. Tax computations and returns would need to be filed within the required deadlines in addition to any payments of tax;
1.1.10	A CLS is subject to tax on any profits or gains generated from its activities;
1.1.11	For Corporation Tax purposes all transactions with 'connected parties' would need to be undertaken on an arm's length basis;
1.1.12	Mutual Trading Status would be difficult to achieve therefore all income and gains would likely be taxable where a CLS is used;
1.1.13	To the extent that the CLS has any 75% owned subsidiaries, they would form a group for group relief purposes, allowing the sharing of tax losses between companies in the same accounting period.
1.1.14	A CLS can have very wide objects (unless these are limited in the company's articles);

Business Considerations

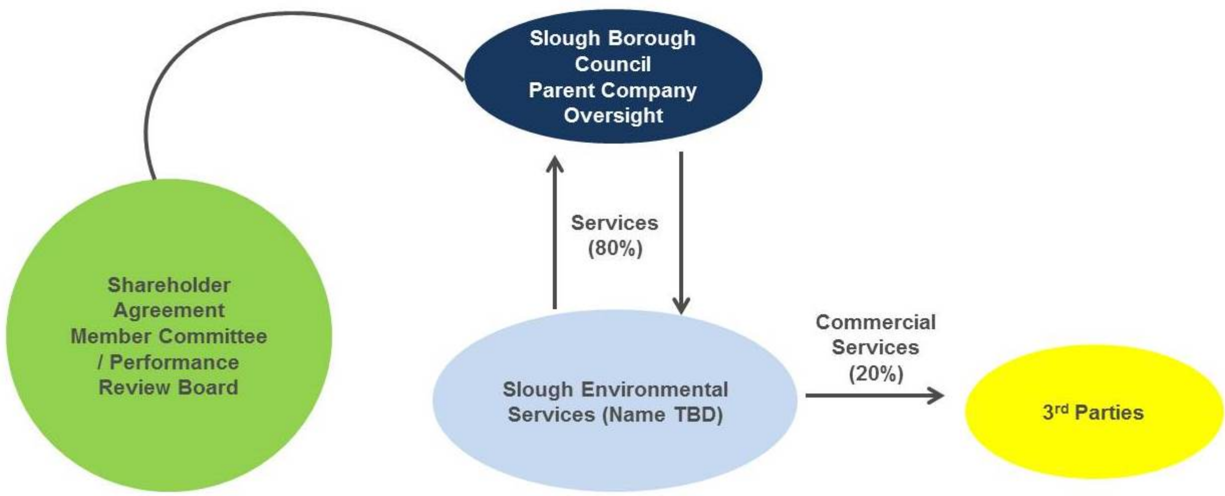
In terms of overall control and also financial and tax planning, the structure of a limited company provides considerable flexibility through the creation of different types of share and loan capital.

It is also simple to admit new shareholders if the Council wishes in the future to make the company a joint venture vehicle (for example, to introduce another local authority to create a joint Teckal company capable of providing similar services to that second authority).

This is reinforced in the diagram below:



A shareholder agreement would set out the relationship between the Council and NewCo in more detail (see Section 5.8 of Cabinet Report and Section 1.25 of Appendix A) and as reinforced in the diagram below;



Option 2 - A company limited by guarantee (CLG): A company limited by guarantee (CLG) is a company where the general members do not hold shares, but instead each member undertakes to pay a nominal figure (usually £1) in the event of the company becoming insolvent. If the company is to be a wholly-owned subsidiary, the Council would initially be the sole member; but a company limited by guarantee can have many members and different categories of members with different voting rights. Changing from a single member company to one with many members is also straightforward.

This form of company is often adopted for charitable or community interest activities. This is rarely used as a vehicle for undertaking commercial activity.

Table 1.2 – A company limited by guarantee (CLG)

