Halfway between profit and non-profit: where are we going?

Profit distribution: Community Interest Companies vs (new) Italian Social Enterprises

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Abstract

Le *Community Interest Companies* sono tradizionalmente considerate uno dei modelli ibridi d'impresa, essendo da sempre ammesse alla distribuzione di utili.
Pur lasciandone inalterata l'ossatura fondamentale, anche la recente riforma delle imprese sociali italiane (d.lgs. n. 112 del 2 luglio 2017) ha introdotto per queste imprese una (limitata?) possibilità di distribuire dividendi ai soci. Per tale via sembrerebbe essersi realizzato il passaggio verso un modello d'impresa sociale ibrido, non dissimile dalle *Community Interest Companies* inglesi.
In effetti, una comparazione tra il consolidato modello di distribuzione dei profitti delle *Community Interest Companies* inglesi e quello delle imprese sociali italiane, alla prima esperienza di *low profit* non legata alla cooperazione sociale, dimostra, nonostante le differenze, una comune tendenza ibrida dei modelli.
Viste in quest'ottica, le "nuove" imprese sociali sembrano potersi inserire in un *trend* che parrebbe spingere - tanto dal lato profit, quanto da quello no-profit - verso modelli ibridi, che coniughino il profitto con il perseguimento di obiettivi d'interesse generale (con una prevalenza, a seconda del modello, ora del primo, ora dei secondi).

1. Introduction. In the last decades, Social Enterprise (hereafter, "SE" and, in plural, "SEs") has become increasingly important all over the world[1]; Europe was not an exception[2].

[1] Indeed, the concept of SE has spread in most regions of the world (DEFOURNY, NYSSES 2012).
[2] Already in 2011, the European Commission underlined that «*the single market needs new, inclusive growth, focused on employment for all, underpinning the growing desire of Europeans for their work, consumption, savings and investments to be more closely attuned to and aligned with 'ethical' and 'social' principles*» and that there are «*high levels of interest in the capacity of social enterprises and the social economy in general to provide innovative responses to the current economic, social and, in some cases, environmental challenges by developing sustainable, largely non-exportable jobs, social inclusion, improvement of local social services, territorial cohesion, etc.*» (EUROPEAN COMMISSION 2011).

However, the notion of SE is not a unitary one. Admittedly, there are different models and different approaches and, throughout the years, many notable scholars have compared them and tried to identify some common traits (see, for example, TRAVAGLINI, BANDINI, MANCINONE 2009; CAFAGGI, IAMICELI 2008; CECOP 2006; KERLIN 2006; IAMICELI 2005).

Among the various aspects of SEs that are interesting from a business law perspective (e.g. activities to carry out, corporate governance, stakeholders' participation) and on which the legislations of the different legal systems have made different choices, the relationship between profits and "social" purposes is one of the most stimulating.

In fact - generally speaking, and not only with reference to SEs - there has traditionally been a clear distinction between non-profit legal entities on one side, for profit ones on the other.

As has been observed (BATTILANA *et al*. 2012), for a long time it was thought that commercial revenue and social value creation were independent. In the last decades, however, we are experiencing an increasing thriving of "hybrid entities" and this movement is referred to as "creative capitalism" (TAYLOR 2009/2010). There is no general definition of hybrid entities, but, in a nutshell, they try to combine the creation of social value with the production of financial revenues (i.e. they are not completely for profit, nor purely non-profit[3]). Of course, as will be discussed, depending on the specific legal structure of the entity, there may be a prevalence of the for-profit side or of the non-profit one.

In general, hybrid entities have been identified as those occupying the middle ground between non-profit and for-profit, combining aspects of both models (SERTIAL 2012; REISER 2010).

As mentioned above, hybrids should allow the creation of social value with the production of financial revenues. However, the exact meaning of financial revenues has nonetheless to be clarified. In fact, what should be relevant in order to consider a legal entity as a hybrid is not profit making itself, but rather

[3] It has to be underlined that the hybridization does not merely refer to profits as it invests also other profiles, such as the entity's purpose and its governance model.

the possibility to distribute it, whether partially or not, to its shareholders or members. Otherwise, if profit making were the only relevant factor, one would reach the paradoxical conclusion that purely non-profit entities are hybrids because, although they cannot distribute profits, they are nevertheless allowed to generate revenues[4].

Instead, what specifically characterizes nonprofits is not only their specific activity - which is of general interest - but also (and especially) the fact that the activity is not carried out for the benefit of their members.

In Italy, since their introduction in 2006, SEs have been regarded as purely non-profit and, hence, they could not be considered hybrids. However, in July 2017, a reform of SEs was enacted as part of a more general reform of the Italian Third Sector.

This paper analyzes the UK Community Interest Company (hereinafter, "CIC" and, in plural, "CICs") model, which is a typical hybrid legal structure (CABRELLI 2016; SERTIAL 2012). Following an overview of CICs (par. 3), in order to understand the hybrid nature of CICs, the analysis will specifically focus on the provision regarding their assets (par. 3.2), profit distributions (par. 3.3) and interest payments (3.4).

Moving on to the Italian SEs, following a general overview (par. 4), in order to fully appreciate the new model of SEs, the former is recalled (par. 4.1). In par. 4.2 the new legal framework is analyzed, with a specific focus on profit distribution.

[4] A confirmation of this may be found in the new Italian Third Sector Code (Legislative Decree no. 17 of 3 July 2017). According to Article 4 (1), Third Sector entities are some private organizations (e.g. associations, foundations, SEs etc.) set up in order to pursue, without profit, civic, solidarity and social utility purposes by carrying out one or more activities of general interest. Article 8 (1) provides that the assets of these entities and their profits, if any, shall be allocated to the activity of the entity and exclusively in order to pursue civic, solidarity and social utility purposes, thus letting understand that profit making is possible also for such entities. Article 8 (2) specifies that the direct or indirect distribution of profits is prohibited.
In the U.S. too one of the notable features of nonprofits is not the fact that they are not making profits at all, but rather the fact that they do not distribute them to their shareholders or members. For example, Section 501(c)(3) of the Internal Revenue Code, in setting out the criteria for tax exemption, specifies that corporations, community chests, funds, or foundations, organized and operated exclusively for some specified purposes (e.g. religious, charitable, scientific), «*no part of the net earnings of which inures to the benefit of any private shareholder or individual*» shall be tax exempt.

