

**Reform of Charity Governance in China: From
Economic and Comparative Perspectives**

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by

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ABSTRACT

In mainland China, given inefficient governance mechanisms, in practice, there occur a range of charity scandals, leading to lack of public confidence in the charitable sector and continuing calls for reform. In this context, this thesis is aimed at making suggestions for reform of the current legal framework relating to charity governance in China based on an economic analysis along with a comparative study of English law and practice.

In terms of economic theories, due to the lack of a comprehensive framework suitable for assessing the efficiency of charity governance, this thesis develops a revised agency theory by taking account of the features of charities and the reasonable aspects of the traditional agency theory and other theories, to facilitate the assessment of charity governance and to direct the legal reform in this respect.

In this theory, the charitable purpose/public benefit of a charity plays the role of the charity trustees' (persons who govern this charity) principal whilst persons who are not the charity trustees but who provide charitable resources to this charity ('key stakeholders') and 'other selected stakeholders' (by operation of law) should act as the supervisors having the rights to make the charity trustees accountable on behalf of the charitable purpose/public benefit. And the human nature of the charity trustees (who are often volunteers) should be understood in a more pragmatic manner, which means that they can usually be trusted but should be monitored in some circumstances to control serious moral hazard.

In this revised agency theory, although agency costs continue their role in evaluating charity governance, their contents should be extended to the costs relating to co-ordinating the supervisors and their collective decision-making process; the costs of supervision, support and enforcement; the costs of the supervisors' moral hazard; the costs of the negative effects of external intervention; and the residual loss. In the meantime, the thesis also carries out a comparative study of English law and practice, which can facilitate the above economic analysis on the one hand and provide both experience and lessons to the future reform of Chinese law on the other.

On this basis, the thesis makes a complete examination of charity governance from four significant aspects, i.e., governmental regulation, internal governance, accountability to third parties and public accountability, in order to provide a variety of reasonable solutions for how to enact or revise the principles or rules of the current legal framework regarding charity governance in China.

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Chapter 1 Introduction

Along with the development of a market-oriented economy in China,¹ its traditional socialist social welfare system is being gradually replaced by a multilevel social welfare system, in which charities are playing an increasingly significant role. However, given inefficient governance mechanisms, in practice, there occur a range of charity scandals, leading to a lack of public trust and confidence in the charitable sector and continuing calls for reform. In this context, this thesis is aimed at making suggestions for reform of the current legal framework relating to charity governance in China from an economic perspective and with a comparative study of English law and practice.

To achieve this goal, this chapter begins by clarifying the research question. Then it further introduces and justifies the usefulness of the research methods utilised to answer this question and points out the main theoretical contributions of this thesis. In addition, it also sets up the background and provides a brief introduction to the argument put forward in this thesis.

1.1 Research Question

For the purposes of this thesis, charity governance means any governance mechanism ensuring that members of the governing body/‘charity trustees’ (i.e., persons who govern and are finally responsible for a charity)² comply with their duties in order to efficiently realise the charitable purpose/public benefit pursued by their charity.

Usually, better charity governance can result in higher public confidence and trust and more financial support from donors, the government and the general public.³ To facilitate sound charity governance, there must be a well-

¹ It is worth noting that, for the purposes of the thesis, the term ‘China’ refers to mainland China, and the legal systems in Taiwan, Macao and Hong Kong will not be discussed in this thesis.

² Regarding the definition and a further examination of charity governance and members of the governing body/charity trustees, see the discussion in Chapter 2 and Chapter 5.

³ Erica Harris, Christine M. Petrovits and Michelle H. Yetman, ‘The Effect of Nonprofit Governance

designed and efficiently implemented legal framework.