A company limited by shares (CLS)	
Key features	
1.1.15	As with a CLS, a CLG may have wide objects unless its member guarantors wish to limit them in the company's constitution. For example, the Council may wish to limit the objects to certain purposes only;
1.1.16	CLGs are usually not for profit organisations but they do not have to be;
1.1.17	In the same way as a CLS, a CLG is a separate legal entity and has limited liability. However, instead of a capital contribution each member guarantor undertakes to pay a nominal figure (usually £1 (one pound)) in the event of any insolvency on the part of the company;
1.1.18	A CLG is similar in structure to a CLS except that its member guarantors do not hold shares in the company;
1.1.19	In constitutional terms a CLG has the benefit of similar levels of flexibility as a CLS;
1.1.20	If a CLG is established as a "for profit" organisation then it is possible to include a provision in its constitution which will describe how profits will be distributed to its member guarantors;
1.1.21	It is relatively inflexible and cannot be used to attract investment or external equity (shareholder) funding later in its life. This may limit the funding options available for a CLG, particularly in relation to funding working capital;
1.1.22	In the first instance, a CLG would be subject to tax on any profits or gains generated from its activities;
1.1.23	Tax computations and returns would need to be filed within the required deadlines in addition to any payments of tax;
1.1.24	To the extent that NewCo has any 75% owned subsidiaries, they would form a group for group relief purposes.
1.1.25	As with a CLS, a CLG may have wide objects unless its member guarantors wish to limit them in the company's constitution. For example, the Council may wish to limit the objects to certain purposes only;
1.1.26	CLGs are usually not for profit organisations but they do not have to be;
1.1.27	In the same way as a CLS, a CLG is a separate legal entity and has limited liability. However, instead of a capital contribution each member guarantor undertakes to pay a nominal figure (usually £1 (one pound)) in the event of any insolvency on the part of the company;
1.1.28	A CLG is similar in structure to a CLS except that its member guarantors do not hold shares in

	the company;
1.1.29	In constitutional terms a CLG has the benefit of similar levels of flexibility as a CLS;

Business Considerations

The main benefit over a CLS is that Mutual Trading Status may apply which would exempt from Corporation Tax any trading profits arising from services provided to the Council.

The benefits of Mutual Trading Status will depend on the nature and role of NewCo and, therefore, its level of profitability. If the external trading activities (with parties other than the Council) are minimal, the Corporation Tax benefits of a CLG and Mutual Trading Status may be relatively small and could be outweighed by the commercial and operational disadvantages of a CLG as set out above. If the activities are more significant, the cost benefit of an exemption from Corporation Tax is likely to be larger and may outweigh any possible downside.

Based on the Councils ambitious commercial aspirations a company limited by shares is the most appropriate vehicle for NewCo. A company limited by shares could be established within a week, using an ‘off the shelf’ articles of association, with the Council as its sole shareholder. The articles can then be tailored to reflect the Council's requirements in due course.

Section 2: Legal framework governing local authority controlled companies

Wholly owned local authority companies are subject to specific rules and restrictions with regard to their management and governance. NewCo is likely to be classified as a local authority controlled company, and therefore subject to the following propriety controls.

Table 1.3 – Legal framework governing local authority controlled companies and the implications of the Council establishing NewCo

Legal framework governing local authority companies and the implications of the Council establishing NewCo	
Propriety Controls	
1.1.30	The Council's participation in NewCo must be identified on the company's official business stationery;
1.1.31	Directors' remuneration and expenses should not be excessive;
1.1.32	Disqualified Councillors are not permitted to act as directors;
1.1.33	NewCo may not engage in party political publicity;
1.1.34	NewCo must provide information on request to the Councillors at meetings of the Council;
1.1.35	NewCo must provide financial information to the Council's auditor;
1.1.36	NewCo's auditor must be approved by Public Sector Audit Appointments Limited);
1.1.37	Minutes of NewCo's meetings must be open to public inspection;
1.1.38	Where a company qualifies as a local authority controlled company, it may in due course become an "arm's length company" if before the start of a financial year, the Council resolves that the company is an arm's length company and at all times from the date of the resolution to the end of the financial year in question:
1.1.39	Each of the directors is appointed for a fixed term of at least 2 years;
1.1.40	No director has been removed by shareholder resolution at a general meeting;
1.1.41	Not more than one-fifth of the directors are officers or members of the Council (or have been members in the preceding five years);
1.1.42	The company has not occupied (as tenant or otherwise) any land owned by the Council other than at the best consideration reasonably available;
1.1.43	The company has entered into an agreement with the Council that it will use its best endeavours to produce a specified positive return on its assets;
1.1.44	Except for the purpose of enabling the company to acquire fixed assets or provide it with working capital, the Council has not lent money to the company or guaranteed any sum borrowed by it or subscribed for any securities in the company;
1.1.45	The Council has not made any grant to the company during the financial year; and
1.1.46	The Council has not made any previous grant to the company the amount of which is in any way related to the financial results of the company in any period.