Lastly, some conclusions are drawn (parr. 5 and 6).

2. Narrowing the concept of Social Enterprise. Before analyzing CICs, it has to be understood whether they may be somehow considered equivalent to a SE; therefore, it is necessary to identify what is meant by SE at a European level.

Even though SEs have in the last decades become increasingly important, especially in Europe, the definition of an SE does not seem to be fixed. Admittedly, notwithstanding the progressive development of a common meaning across Europe (EUROPEAN COMMISSION 2016), the definitions of SE continue to encompass, in the language of Member States' legislators and academics, a great variety of legal entities carrying out different activities.

However, regardless of these differences, and limiting the analysis to Europe, it seems possible to identify some common traits (FICI 2017)[5]. To this end, the definition of SE provided in the European Commission Communication "Social Business Initiative" of 2011 is particularly relevant. According to this definition, a SE is «*an operator in the social economy whose main objective is to have a social impact rather than make a profit for their owners or shareholders*». Furthermore, «*it operates by providing goods and services for the market in an entrepreneurial and innovative fashion and uses its profits primarily to achieve social objectives*» and «*it is managed in an open and responsible manner and, in particular, involve employees, consumers and stakeholders affected by its commercial activities*».

Hence, SEs have, at least, three specific features.

[5] It is worth mentioning that, at a EU level, it was identified a tendency to mix two different approaches which refer to two distinct phenomena (EUROPEAN COMMISSION 2016). The first attempts at identifying the key-features of SEs, whereas the second - «social entrepreneurship» - tends to focus more on entrepreneurial dynamics which are oriented to social innovation and social impact. The first approach is the most used in Europe (EUROPEAN COMMISSION 2016) and the definitions provided by Member States' legislations are of two types: either "organizational" (i.e. they focus on the specific features showed by SEs) or "sector-specific" (i.e. they rather look at specific types of organizations which carry out their activities in the field of social inclusion).

Firstly, they generally have an exclusive - or, at least, prevalent - “social” purpose (i.e. aim at providing a benefit to the community or, however, pursue a general interest).

Secondly, their activity is carried out in an innovative and entrepreneurial way, and SEs are managed in an open and responsible manner and involve stakeholders: obviously this does not mean that traditional companies are not managed in such a way, but SEs are subjected to additional managing and governance requirements (see also FICI 2017).

Thirdly, profit distribution is excluded or somehow limited; in fact, its profits and assets must be totally or partially reinvested in its activity.

Thus, as far as profit distribution is concerned, SEs are not necessarily non-profit. What matters, in fact, is that their profits are primarily - not exclusively - used to achieve social objectives. It follows that legislations on SEs have mainly two options: they either envisage a clear prohibition for SEs to distribute profits to their members and interests to their investors, or they require SEs to use their profits mainly for their social activity, but leaving some space for the remuneration of shares, bonds and other instruments. Thus, the fact that CICs can distribute profits (see par. 3.3) doesn’t prevent them from being considered as SEs (provided, of course, that they show all the other above-mentioned features of SEs).

Behind the two options lie two approaches.

On one side, the non-profit nature of a legal entity, has generally been considered necessary in order to ensure that the users and the general public trusted those enterprises, whose business was carried out for social and solidarity purposes (e.g. HANSMANN 2003; for further details see par. 4).

On the other, however, it cannot be denied that for social issues to be efficiently and effectively faced economic resources are needed. Therefore, SEs - like other legal entities, such as, typically, companies - may have the need to make themselves more appealing to investors.

While CICs have since their introduction in 2005 adopted this latter approach - and, actually, the most recent modifications continued on this path

by removing some of the existing limits to profit distributions (see *infra*, par. 3.5) - Italian SEs, on the contrary, have always adopted a purely non-profit approach, at least until the 2017 reform.

3. Community Interest Companies and community interest test. As far as social entrepreneurship is concerned, the UK has traditionally been a pioneer. According the last data, there are approximately 70,000 SEs in the country[6].

In the UK a SE may be set up in the form of a limited company, of a charity (or from 2013, a charitable incorporated organization), of a co-operative, of a sole trader or business partnership, or of a CIC. Among the various, the CIC form seems the most interesting. Admittedly, on one hand this is a type of company which was specifically designed for the social sector; on the other, since its establishment in 2005 it has been constantly increasing in number: as of 11 January 2018, there more than 13,000 CICs set up in the UK[7].

The CIC legal form was introduced with the "*Companies (Audit, Investigations and Community Enterprise) Act 2004*" (hereinafter, the "2004 Act")[8] and is further regulated by the 2005 "*Community Interest Company Regulations*" (hereinafter, the "2005 Regulations").

A company limited by shares or a company limited by guarantee without a share capital may both be formed as or become a CIC. A company limited by guarantee and having a share capital may become CIC[9].

[6] See the *"State of Social Enterprise Report 2017*", available at https://www.socialenterprise.org.uk/the-future-of-business-state-of-social-enterprise-survey-2017

[7] See https://www.gov.uk/government/organisations/office-of-the-regulator-of-community-interest-companies. Moreover, the number seems to be constantly growing: in January 2018 approximately 220 new CICs. Were set up. See https://www.gov.uk/government/statistics/community-interest-companies-new-cics-registered-in-october-2013.

[8] The provisions relating to the appointment of the regulator of CICs entered into force on the 1 January 2005 while the remaining provisions relating to CICs on 1 July 2005.

[9] See section 26 of the 2004 Act.

The 2004 Act has introduced an *ad hoc* office, the Regulator of CICs (so-called regulator), appointed by the Secretary of State and which is entrusted with some functions and powers referring to CICs[10].

A CIC has to operate for the benefit of a community. Neither the 2004 Act, nor the 2005 Regulations identify the concept. Rather, they use a different approach. The former states that, in order to become a CIC, the activities that it wants to perform have to satisfy the so-called community interest test, and this happens if «*a reasonable person might consider that its activities are being carried on for the benefit of the community*»[11]. The latter, identifies the activities that cannot be regarded as those which a reasonable person might consider are carried on for the benefit of the community[12].