Hence, this thesis is aimed at dealing with this question: how can the current legal framework concerning charity governance in China be improved in a cost-effective manner? An economic and comparative analysis will be carried out to help assess the laws, policies and practices associated with charity governance in China and England, and to further recommend a range of solutions to address the problems of Chinese law and practice. To the best of the author's knowledge, this thesis is the first time that an economic and comparative analysis of Chinese law regulating charity governance has been undertaken, as will be discussed below.

1.2 Research Methods

This thesis carries out its study from an economic perspective and with a comparative analysis of English law and practice. In terms of economic theories, due to a lack of a comprehensive framework suitable for assessing the efficiency of charity governance, this thesis develops a revised agency theory, to facilitate the assessment of charity governance and to direct the legal reform in this respect.

The thesis also carries out a comparative study of English law and practice concerning charity governance, which may provide both insightful experience and lessons for the future reform of Chinese law.

1.2.1 Economic Theories

1.2.1.1 Why Are Economic Theories Chosen as the Main Research Method?

Many legal systems, institutions and mechanisms can be 'best understood and explained as efforts to promote the efficient allocation of resources'.⁴

on Donations: Evidence from the Revised Form 990' (2015) 90(2) *The Accounting Review* 579.

⁴ Richard A. Posner, *Economic Analysis of Law* (3rd edn, Little, Brown and Company 1986) 20.

This argument is of great value in assisting this thesis to identify the ways to enhance charity governance.

In terms of charity governance, if there was no cost relating to designing and implementing legal rules aiming to ensure compliance by members of a charity's governing body, those rules could be as strict as possible.

However, the reality is that resources are limited, so the law has to take costs into account. In this context, economic theories can help interpret or evaluate which legal principle, system or mechanism is cost-effective in terms of improving charity governance.

1.2.1.2 The Challenges Facing an Economic Analysis of Charity Governance and the Contributions of this Thesis

In this respect, a variety of economic and social theories⁵ are available, such as agency theory, stewardship theory, crowding out theory, stakeholder theory, enterprise ownership theory and public goods theory. However, it will be seen in Chapter 3 that, in relation to charity governance, none of these theories can provide a comprehensive theoretical framework in assessing the efficiency of charity governance.

For example, the traditional agency theory ignores the altruistic motivation⁶ and voluntary nature of charity trustees, thus some of its suggestions on controlling misconduct or mismanagement (i.e., 'moral hazard')⁷ of the governing body in a for-profit company may not work well in the context of charity governance. In contrast to agency theory, stewardship theory and crowding out theory take the non-monetary motivations of charity trustees very seriously,⁸ but cannot provide a complete solution to avoiding or

⁵ With respect to a recent summary of theories in relation to charity governance, see Noel Hyndman and Paul McDonnell, 'Governance and Charities: An Exploration of Key Themes and the Development of a Research Agenda' (2009) 25(1) *Financial Accountability & Management* 5.

⁶ Lex Donaldson and James H. Davis, 'Stewardship Theory or Agency Theory: CEO Governance and Shareholder Returns' (1991) 16(1) *Australian Journal of Management* 49.

⁷ As to the interpretation of 'moral hazard', see the discussion in Chapter 3.

⁸ Charles Perrow, *Complex Organizations: A Critical Essay* (Random House 1986) 234; Bruno S. Frey,

reducing the charity trustees' moral hazard.

Stakeholder theory pays special attention to the role of stakeholders in charity governance,⁹ but cannot clarify the scope of stakeholders relating to a charity, let alone explain how to distribute the rights, duties and liabilities of those stakeholders in supervising its charity trustees. Enterprise ownership theory explains the important role of persons voluntarily providing charitable resources in maintaining the existence of any charity,¹⁰ but cannot further provide solutions for ensuring sound charity governance. Public goods theory helps justify the government as the regulator,¹¹ but also cannot offer any further recommendations on improving the legal framework regarding charity governance.

Therefore, before it undertakes a comprehensive assessment of charity governance, the thesis has to deal with this question. Accordingly, one contribution of this thesis is to develop a revised agency theory which critically draws on a range of insights from the theories mentioned above, and provides a more reasonable framework explaining and examining the current laws and practices concerning charity governance in China.

