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Key legal considerations when establishing an employee-owned entity to deliver public sector services

Resource type: **Checklist**

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A non-exhaustive checklist of legal considerations when establishing a new employee-owned entity to undertake the delivery of certain public sector services.

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Preliminary questions about externalisation

- ❑ Establish what benefits externalisation of the service will bring to:
 - ❑ service users;
 - ❑ employees; or
 - ❑ the public body.

For example, what improvement or innovation can the employee-owners bring to the service that the public body is unable or unwilling to make?

- ❑ Establish whether the public body has the power to transfer the service to an external entity. For more information, see Practice notes:
 - ❑ *Central government: sources of powers* (www.practicallaw.com/2-384-0545);
 - ❑ *The well-being power under the Local Government Act 2000* (www.practicallaw.com/8-383-9997); and
 - ❑ *Local government: powers to participate in external organisations* (www.practicallaw.com/1-503-6282).
- ❑ Consider the statutory duties that apply to the service(s) that are being transferred and assess whether an employee-owned entity is the best option to discharge those duties.
- ❑ Identify the contracts, liabilities, property, other assets and staff that comprise the undertaking that will be transferred (see *Practice notes, Due diligence in outsourcing* (www.practicallaw.com/2-381-2359) and *Due diligence: joint ventures* (www.practicallaw.com/8-380-8651)).

- ❑ Identify the working practices and other commercial relationships that support the services' delivery.
- ❑ Identify the key stakeholders in the new entity's establishment.
- ❑ Consult the key stakeholders early and regularly during the process. For more information, see Practice notes:
 - ❑ *Duty to consult: when does it arise and what does it entail?* (www.practicallaw.com/0-507-0974);
 - ❑ *Public sector equality duties* (www.practicallaw.com/2-503-2716); and
 - ❑ *TUPE (6): obligations to inform and consult* (www.practicallaw.com/5-380-7945).
- ❑ Consider engaging:
 - ❑ the relevant professional bodies;
 - ❑ other local service providers; and
 - ❑ the elected members, if the public body is a local authority.
- ❑ Consider whether the new entity could share resources or premises with the public body and how any resource sharing or collaboration could be managed (see *Shared services and partnership working toolkit* (www.practicallaw.com/1-503-6705)).
- ❑ Conduct a preliminary analysis of whether an employee-owned entity is a viable means of service delivery, considering the nature of the service(s).

Business case for the establishment of the entity

- ❑ Use the preliminary analysis to develop a business plan. Account for the fixed costs and overheads (including insurance) currently carried by the public body.
- ❑ Determine whether the new entity will be dependent on the public body or more than one public body for services contracts. What would the impact on the entity be if those contracts were:
 - ❑ not forthcoming;
 - ❑ time limited; or
 - ❑ subject to onerous conditions?

- ❑ Consider the amount of funds the public body can contribute to the new entity in both start-up and ongoing costs.
- ❑ Explore alternative sources of funding. For example:
 - ❑ could the new entity apply for grant funding from trusts and foundations, or secure investment from social investors (see *Standard document, Grant agreement* (www.practicallaw.com/8-502-7825));
 - ❑ consider whether the entity will have any assets over which it can secure borrowings (see *Quick guide, Methods of raising debt finance and Corporate loan facilities: a quick guide* (www.practicallaw.com/5-381-1297)); and
 - ❑ if the new entity will be seeking investment from community members, financial services regulation may be engaged and specialist advice will be required.
- ❑ Consider a range of sources of income for the new entity. As well as service contracts, could the new entity undertake other income-generating activities, such as offering services to self-funding service users, or running training or events and charging subscriptions for membership, as the case may be?
- ❑ Consider the new entity's liability for tax. Could the new entity be structured as a charity and benefit from charitable tax breaks? (See *Practice note, What is a charity?* (www.practicallaw.com/6-503-5888))?

For more information on key questions to address when appraising the business case, see *Practice note, Mutualising public services: Assessing the business case for mutualisation* (www.practicallaw.com/7-507-2663).