It is worth observing two profiles.

First, the community interest test is a flexible criterion and it has the advantage of not limiting *ex ante* the activities that a CIC may carry out. Any activity can be carried out by a CIC, provided that a reasonable person would think that it was performed for the benefit of the community. Nevertheless, it raises some doubts. For instance, the law does not clarify the meaning of "reasonable person". Traditionally, in the common law world (similarly to, for example, Italy) this standard refers to a hypothetical ordinary and reasonable person, the so-called *Man on the Clapham omnibus*. However, it has been observed (CABRELLI 2016) that arguing that the criterion has the same meaning within the CIC frameworks would be mere speculation.

[10] See section 27 of the 2004 Act. For example, the regulator decides whether or not a new company is eligible to be formed as a CIC, may issue guidance, or otherwise provide assistance, about any matter relating to CICs; may consent to the transfer of the assets during CIC's life (*infra* 3.2); in windings-up, under some conditions, decides on the amount and proportion of asset distributions to asset-locked bodies (*infra* 3.2).

[11] See section 35 (2) of the 2004 Act.

[12] These activities include (i) the promotion of, or the opposition to, changes in any law applicable in Great Britain or elsewhere or in the policy adopted by any governmental or public authority in relation to any matter; (ii) the promotion of, or the opposition (including the promotion of changes) to, the policy which any governmental or public authority proposes to adopt in relation to any matter; and (iii) activities which can reasonably be regarded as intended or likely to provide or affect support (whether financial or otherwise) for a political party or political campaigning organization or influence voters in relation to any election or referendum. See section 3 of the 2005 Regulations.

Secondly, the activities identified by the law as those which a reasonable person cannot consider as performed for the benefit of the community, may nevertheless be carried out by a CIC if two conditions are met. First of all, they have to be reasonably regarded as incidental to other activities, which a reasonable person might consider are being carried on for the benefit the community. In addition, these other activities do not have to be reasonably regarded as incidental to those that the law regards as not performed for the benefit of the community (on which see footnote no. 12). The concept of "reasonable person" plays, again, a key role and doubts similar to the above-mentioned are likely to arise.

Moreover, it is worth observing that the term "community" could also mean just one section of the community[13]. Any group of individuals may constitute a section of the community if (i) they share a readily identifiable characteristic; and (ii) other members of the community of which that group forms part do not share that characteristic[14]. Thus, for the purpose of CIC, not only does a group of people have to share some common, readily identifiable characteristics - which raises some doubts with reference, for example, to the minimum degree of similarity of the features - but their common characteristics must not be shared by other members of the community.

Furthermore, CICs have to be managed in a manner that allows the stakeholders' interests to be taken into account[15].

It should already be clear, then, that CICs are SEs. In fact, they have the first two distinctive features of the definition of SE provided above. The framework on profit distributions still has to be analyzed nevertheless.

3.1 More than non-profit, less than for profit. As mentioned, CICs carry out their activity for the benefit of the community. Therefore, there is a marked difference between them and purely profit-driven companies whose

[13] See section 35 (5) of the 2004 Act.
[14] See section 5 of the 2005 Regulations.
[15] For instance, the CICs' annual report has to describe the steps which the company has taken during the financial year to consult persons affected by the company's activities, and the outcome of any such consultation (see section 26 (b) of the 200 Regulations)

main purpose, in a nutshell, is maximizing - or, at least, pursuing - profits to be distributed as dividends among the shareholders.

CICs may distribute profits and pay interests; however, this has to be balanced with the need that the benefit community remains their «core business». To this aim, the law sets some limits to CICs' ability to transfer their assets, to distribute dividends, and to pay interests.

3.2 The asset-lock. The asset-lock is a specific feature of CICs and it is meant to ensure that their assets are not used for purposes other than the benefit of the community.

A CIC is not allowed to transfer assets other than full consideration (i.e. their market value)[16]. Conversely, an asset disposal made at the assets' market value would be legitimate. Admittedly, in such cases, even though the CIC is transferring its assets, it is nevertheless retaining their market value and, thus, this does not have any negative impact on the benefit community purpose.

The full market criterion does not apply when the assets are transferred (i) to any specified asset-locked body, or (ii) with the consent of the regulator, to any other asset-locked body. Both options refer to asset-locked bodies, although the first deals with those specified in the memorandum or articles of association of the company, whereas the second one deals with those not specified, but to which the CIC may nonetheless, with the consent of the regulator, transfer its assets[17].

The possibility to transfer assets to asset-locked bodies is justified by the fact that such entities include other CICs, charities, or bodies established outside the UK that are equivalent to any of these entities. In other words, bodies that have objectives similar to those of the CIC transferring its assets.

[16] See section 1 of Sch. 1-2-3, 2005 Regulations.
[17] See section 1 of Sch. 1-2-3, 2005 Regulations. Of course, the consent of the regulator is required only for the situations in which the transfer is made for a value lower than the full market value of the assets.

As will be observed in more detail, transfers to asset-locked bodies have an indirect impact on the amount of profits distributable to shareholders (see *infra*, par. 3.3).

Lastly, the transfer of assets is also legitimate if it is made in a way that, although not involving a transfer of assets to an asset-locked body, it is nevertheless made for the benefit of the community.

This mechanism ensures that CIC's assets are used for the benefit community while a CIC is operating.

What about other situations, such as winding-ups? The law ensures that the asset-lock works also in such cases, both with reference to voluntary winding-ups and to those decided by a court pursuant to the Insolvency Act 1986[18].

If a winding-up is declared and, after having satisfied the company's liabilities, there are some assets of the company left, these residual assets shall be distributed to those members of the CIC (if any) who are entitled to share in any distribution of assets on the winding-up of the company according to their rights and interests in the company[19].

If even after such distribution there are residual assets left, they shall be distributed to the asset-locked body (or bodies), if any, specified in the memorandum or articles of the company. In this case the regulator will decide the amounts and proportions to be distributed.

However, it might be the case that the asset-locked body to which the memorandum or articles of the company refer is itself in the process of being wound up. Or, it may also be that a member or director of the company represents to the regulator that this asset-locked body is not a suitable recipient of the CIC's remaining residual assets and that the regulator agrees with these representations.