A complete discussion of this revised agency theory will be made in Chapter 3. Here, it is only necessary to point out that, the contents of agency costs in this theory mainly comprise the monitoring costs (which can be further divided into the costs relating to co-ordinating supervisors and their collective decision-making process; the costs of supervision, support and enforcement; the costs of the supervisors' moral hazard; and the costs of the negative effects of external intervention), and the residual loss.¹² Those

'On the Relationship between Intrinsic and Extrinsic Work Motivation' (1997) 15 *International Journal of Industrial Organization* 427.

⁹ Ciaran Connolly, Noel Hyndman and Danielle McConville, 'Conversion Ratios, Efficiency and Obfuscation: A Study of the Impact of Changed UK Charity Accounting Requirements on External Stakeholders' (2013) 24 *Voluntas* 785, 788.

¹⁰ Henry Hansmann, *The Ownership of Enterprise* (Harvard University Press 1996) 227-245.

¹¹ Burton A. Weisbrod, 'Toward a Theory of the Voluntary Nonprofit Sector in a Three-Sector Economy' in Edmund S. Phelps (ed), *Altruism, Morality, and Economic Theory* (Russell Sage Foundation 1975) 171-195.

¹² These costs will be analysed in detail in Chapter 3.

costs are taken into account in evaluating the current problems in four vital aspects of charity governance (i.e., governmental regulation, internal governance, supervision by third parties and public accountability), and in further offering recommendations on legal reform throughout the thesis.

Of course, it is worth noting that, this thesis will not utilise any complex mathematical model to carry out the economic analysis of charity governance. Instead, it seeks to deploy some basic economic ideas to interpret and assess the legal framework concerning charity governance.

1.2.2 Comparative Analysis

1.2.2.1 Why English Law Has Been Selected for the Comparison

The reason the thesis chooses comparative analysis as the other research method is quite simple: it ‘can provide a much richer range of model solutions than a legal science devoted to a single nation’.¹³ Nevertheless, here it is necessary to explain the main reasons for selecting English law (rather than laws in other jurisdictions) as the object to be compared.

First, in terms of the study and practice relating to charity governance, civil law countries do not perform well. Given that China is a civil law country, it would seem to be more reasonable and easier to compare Chinese law with laws in other civil law jurisdictions, such as France and Germany. However, in Germany, corporate governance plays a very small role in the non-profit sector.¹⁴ Similarly, France does not truly have any mature academic research and legal reform relating to non-profit governance.¹⁵ Therefore, neither country can provide effective guidance to China in reforming its law and policy dealing with charity governance.

¹³ Konrad Zweigert and Hein Kötz, *An Introduction to Comparative Law*, translated by Tony Weir (2nd edn, OUP 1987) 15.

¹⁴ Thomas von Hippel, ‘Nonprofit Organizations in Germany’ in Klaus J. Hopt and Thomas von Hippel (eds), *Comparative Corporate Governance of Non-Profit Organizations* (CUP 2010) 226.

¹⁵ Katrin Deckert, ‘Nonprofit Organizations in France’ in Klaus J. Hopt and Thomas von Hippel (eds), *Comparative Corporate Governance of Non-Profit Organizations* (CUP 2010) 324.

Second, in contrast to Chinese law, English law¹⁶ experienced the problems concerning charity governance much earlier and improved its legal system governing charities accordingly. For example, in terms of governmental regulation, following the recommendation in the Strategy Unit Report ‘*Private Action, Public Benefit*’¹⁷ to ensure independent, open and proportionate regulation, the Charity Commission, the former office of the Charity Commissioners,¹⁸ was restructured and modernised as an independent regulator to replace the Charity Commissioners in regulating charities.¹⁹ In contrast to English law, charity regulators were not identified in Chinese law until the enactment of the Charity Law 2016 (China) (‘慈善法’).²⁰ However, so far even the basic regulatory principles, such as proportionality and accountability, are still not clarified by Chinese law or formally recognised by Chinese charity regulators.