Legal structures

- ❑ Will the legal form of the vehicle be:
 - ❑ a company limited by shares (see *Company formation and constitution topic* (www.practicallaw.com/2-103-1146));
 - ❑ a company limited by guarantee (see *Practice note, Companies limited by guarantee* (www.practicallaw.com/3-382-2683));
 - ❑ an industrial and provident society;
 - ❑ a community interest company, which can be structured as a company limited by guarantee or a company limited by shares (see *Practice note, Community interest companies: CICs* (www.practicallaw.com/5-384-0836)); or

- ▣ a charitable company limited by guarantee that registers with the Charity Commission.
- ▣ Consider the extent to which the potential risks to individual directors can be managed by establishing an incorporated vehicle (see *Practice note, Directors' general duties under the Companies Act 2006* (www.practicallaw.com/7-376-4884)).
- ▣ Consider how the "social mission" of the new entity will be protected by the constitution. For example, could the:
 - ▣ new entity's objects (that is, its purposes) be limited; or
 - ▣ assets of the new entity be protected by an asset lock to prevent assets from being sold at an undervalue and ensure assets are used for the benefit of the community (see *Practice note, Social enterprises: legal structures* (www.practicallaw.com/2-502-5669))?

Remember the constitution must also be sufficiently flexible to permit the entity to take advantage of any business opportunities that may arise.

- ▣ Consider how the new entity will access finance and the implications on the legal structure.
- ▣ Can tax liabilities be avoided or reduced by adopting charitable status (see *Practice note, What is a charity?* (www.practicallaw.com/6-503-5888))?

Tax breaks for charities include:

- ▣ exemption from income tax, capital gains tax and corporation tax on profits (although profits may only be used to achieve the charity's purposes);
 - ▣ exemption from paying stamp duty land tax on properties purchased;
 - ▣ 80% rate relief (for properties that are completely or mainly used for charitable purposes); and
 - ▣ eligibility for gift aid on donations.
- ▣ Will any directors of the new entity receive a salary?
- ▣ Consider the formalities that are required for establishing the relevant structure, including registration requirements and how long this is likely to take.

For further information, see *Practice note, Social enterprises: legal structures* (www.practicallaw.com/2-502-5669).

Charitable status

- ❑ If the new entity is established as a charity, consider the extent to which its activities will be charitable, as defined by law.
- ❑ Remember charity law will apply and the new entity will be regulated by the Charity Commission (see *Practice note, Charity Commission inquiries and regulatory compliance casework: overview* (www.practicallaw.com/3-506-0921)).

Governance

- ❑ How will the key stakeholders be integrated into the legal structure?
- ❑ Consider who will sit on the board of directors (or trustees) of the new entity.
- ❑ Who will the members be?
- ❑ How much involvement does the public body want?
- ❑ If the new entity will have a trading subsidiary, consider how it will be governed.

For more information, see Practice notes:

- ❑ *Partnership working between the public sector and the third sector* (www.practicallaw.com/5-502-5700).
- ❑ *Mutualising public services* (www.practicallaw.com/7-507-2663).
- ❑ *Local government: appointment of members and officers to external organisations* (www.practicallaw.com/3-503-6323).

Establishing and running the separate entity

- ❑ Allow time in the planning of the transfer for registration with Companies House and an application to the Charity Commission or community interest companies' regulator to be prepared and processed.
- ❑ Ensure establishment costs are accounted for, including:
 - ❑ company registration fees;
 - ❑ acquiring premises and equipment;
 - ❑ establishing office management, human resources, information technology and other

systems; and

- ▣ expert financial, legal and other consultancy advice.

- ▣ Decide who will be the:
 - ▣ bankers;
 - ▣ auditors;
 - ▣ accountants;
 - ▣ insurers; and
 - ▣ legal advisers.

- ▣ Decide who will manage the company registers.

- ▣ Ensure the new entity has the insurance policies that are required by law, as well as any other policies it needs.