[18] See section 23 of the 2005 Regulations.
[19] In any case, no member shall receive an amount exceeding the paid-up value of the shares which he holds in the company.

In such situations - and also if the memorandum or articles of the company do not specify an asset-locked body - the regulator will decide to which asset-locked bodies and in which proportions the assets are to be distributed.

However, for any of its determinations, the regulator has to consult with the directors and give notice of any regulation to the company and to the liquidator[20].

3.3 Dividend distributions. As far as dividends are concerned, a complex system based on three elements - the maximum dividend per share, the maximum aggregate dividend (hereinafter, the "m.a.d.") and the capacity to carry-over unused dividend payments for up to 5 years - used to be in place. However, as of October 2014, in order to simplify the system, the maximum dividend per share and the capacity to carry-over unused dividend payments were removed[21]. Thus, today, the sole element regulating dividend distributions is the m.a.d.[22] [23].

A relevant company may distribute dividends only insofar as its memorandum and articles permit it to do so and if an ordinary or special resolution of the company's members has approved the declaration of the dividend.

[20] See section 23 (7) and (8) of the 2005 Regulations.

[21] An overview of the different opinions on the issue can be found in the consultation process documents, available at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/264664/CIC-13-1333-community-interest-companies-response-on-the-cic-consultation.pdf

[22] See "*Office for the regulator of Community Interest Companies*: *Information and guidance notice"*, Department for Business, Energy and Industrial Strategy, May 2016.

[23] Of course, the issue of dividend distributions arises only with reference to CICs set up as companies limited by shares (CIC with a share capital), adopting Schedule 3 of the 2005 Regulations (*Alternative provisions prescribed for the memorandum or articles of a community interest company limited by shares, or limited by guarantee with a share capital*). In fact, if a CIC is set up in the form of a company limited by guarantee without share capital it cannot pay dividends. Moreover, if a CIC is set up as a company limited by shares (CIC with a share capital), but it adopts Schedule 2 of the 2005 Regulations (*Provisions prescribed for the memorandum or articles of a community interest company limited by shares, or limited by guarantee with a share capital*) it is allowed pay dividends exclusively to specified asset-locked bodies, or other asset-locked bodies with the consent of the regulator. The amount of payable dividends is not subject to the dividend cap, but to those same limits applicable to ordinary companies.

Furthermore, and more importantly, following the declaration of the dividend, the total amount of all the dividends declared on shares in the company for the financial year for which the dividend is declared cannot exceed the m.a.d. for that financial year.

The understanding of m.a.d. is essential to fully appreciate to what extent CICs may distribute profits.

With reference to a given financial year, a m.a.d. is declared when the total amount of all dividends declared on the relevant company's shares for that year, less the amount of any exempt dividends, is equal to the "aggregate dividend cap" which had effect in relation to that company on the first day of the financial year in respect of which the dividends are declared[24].

There are two profiles of this definition that need to be stressed.

The first is that the exempt dividends are not taken into account for the m.a.d.'s purposes. A dividend declared on a share is considered exempt if at least one of the following conditions is met: the dividend is declared on a share which is held by an asset-locked body (excluding the situations involving a share that the directors recommending the dividend are aware is being held on trust for a person who is not an asset-locked body), or the dividend is declared on a share which is held on behalf of an asset-locked body (or is believed by the directors recommending the dividend to be so held).

The fact that dividends concerning shares owned by an asset-locked body (or held on its behalf) are not relevant for m.a.d.'s calculation is understandable if it is borne in mind what was said above (*supra* par. 3.2) on asset-locked bodies. Hence, when dividends refer to shares directly or indirectly held by these bodies, which have objectives somehow similar to those of CICs, the law excludes *a priori* the existence of a risk for the benefit community.

Furthermore, the asset-locked body by (or on behalf of which) the share on which the dividend declared is held (or on behalf of which the directors declaring the dividend believe that it is held) has to be named in the memorandum or articles of the company as a possible recipient of the CIC's

[24] See section 19 of the 2005 Regulations.

assets. If there are no indications, the regulator shall consent to the declaration of the dividend.

The other important element of the definition is the aggregate dividend cap, which is currently set at a level of 35% of a relevant company's distributable profits[25]. The expression "company's distributable profits" has to be read in accordance with the Companies Act 2006, which refers to a company's accumulated, realized profits, so far as not previously utilized by distribution or capitalization, less its accumulated, realized losses, so far as not previously written off in a reduction or reorganization of capital duly made[26].

Consequently, this mechanism forces CICs to reinvest in their activity no less than 65% of their annual profits[27]. The 35% cap identifies, however, the maximum level of distributable profits; it follows that a CIC may decide to distribute less than the cap and, consequently, reinvest more.

As mentioned, distributions to asset-locked bodies are not taken into account when calculating the aggregate dividend cap. This carries some important consequences in terms of distributable profits. Admittedly, if a company decides to distribute a certain amount of its profits to one of such bodies, this amount will be (i) uncapped; and (ii) deducted from the distributable profits. Therefore, in such situations, not only will the profits distributable to individual investors keep on being subject to the cap, but they will also be proportionally reduced[28].

[25] See section 22 (1) b) of the 2005 Regulations. Although the regulator may set a new aggregate dividend cap with the approval of the Secretary of State, the cap remained steady since the CICs' introduction.

[26] See section 830 of the Companies Act 2006.

[27] If, for example, a CIC has, for a given financial year, distributable profits for £150,000, it will be allowed to distribute a maximum of £52,500; thus, £97,500 will have to be reinvested.

[28] Consequently, in the example mentioned in the footnote above, the situation would be the following. A CIC may decide to distribute to an asset-locked body (e.g. another CIC) an uncapped dividend of, for instance, 70% of its distributable profits. Thus, the amount of profits distributable to individuals will be £45,000. Following this reduction, it will be the remaining amount to be subject to the 35% cap. Thus, in this example, only £15,750 are available for dividend distribution to individuals, whereas in the one made in footnote no. 27, absent a distribution to an asset locked body and with the initial same amount of distributable profits, the CIC could distribute £52,500.
A comparison of the two examples shows that the distribution of dividends to asset-locked bodies, because uncapped and exempt, has important consequences in terms of profits distributable to individuals.