Another example is associated with internal governance. In this respect, in designing fiduciary duties, English law recognised the problems that could arise from excessive burdens being placed on charity trustees a long time ago:

If the administration of the funds, though mistaken, has been honest, and unconnected with any corrupt purpose, the Court, while it directs for the future, refuses to visit with punishment what has been done in time past. To act on any other principle would be to deter all prudent persons from becoming trustees of charities.²¹

Accordingly, English law is not only aimed at regulating the conduct of charity trustees, but also seeks to avoid placing excessive burdens on those

¹⁶ Given that, in the UK, English law (along with the law in Wales) is, more or less, different from the law in Scotland or Northern Ireland, in providing a comparative assessment of Chinese law, the thesis only examines English law rather than the law of the whole UK.

¹⁷ Cabinet Office Strategy Unit, *Private Action, Public Benefit: A Review of Charities and the Wider Not-For-Profit Sector* (Cabinet Office Strategy Unit 2002).

¹⁸ Hubert Picarda QC, *The Law and Practice Relating to Charities* (4th edn, Bloomsbury Professional 2010) 763.

¹⁹ Charities Act 2006 (CA 2006), ss 6-7.

²⁰ Charity Law 2016 (China) (CL 2016 (China)), s 6.

²¹ *Attorney General v Corporation of the City of Exeter* (1826) 2 Russell 45, 54.

charity trustees through a range of mechanisms, such as indemnity insurance for charity trustees²² and the power of the Charity Commission to relieve charity trustees from liability.²³ By contrast, Chinese law neither provides detailed rules relating to fiduciary duties²⁴ nor contemplates reducing the burdens of charity trustees as necessary.²⁵

As a matter of fact, charity law in England is well established having developed from the Charitable Uses Act 1601. Meanwhile, English law has changed fundamentally in accordance with the political, social and economic transformation.²⁶ Therefore, although English charity law still has to adjust itself in response to ‘a time of profound economic, social and technological change’,²⁷ both its experience and lessons can benefit China greatly in rethinking and reforming its legal system in respect of charity governance.

Third, related to the above two points, there is an increasing demand among Chinese legislators, regulators and research institutes to have a deeper understanding of and to learn from English law and practice regarding charities. For example, there is one chapter (Chapter 5) in the recently enacted Charity Law 2016 (China) that introduces and provides legal rules governing charitable trusts. Meanwhile, after the enactment of this new law, in 2016, a delegation of the Ministry of Civil Affairs (‘民政部’), the charity regulator at the national level in China, made a visit to the Charity Commission during the period between 24th October and 27th October to build a closer relationship with this Commission and to draw on its relevant

²² Charities Act 2011 (CA 2011), s 189.

²³ CA 2011, s 191.

²⁴ One rule directly related to fiduciary duties in the recently enacted Charity Law 2016 (China) is to require that the managers of a charity cannot participate in the decision relating to the transaction between this charity and themselves and that the matters concerning the related transaction must be disclosed to the public. CL 2016 (China), s 14.

²⁵ There is no similar rule reducing or relieving the liability of charity trustees to section 191 of the Charities Act 2011 in the Charity Law 2016 (China).

²⁶ For example, see Michael Chesterman, *Charities, Trusts, and Social Welfare* (Weidenfeld and Nicolson 1979).