- ▣ Ensure the necessary human resources, Pay as You Earn and other staff-management systems are in place (see *Standard document, Staff handbook* (www.practicallaw.com/8-386-8683)).

- ▣ Consider the systems that are needed to ensure the new entity satisfies any other regulation it is subject to. For example, data protection, and safeguarding children and vulnerable adults (see *Practice notes, Safeguarding Vulnerable Groups Act 2006* (www.practicallaw.com/7-500-6748) and *Data sharing and data security* (www.practicallaw.com/8-384-0929)).

For more information, see *Company formation and constitution* (www.practicallaw.com/2-103-1146).

Due diligence before the transfer

- ▣ Undertake a comprehensive due diligence exercise of the contracts, liabilities, property, other assets and staff that were identified during the preliminary stages of the project.

- ▣ Critically review:
 - ▣ the title documents to any properties;
 - ▣ employee service agreements;

- ❑ any key service delivery support contracts; and
- ❑ all other pertinent documents.

For more information, see *Practice note, Due diligence and post-completion integration: acquisitions* (www.practicallaw.com/6-107-3752) and *Checklist, Due diligence: asset purchases* (www.practicallaw.com/7-100-1854).

Treatment of premises, assets and liabilities

- ❑ Consider how the entity will hold any property. Will the public body continue to hold the freehold or leasehold and lease, licence or sublet the property to the new entity?
- ❑ Consider what will happen to any existing contracts with suppliers. For example:
 - ❑ will the contracts terminate;
 - ❑ can the contracts be assigned (see *Practice note, Contracts: assignment* (www.practicallaw.com/7-381-7509)); or
 - ❑ can the contracts be novated (see *Practice note, Contracts: novation* (www.practicallaw.com/5-381-7510))?
- ❑ To what extent will the new entity have access to or rights over confidential information, know-how and other intellectual property rights belonging to the public body after the transfer? For example:
 - ❑ consider the intellectual property rights that will be needed for the new entity to operate (see *Practice note, Intellectual property: overview* (www.practicallaw.com/8-383-4565)); and
 - ❑ will these rights be transferred to the new entity or will the new entity licence these rights from the public body?
- ❑ Consider tangible property (such as equipment).
- ❑ Consider ongoing liabilities.

Staff

- ❑ Consider how many staff will transfer and conduct thorough due diligence of the terms of their employment. For example:

- ❑ Consider the risk that the public procurement rules may apply, if the public body intends to award a contract to the new entity. If the rules do apply and the public body intends to advertise the contract, consider how the new entity could submit a valid tender and the consequences of failing to win the tender. For more information, see *Quick guide, Public procurement in the UK* (www.practicallaw.com/9-386-0686).
- ❑ Consider the risk of breaching the rules against state aid, if the public body will be offering assistance to the new entity with establishment costs or working capital. For more information on state aid, see *Checklist, State aid* (www.practicallaw.com/4-384-0525).
- ❑ Consider any tax and accounting implications.

Documents: transfer deed and services contract

- ❑ Negotiate how the contract will allocate risk between the public body and the new entity.
- ❑ Assuming there is a contract for services between the public body and the new entity, define the service(s) the new entity will deliver as precisely as possible.
- ❑ Consider including a schedule listing the assets, including any intellectual property rights, property, contracts and staff that comprise the undertaking.
- ❑ Ensure the new entity is protected by warranties from the public body, including in relation to the transferring staff, intellectual property rights and other assets.
- ❑ Include provisions for assigning and subcontracting, if appropriate.
- ❑ Ensure the contract includes procedures for the event of contractual breach.
- ❑ Consider including an "exit management plan", to ensure consistent standards of service delivery if the contract is terminated.
- ❑ Consider the term of any service delivery contracts, to give the entity sufficient stability to encourage investment.

Resource information

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This resource is maintained, meaning that we monitor developments on a regular basis and update it

as soon as possible.

Resource history

Resource created

We will track here amendments to this resource that reflect changes in law and practice.

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