3.4 Interest payments. Limits are set also on interest payments. To this aim, the so-called interest cap was introduced. The interest cap used to be 10% of the average amount of a CIC's debt, or sum outstanding under a debenture issued by it, during the 12-month period immediately preceding the date on which the interest on that debt or debenture becomes due[29].

However, in order to encourage more investments in CICs, as of October 2014, the interest cap was doubled and, hence, raised to 20%[30].

The interest cap applies to debentures issued by, and debts of, a CIC in respect of which a performance-related rate of interest is payable and provided that the agreement to pay interests at a performance-related rate was entered into by the company on or after the date on which it became a CIC.

For such debentures and debts, the CIC is not liable to pay interest at a higher rate than the applicable interest cap[31].

In order for the average amount of a debt or sum to be identified, the aggregate of the amount of the debt or the sum outstanding under the debenture at the end of each day during the 12-month period has to be divided by the number of days during that 12-month period[32].

4. Social Enterprises in Italy. According to the latest available data, in 2013 there were 774 private organizations in the "L" section (i.e. the SEs section) of the Italian register of undertakings and, thus, SEs, in Italy, do not seem to represent a significant phenomenon[33].

For further details and explanations, see Annex 1 to the *Office for the regulator of Community Interest Companies*: *Information and guidance notice* (footnote no. 22).

[29] See Schedule 4 of the 2005 Regulations.

[30] A complete overview of the different opinions on the issue can be found in the consultation process documents, available at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/264664/CIC-13-1333-community-interest-companies-response-on-the-cic-consultation.pdf

[31] See Section 21 of the 2005 Regulations.

[32] See Schedule 4 of the 2005 Regulations.

[33] See *Iris Network* report, 2014, available at http://irisnetwork.it/attivita/rapporto-impresa-sociale/. According to the report, slightly more than 100 of the approximately 770 SEs are mutual benefit societies which, in 2012, were obliged by law to register under the "L" section (Article 23 of Law Decree no. 221 of 18 October 2012). This was due not really to the fact that

Italian SEs could not distribute profits for long time. Admittedly, as will be observed, while SEs could obviously generate revenues, there has traditionally been a prohibition for them to distribute dividends. In general, such prohibitions have been deemed necessary in order to ensure that the users and the general public trusted those enterprises whose business was carried out for social and solidarity purposes (MOSCO 2017; HANSMANN 2003).

The non-profit was seen mainly as an effective form of consumer protection tool, especially in situations of asymmetric information (ORTMANN, SCHLESINGER 2002; HANSMANN, 1994). This theory moves from the idea that the contract, because of information asymmetries, fails in protecting the consumer from enterprises' abuses: in this context, then, the prohibition to distribute profits is meant to show to the consumers that the enterprise is not interested in taking advantage of such asymmetries in order to increase its profits (HANSMANN 1980)[34].

The social activity carried out by SEs not only implied that they should carry out their activity in specific sectors that the legislator considered socially useful, but also a prohibition on distributing the profits that SEs had possibly made through their activity (MARASÀ 2014).

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they had the features of SEs, but rather to the reform of the Italian register of the undertakings. Thus, the actual SEs are slightly more than 650.
As it will be said (*infra* in the text), the qualification of SE may be recognized to any private organization. The organization mainly adopted by SEs is the co-perative (38% of the total amount of SEs). Among the co-operatives, the social co-operative prevails (86%). The limited liability companies represent 30% of the total amount of SEs (among the three models of limited liability companies, the *società a responsabilità limitata* is the prevailing one). Partnerships represent only 11% of the total amount of SEs and nonprofit institutions - other than social co-operatives - are barely 2% (half of which are associations).
To sum up, SEs in Italy are mainly set up as co-operatives (especially social co-operatives) and limited liability companies.
These numbers, however, do not consider those social co-operatives which are not SEs. The data on social co-operatives in general (thus, both those that are SEs and those that are not) - especially if compared to the data on SEs - show that they represent a significant phenomenon: among the over 114,000 cooperatives registered in the Italian register of co-operatives, more than 23,000 are social co-operatives. See data from the Italian Ministry of Economic Development, available at: http://dati.mise.gov.it/index.php/lista-cooperative/list/1?resetfilters=0&clearordering=0&clearfilters=0, last access: March 2018).

[34] On the other side, however, many scholars have underlined the downsides of the non-distribution constraint which, among other things, forces SEs to widely use debts instruments, rather than capital (ZOPPINI 2000). For interesting contributions on this debate see CAPECCHI 2007; BACCHIEGA, BORZAGA 2001.

However, this prohibition imposed on SEs coexisted (as will be said in more detail in par. 4.1) with the possibility for social co-operatives to distribute profits, and this might explain the failure of the former and the success of the latter.

Thus, in spite of the fact that CICs and Italian SEs were introduced almost in the same year (2005 the former, 2006 the latter), the two models had a completely different approach as far as profit distributions were concerned.

With Law no. 106 of 6 June 2016, however, the Italian Parliament entrusted the government with the reform of the so-called Third sector, of the SE and of the civil service. So, Legislative Decree no. 112 of 2 July 2017 (hereinafter, the "Decree") was issued in order to adapt the "old" SE to the new principles.

To fully understand the innovation of the Decree it is worth referring to the previous model of SE (i.e. the one regulated by Legislative Decree no. 155 of 24 March 2006).

4.1 The Italian Social Enterprise in the previous framework. Under the previous framework, the *status* of SE could be obtained by any private organization (e.g. associations, foundations, partnerships, limited liability companies, co-peratives etc.) which carried out as (i) main activity - thus, not necessarily as an exclusive one -, (ii) permanently, and (iii) without profit, an activity aimed at producing or exchanging goods or services of social interest[35] and for general interests' purposes.

By definition, SEs could not pursue profit and, therefore, when they were set up as companies or co-operatives they represented an undeniable exception to the for-profit nature of companies.