²⁷ House of Lords Select Committee on Charities, *Stronger Charities for a Stronger Society* (Report of Session 2016-17) (Select Committee on Charities 2017) 6.

experience and practices in regulating charities and charitable activities.²⁸

In addition, recently a great deal of professional research institutes focusing on the study of charities and charity law have been established in China, such as the China Philanthropy Development Research Institute of Shanghai Jiaotong University, the China Philanthropy Research Institute of Beijing Normal University, the China Institute for Philanthropy and Social Innovation of Renmin University of China and the School of Philanthropy of Sun Yat-sen University, which carry out a range of academic activities in support of the legal reform, the policy-making of the government and the development of the charitable sector as a whole. Among them, the China Philanthropy Research Institute of Beijing Normal University, with which the author has co-operated several times and thus is quite familiar, often has a detailed analysis of English law and practice in its academic projects funded by the government, foundations and other organisations.

Hence, the fact that charity law in civil law jurisdictions is less developed, the comparatively well-designed legal and regulatory rules in England and the increasing demand of Chinese legislators, regulators and research institutes for a better understanding of the experience of English law form the basic reasons for this comparative study of the law and practice regarding charity governance in China and England.

1.2.2.2 The Main Difficulties of Comparative Study and the Contributions of this Thesis

Comparative study itself usually faces many challenges in practice, such as how to identify the definition, scope and context of comparative law itself, and how to understand the relationship between a given legal system and its

²⁸ On 27th October 2016, the author, representing the Charity Law & Policy Unit at the University of Liverpool, held a seminar for this delegation at the Liverpool Office of the Commission, where the members of this delegation were very interested in English charity law and practice, and asked a variety of problems associated with how England tackled the relevant issues which were troubling Chinese regulators and practitioners at that time.

political, social, economic and cultural contexts.²⁹

For the purposes of this thesis, the main difficulty lies in the fact that China and England do not share the same legal system. In contrast to England, a typical common law jurisdiction, China is a civil law country, leading to a range of different legal mechanisms, rules, ideas and practices. For example, China does not accept case law, which means that all legal rules, including those governing fiduciary duties, have to be provided by statutory law. In addition, Chinese law does not accept the ‘consideration’ theory of English law, and accordingly recognises an *inter vivos* donation as a type of contract (‘donation contract’).³⁰

Hence, a comparative analysis of Chinese law and English law is much more difficult than that focusing on the laws in jurisdictions with the same legal tradition and system (such as common law jurisdictions or civil law jurisdictions). That may be one important reason why there are a range of books carrying out a comparative study of charity law in common law countries,³¹ but there is no similar comparative analysis of Chinese charity law and English charity law. As a result, this thesis is the first comparative analysis of English law and Chinese law regulating charity governance.³²

In order to tackle the challenge in comparing Chinese and English charity law, this thesis takes the following steps. First, it clarifies the meaning and scope of the key terms used in this study, such as Chinese law, charities, charity governance and members of the governing body/charity trustees, in Chapter 2.

²⁹ For example, see Geoffrey Samuel, ‘Comparative Law and the Court: What Counts as Comparative Law’ in Mads Andenas and Duncan Fairgrieve (eds), *Courts and Comparative Law* (OUP 2015) 54.

³⁰ Contract Law 1999 (China) (CL 1999 (China)), Chapter 11.

³¹ For example, see Kerry O’Halloran, *Charity Law and Social Inclusion: An International Study* (Routledge 2007); Kerry O’Halloran, Myles McGregor-Lowndes and Karla W. Simon, *Charity Law & Social Policy: National and International Perspectives on the Functions of the Law Relating to Charities* (Springer 2008).

³² Regarding a brief but interesting comparative study of charity law between the US, another common law country, and China, see Stephanie Hoffer, ‘A Comparison of Tax Exempt Organizations in the People’s Republic of China and the United States’ (2005) 3(1) *Loyola University Chicago International Law Review* 1.

This can help identify the scope to be compared and reduce the difficulties in understanding and examining English and Chinese legal rules relating to charity governance. For example, the discussion relating to charity governance in this thesis focuses on four core aspects, i.e., governmental regulation, internal governance, supervision by third parties and public accountability.³³ In this respect, this thesis can contribute to the related knowledge and ideas to facilitate any future comparative study of charity law between China and England, in particular the laws regarding charity governance.