It is necessary to clarify this point. The vast majority of the Italian academics and the case law agree that, according to the general definition of

[35] This type of goods and services were directly identified by Article 2 (1) of Legislative Decree no. 155 of 24 March 2006 and included, for instance, education, healthcare, social assistance etc.

entrepreneur[36] provided by the Italian civil code (Article 2082), the pursuit of profit is not an essential requirement in order to be legally qualified as entrepreneur (MARASÀ 2014). However, as far as companies are concerned, Article 2247 of the Italian civil code stipulates that a company is set up by two or more people to carry out an economic activity and in order to share among them the profits deriving from this activity: hence, when the enterprise is set up as a company, the law requires the pursuit of profit. It follows that, as mentioned, since SEs could not distribute profits, when they were set up as partnerships, limited liability companies or co-operatives they represented an undeniable exception to the for-profit nature of such organizations.

SEs could obviously generate revenues; what was prohibited (except for social co-operatives) was their direct or indirect distribution to SE's directors, shareholders, workers *etc.*[37]. Profits had to be either employed for the implementation of the SE's activity or re-invested within the SE by means of a share capital increase. Conversely, such prohibition was not imposed on social co-operatives, which were admitted to profit distributions, although within the limits set by their framework[38].

This non-profit nature of SEs was also granted by means of other specific provisions. So, for instance, not only were SEs not allowed to distribute - also indirectly - dividends, but the law set a limit on the remuneration of financial

[36] It is worth mentioning that the general definition refers to any type of enterprise (e.g. individual, collective).

[37] Article 3 (2) of Legislative Decree no. 155 of 24 March 2006. Article 3 clearly listed the profit distributions that had to be considered "indirect"; however, it has been observed, that there was space left to make those indirect distributions not listed by the article (CAPECCHI 2007).

[38] The social co-operatives (introduced by Law no. 381 of 8 November 1991) and their *consortia*, whose by-laws envisaged the provisions of Articles 10 (2) (on social balance sheet) and 12 (concerning the involvement of employees and of the people affected by the activity of the entity) of the decree on SEs acquired the *status* of SEs (see Art. 17 (3) of Legislative Decree no. 155 of 24 March 2006). The provisions on SEs applied to social co-operatives and to their *consortia* only in compliance with the specific framework on co-operatives.
Notwithstanding some similarities with SEs, it does not seem that the social co-operatives which were not SEs pursuant to Italian Law could be fully considered as part of the phenomenon described in par. 2.
Admittedly, while social co-operatives showed two of the three features of SEs (i.e. "social" purpose and constraint on profit distribution) they were not specifically obliged to involve stakeholders. In fact, as noticed above, the involvement of the employees and of the people affected by the activity of the social co-operative was one of the conditions for them be recognized as SEs.

instruments other than shares (e.g. bonds), which could not receive an interest rate higher than 5% beyond the base lending rate[39]. Furthermore, for-profit companies could not control SEs[40] and mergers, splits and transformations were admitted only insofar as the non-profit nature of the SE was safeguarded[41].

4.2 The "new" Italian Social Enterprise. Between non-profit and investment profitability. This was the situation before July 2017. Although the Decree did not change the overall structure of SEs, it nevertheless marked a difference between the old and the new model of SE.

In the new framework as well, the SE status can be obtained by any private organization[42] as long as it carries out as main activity and on an ongoing basis a non-profit business activity of general interest which has a civic, solidarity or social interest aim. Furthermore, the law provides that SEs have to act in a responsible and transparent manner and promote the participation of the workforce and other stakeholders that might be interested in their activity.

It is worth observing that the new SE is similar to the previous one at least under three viewpoints.

First of all, as in the past, SEs have to permanently carry out a business activity aimed at pursuing a civic, solidarity or social interest objective. These types of activities are identified by the law itself and include, for example, healthcare, education, environment protection etc.[43]

[39] Article 3 (2) d) of Legislative Decree no. 155 of 24 March 2006. See, on this profile FICI 2007. This limit, however, did not apply to banks and to authorized financial intermediaries.
[40] Article 4 (3) of Legislative Decree no. 155 of 24 March 2006.
[41] Article 13 (1) of Legislative Decree no. 155 of 24 March 2006. Moreover, the effectiveness of such operations depended on, among other things, an authorization of the Italian Ministry of Labor and Social Policies.
[42] Article 1 (2) of the Decree. However, paragraph 2 provides an exception to this general rule by stating that the status of SE cannot be acquired by, *inter alia*, public administrations and single-member companies in which the only member is a natural person.
[43] See Article 2 (1) of the Decree.

Secondly, the general interest business activity has to be their main activity. To this aim, the law considers the main activity the one producing more than the 70% of the overall profits of SE[44].

Thirdly, the no-profit requirement continues to exist in the new definition of SE. Profits (if any) have to be either employed for the implementation of SEs' activity or re-invested in the SE itself by means of a share capital increase[45]. The direct or indirect distribution of profits to the SE's directors, shareholders, workers etc. is still not allowed and, in order to avoid any abuses, the law also identifies the cases of indirect distribution[46] (which, compared to the former law, have been increased in number).

Thus, the core of the SE has been somehow preserved. What is new, then?

The interesting modification concerns the possibility of distributing profits. In fact, although, as mentioned, SEs are still defined as no-profit entities, the reform nevertheless provides an exception to the profit distribution prohibition. Admittedly, if a SE is set up as a partnership, limited liability company or co-operative, it may use less than 50% of its annual profits to increase its share capital or, above all, to distribute dividends to its shareholders. This is the "general" limit, whose purpose is ensuring that at least more than half of the SE's annual profits are employed for the implementation of SE's activity or re-invested in the SE by means of a share capital increase.

[44] See Article 2 (3) of the Decree.

[45] See Article 3 (1) of the Decree. SEs may, however, use a maximum of 3% of their annual profits in order to contribute to funds set up for the promotion and development of SEs.

[46] The law considers as indirect distribution of profits (Article 3 (1) of the Decree): a) the payment to directors, statutory auditors etc. of remunerations not proportionate to the activities they carried out, to their responsibilities and to their specific competencies and that are, however, higher to those recognized in legal entities operating in the same or similar sector and under similar conditions; b) the payment to workers of a remuneration higher than 40% of the amount envisaged for equivalent positions in the collective agreements; c) the payment of interests on financial instruments to subjects other than banks and financial intermediaries higher than 5% beyond the base lending rate; d) the purchase of goods and services, if a consideration higher than their normal value is paid; e) the transfer of goods and the supply of services to, *inter alia*, shareholders, associates, founders, members of the administrative board or of the board of auditors, applying conditions that are more favorable than those of the market (unless this is, pursuant to Article 2 of the decree, the activity of the SE); and f) the payment to subjects other than banks and authorized financial intermediaries of interests higher than the annual reference interest rate raised by 4%.