Second, this thesis also sets up the aim of the comparative analysis, i.e., facilitating the assessment of whether any principle, mechanism or rule contributes to reducing agency costs in relation to charity governance. In other words, the comparative analysis carried out in this thesis aims to assist an economic evaluation of charity governance and its related problems in China and England.

In this context, it is not important whether a donation is a contract, or whether fiduciary duties are provided by statutory law or case law. Instead, what matters is whether any specific legal principle, system or rule in England and China can greatly assist in the reduction of agency costs. Therefore, through the comparative study, any difference or similarity relating to legal rules and practices between the two jurisdictions will be further assessed and evaluated by the revised agency theory of this thesis. This will assist the judgment on whether it is necessary to incorporate some specific legal principles or rules in England into Chinese law.

Meanwhile, when the same or similar legal rules or problems regarding charity governance exist, this thesis will further discuss whether the current Chinese law should be sustained, or whether there are still some more detailed and reasonable rules and practices in England that may better reduce agency costs and thus should be taken into account in improving the

³³ Those four aspects will be explored in Chapters 4-7 respectively.

current rules or practices in China. For example, although charity regulators in both jurisdictions are facing challenges regarding proportionality and accountability, in contrast to Chinese law, English law has developed a range of well-designed systems, rules and approaches to handle them.³⁴ In this context, this thesis will identify and incorporate them as part of the reform suggestions for Chinese law concerning charity governance.

1.3 Background³⁵

In this section, the thesis sets up the background of its study, which can be further divided into two points. First, with the emerging market-oriented economy in China, its traditional socialist social welfare system is being gradually replaced by a multilevel social welfare system, which allows charities to play an increasingly significant role. Second, due to inefficient governance mechanisms, there occur a range of charity scandals, reducing public trust in the charitable sector and resulting in continuing calls for reform. A more detailed analysis is carried out as follows.

1.3.1 The Increasingly Important Role of Charities in Social Welfare Delivery

1.3.1.1 Insufficient Social Welfare Provision by the Government in Developing a Market-oriented Economy

For the purposes of this thesis, the term ‘social welfare’ is used in a wider sense, including both the welfare focusing on the underprivileged and that delivered to any other group or to the general public. Charities played an important role in social welfare delivery both in ancient China³⁶ and during the period of the Republic of China (1911-1949).³⁷ However, after the

³⁴ See the discussion in Chapter 4.

³⁵ Some of the material in this section has been published in Dejian Li, ‘Comments on the Emerging Law on the Administration of Foreign NGOs in China: Based on Its Historical, Political, Social and Legal Contexts’ (2015) 13(1) *International Journal of Charity Sector Law* 15.

³⁶ Karla W. Simon, *Civil Society in China: The Legal Framework from Ancient Times to the ‘New Reform Era’* (OUP 2013) xxviii.

³⁷ Miu Chung Yan and others, ‘Charity Development in China: An Overview’ (2007) 17(1) *Asia*

establishment of the People's Republic of China (PRC) by the Communist Party of China, according to the socialist ideology held by the leadership at that time, charity itself was considered as part of the capitalist regime and 'an instrument of the ruling class that was used to control, denigrate, and mark off as different the poorer classes of society'.³⁸

Accordingly, after the establishment of the PRC, along with the setting up of a planned economy ('计划经济'),³⁹ China established a socialist social welfare system, fully responsible for the social welfare delivery. In this context, all independent charities were either incorporated into part of the government (such as Red Cross Society of China) or prohibited as illegal organisations. Foreign charities had to leave China whilst their branches and the charities they funded suffered the same destiny as Chinese domestic charities.⁴⁰ Accordingly, no independent charities existed in mainland China after the establishment of this socialist social welfare system.