Additionally, an "individual" limit is set as well. In fact, SEs cannot distribute to each shareholder more than the maximum interest rate of the Italian postal savings certificates (the *buoni fruttiferi postali*, BFP) increased by 2.5%. This is the same limit set for the distribution of dividends to a particular category of shareholders in a specific type of cooperative, the so-called *cooperativa a mutualità prevalente*[47].

Thus, notwithstanding the fact that the new law keeps on identifying SEs as non-profit entities, the distribution of dividends, even though limited, is today allowed.

With reference to interest payments[48] and SEs' assets[49] the new framework is essentially the same.

If violations arise, the assets of SEs are assigned to funds set up for the promotion and development of SEs[50].

The framework on social co-operatives is essentially the same: the provisions on SEs apply to them only in compliance with the specific framework on co-operatives and only insofar as compatible with it, but they are now SEs by law.

[47] This type of cooperative differentiates from the ordinary one because its activity, depending on the specific type of *cooperativa a mutualità prevalente*, shall be carried out for the most part in favor of its members, shall for the most part make use of their job performances or shall for the most part make use of goods and services provided by them. In addition, this type of cooperative has stricter limits than the ordinary cooperative as far as dividend distribution is concerned.

[48] The remuneration of financial instruments other than shares and held by subjects other than banks and financial intermediaries cannot be higher than the limit set for the distribution of profits increased by 2% (see Article 3 (2) c) of the Decree). Furthermore, the interests paid to subjects other than banks and financial intermediaries cannot be higher than the base lending rate increased by 4 points (see Article 3 (2) f) of the Decree).

[49] Mergers, splits and transformations are admitted only insofar as the non-profit nature of the SE is safeguarded. The sale of the company or of a branch is permitted and uncapped provided that it is realized in such way that ensures that the buyer keeps on carrying out the activities and on pursuing the goals of the SE. For all these operations the consent of the Italian Ministry of Labor and Social Policies is required. See Article 12 of the Decree.
In cases of winding-ups (*liquidazione coatta amministrativa*) the assets of SEs are assigned to funds set up for the promotion and development of SEs (See Article 14 of the Decree).

[50] See Article 15 (8) of the Decree.

5. CIC *vs* SE: profit distribution. This analysis focused specifically on profit distribution. In fact, despite the fact that there are other interesting profiles worth comparing[51], this is the aspect on which the reform was most innovative.

The Italian system switched from a framework under which SEs were not allowed to distribute profits, to a more flexible one, pursuant to which, if an SE is set up as a partnership, limited liability company or co-operative it can distribute profits within the above-mentioned limits.

If the low number of Italian SEs is considered (par. 4), this shift may be a reaction of the Italian legislator to the compelling need to make SEs more attractive to investors: in fact, as for-profit ones, also non-profit entities, have the need to attract investments by recognizing to the investors some form of remuneration of their capital (Mosco 2017).

Therefore, the idea of giving access to SEs to dividend distributions within certain limits is understandable, although some concerns may arise (*infra*).

This mechanism, like the one arranged for CICs, is aimed at ensuring that the majority of profits are re-invested in the activities of the SE; however, between the two there are three main differences.

First of all, the m.a.d. system requires CICs to retain more profits than Italian SEs, with a spread between the two mechanisms of 15%. In fact, while the aggregate dividend cap is currently set at 35% (thus requiring CICs to re-invest at least 65% of their distributable profits in their activity), Italian SEs are required to re-invest at least 50%.

Secondly, to determine the amount of profits available for distribution, the UK legislation directly takes into account exempt dividends, which are not considered when calculating the aggregate dividend cap. Conversely, the Italian legislation does not envisage exempt dividends.

[51] One of the notable differences between UK CICs and Italian SEs concerns the identification of the social finality. In fact, in the UK, this task falls within the competence of a public regulator whereas in Italy, as in other countries such as France or Finland, the social finality is directly identified by the law. As observed (CAFAGGI F., IAMICELI P. 2008), this second option may be the symptom of a uniformity concern, whereas the former approach shows a higher consideration of the specific role of SEs.

Thirdly, Italian SEs suffer both a general limit and an individual one. Conversely, since 2014, the UK has removed all the other existing limits to dividend distributions in order to leave a single, general cap (the m.a.d.). This means that CICs may be even more attractive for investors: in fact, once the 35% cap is respected, there are no other specific limitations to dividend distributions and this may lead, at an individual level, to higher remunerations than those obtainable, in a comparable situation, by Italian SEs' shareholders.

The introduction of the individual limit was questioned. Indeed, it has been observed that, on one side, lacking the same possibility for other types of enterprises with social purposes, the possibility for the SEs to distribute profits may discourage the setting up of these other types of enterprises (Mosco 2017). On the other side, the individual limit to the distribution of profits - as seen (*supra*), borrowed from the legal framework on a specific type of cooperative, the *cooperativa a mutualità prevalente* - does not seem a workable solution with reference to SEs. Admittedly, there is a huge difference between the former and the latter. The *cooperative a mutualità prevalente*, in fact, do not carry out their activity on the market (see footnote no. 47), whereas SEs do operate on the market, even though in specific areas (see *supra* par. 4.2). Therefore, the imposition of the individual limit, without the further provision requiring the enterprise to not operate mainly on the market as in the above-mentioned cooperatives, may not be enough to limit the distribution of profit. Furthermore, such a limit allows remunerations that, nowadays, are not easy to find on the market (Mosco 2017).

This, of course, depends on SEs being defined - as they still are - as non-profit entities. And this leads to the heart of the issue.

6. Conclusions. As stated (par. 4), while in the past SEs could not distribute profits, social co-operatives could (albeit within the limits set by their framework). It is not a coincidence that these co-operatives have in Italy traditionally represented the main model of enterprise operating in the social sector (see also footnote no. 33). Therefore, social co-operatives, already

before the reform, represented (and, still today, represent) a hybrid model. However, because of the difference between their specific objective (so-called *scopo mutualistico*) and the ordinary profit purpose (so-called *scopo lucrativo*), the notion of "hybrid" has, in this case, a meaning that does not completely coincide with its common understanding. Admittedly, not only does the co-operative characterization bring with it (in the same terms as those of the general model of the *cooperativa a mutualità prevalente*) the possibility of distributing part of the revenues generated, but also the primary objective of co-operatives itself (i.e. producing an advantage to their members by providing them goods, services and jobs at better conditions than those offered by the market) is partially hybridized by the provision requiring social co-operatives to operate in the general interest of the community, rather than exclusively that of their members, through the so-called *rapporto mutualistico* (i.e. the exchanges between a cooperative and its members aimed at producing an advantage for the latter).

Following the reform, the SEs set up as social co-operatives do not represent the only hybrid model of SE anymore.

In fact, although Italian SEs are still identified as non-profit entities, it is undeniable that the 2017 reform has determined for SEs set up as companies, too, a shift to a more markedly hybrid model, closer to that of the UK CICs.

The reform has, thus, aligned the framework on these SEs to that already in force for social co-operatives. Conversely, the SEs established in forms other than companies (e.g. associations, foundations) keep on being excluded from profit distributions and are, consequently, penalized.

Although the analysis of other SEs models does not fall within the scope of this work, it must nevertheless be underlined that hybrid forms of entities

comparable to SEs also exist in other countries such as, for example, Finland[52], Belgium[53], France[54] and, outside Europe, in the US[55].

As noticed, the reform shows a better understanding of the relationship between profit and social purposes; it now seems clearer that the non-profit nature of a legal entity is not a direct consequence of its social purposes (D'AMBROSIO 2017).

If this is true, then, there are no obstacles for for-profit entities to take something from the nonprofits (i.e. also social purposes) and for the latter to take something from the former (i.e. the possibility to partially distribute profits).

Hence, profit and non-profit are getting closer and the recent thrive of hybrid legal entities seems to testify this. In an ideal scheme, until recent times, there were two extremes: nonprofits on one side, for-profit entities on the other. Nowadays, along the path from one extreme to another, there are many legal entities with several nuances.

Widening the focus, we may see this new "low-profit" Italian SE as a symptom of this hybridization process which lately, in Italy, seems to be increasingly frequent. A similar process, for example, took place recently with reference to amateur sport companies. Normally, amateur sport activities were carried out by associations without legal personality, associations with legal

[52] Finnish SEs, like L3Cs (see footnote no. 55), have no limits on profit distributions, but are nevertheless obliged to respect their mission (i.e. providing employment opportunities and work integration, see Section 1 of the Finnish Social Enterprise Act, Act no. 1351 of 30 December 2003).

[53] In Belgium the '*Sociétés à finalité sociale*' are allowed to distribute profits, but a cap is set (Article 661 (5) of Belgium Companies' Code provides that "*lorsque la société procure aux associés un bénéfice patrimonial direct limité, que le bénéfice distribué à ceux-ci ne peut dépasser le taux d'intérêt fixé par le Roi en exécution de la loi du 20 juillet 1955 portant institution d'un Conseil national de la coopération, appliqué au montant effectivement libéré des parts ou actions*").

[54] Also French "*sociétés coopératives d'intérét collectif*" are allowed to distribute profits, although in a limited way. In fact, pursuant to Article 19-*nonies* of Law no. *47-1775* of 10 September 1947 (the articles on the *sociétés coopératives d'intérét collectif* were introduced by Law no. 2001-624 of 17 July 2001), at least 50% of their profits must go to the indivisible reserve and the total amount of the distributions cannot exceed the sums left.

[55] In the U.S. the Low-Profit Limited Liability Company (L3C) is a specific type of limited liability company that shares features of both for-profit (L3C may distribute profits) and non-profit (L3C pursues charitable purposes) (see SERTIAL 2012; REISER 2010; TAYLOR 2009; BILLITIERI 2007). It is not possible to analyze L3Cs, but it is worth underlining that L3C models do not have specific requirements or limitations on profit distributions (e.g. SERTIAL 2012).

personality, limited liability companies or co-operatives. In any case, similarly to former SEs, the activity had to be carried out without profit and both direct and indirect profit distributions were prohibited.

However, the possibility for companies to carry out such activities for-profit was recently introduced[56]. Interestingly enough, however, (and differently from the new SEs), the legislator did not set any limits to profit distributions[57].

By the same token, in the for-profit world, too, there are cases of shifts from the extreme to the center. Probably the most notable example is benefit corporations, firstly introduced in many states of the US and, more recently (2015), introduced also in Italy. It is not possible to analyze the frameworks on benefit corporations; however, in a nutshell, while pursuing profits, these corporations must operate in a sustainable and responsible manner and produce a "public benefit". Furthermore, they overcome shareholders primacy by forcing directors to either just consider stakeholders' interests or even balance them with shareholders' profit maximization[58].

Thus, it seems that the general trend is toward hybrid models and, depending on the models, one time non-profit is eroded, another one profit is. The absolute relevance of today's social and environmental pressing problems, their importance in the current public debate and the shortcomings of the welfare state require nonprofit and for-profit businesses to join the challenge. If it is borne in mind that both models have limits[59] (e.g. TAYLOR 2009/2010), perhaps hybrid entities may represent an interesting path for legislators, also at a European level.

If SEs are put into this context, then, it should also be easier to accept their profit distribution mechanism.

[56] Article 1 (353 and 354) of Law no. 205 of 27 December 2017.
[57] From such perspective this model reminds L3Cs'approach (see footnote no. 55).
[58] On benefit corporations see, among the various: MOSCO, 2017; BAUCO and others, 2017; COCCIOLILLO, 2017; CASTELLANI and others, 2016; LENZI, 2016; MCDONNEL, 2014; GRANT, 2013.
[59] Nonprofits face more difficulties than for-profit entities in attracting capitals (e.g. they may have a limited access to capitals because of the prohibition to distribute profits and interests). For-profit entities, at the same time, because of shareholder primacy and of the profit maximization principle - that, although over time mitigated and, however, different in the various countries - keeps on playing an important role in corporate law - may be inadequate for pursuing social aims (even if they do so in addition to profit generation).

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