Since the carrying out of the 'Reform and Opening Up' ('改革开放') policy in 1978, the planned economy has been gradually transformed into a market-oriented economy (the so-called 'socialist market economy').⁴¹ Alongside the market-oriented economic reform, China has fundamentally changed its traditional social welfare system in order to make citizens take on more responsibility in support of their family members and themselves. In this context, at the initial stage of this new policy, the government chose to cut its social welfare expenditure,⁴² and '[t]he provision of security by way of guaranteed access to jobs or land was discontinued'.⁴³ Consequently,

Pacific Journal of Social Work & Development 80.

³⁸ *ibid* 80.

³⁹ Under such an economic system, the state was the only owner of all public enterprises and was responsible for the whole operation of economic production, exchange and consumption whilst enterprises could receive the financial support from the state and workers could receive their wages regardless of their performance. Generally, see Arnaldo Gonçalves, 'China's Swing from a Planned Soviet-Type Economy to an Ingenious Socialist Market Economy: An Account of 50 Years' (2006) <<http://ssrn.com/abstract=949371>> accessed 20 September 2017; Immanuel C. Y. Hsü, *The Rise of Modern China* (6th edn, OUP 2000).

⁴⁰ Simon (n 36).

⁴¹ Loren Brandt and Thomas G. Rawski (eds), *China's Great Economic Transformation* (CUP 2008).

⁴² Yan and others (n 37) 90.

⁴³ Stein Ringen and Kinglun Ngok, 'What Kind of Welfare State Is Emerging in China?' (2013)

millions of employees have lost their jobs in state-owned enterprises,⁴⁴ social inequality has become much more severe,⁴⁵ and there have emerged a host of other novel social, economic, cultural and environmental problems.

Currently, China is facing severe pressure in delivering public goods. Hundreds of millions of the disadvantaged, such as older people, the disabled, impoverished students, unattended children and the unemployed, need to be relieved in terms of health care, education, financial support and other areas. For example, by the end of 2013, even given the lower living standards in China compared to Western countries, there were 82.49 million poor people living in rural areas; and China's elderly population--those aged over 60--was 202.43 million, among whom 131.61 million were aged over 65.⁴⁶ By the end of 2013, there were 9.26 million registered unemployed people in urban areas.⁴⁷ In addition, according to the China Disabled Persons' Federation (CDPF), a national umbrella organisation for persons with diverse disabilities in China, there were an estimated 85.02 million disabled people by the end of 2010, of whom 25.18 million were extremely disabled.⁴⁸

And the environmental pollution is very severe in almost all aspects.⁴⁹ For

United Nations Research Institute for Social Development Working Paper 2013-2 <[http://www.unrisd.org/80256B3C005BCCF9/\(httpAuxPages\)/28BCE0F59BDD3738C1257BE30053EBAC/\\$file/Ringen%20and%20Ngok.pdf](http://www.unrisd.org/80256B3C005BCCF9/(httpAuxPages)/28BCE0F59BDD3738C1257BE30053EBAC/$file/Ringen%20and%20Ngok.pdf)> accessed 20 September 2017.

⁴⁴ 'The figure for 1998 was 6.1 million.' Yan and others (n 37) 81.

⁴⁵ The Economist, 'Gini Out of the Bottle' *The Economist* (London, 26 January 2013) <<http://www.economist.com/news/china/21570749-gini-out-bottle>> accessed 20 September 2017.

⁴⁶ National Bureau of Statistics of the People's Republic of China, *Statistical Communique on the National Economy and Social Development 2013* (National Bureau of Statistics 2014) <http://www.stats.gov.cn/tjsj/zxfb/201402/t20140224_514970.html> accessed 20 September 2017.

⁴⁷ Ministry of Human Resources and Social Security of the People's Republic of China, *Statistical Communique on Human Resources and Social Security Development 2013* (Ministry of Human Resources and Social Security 2014) <http://www.mohrss.gov.cn/SYrlzyhshbzb/dongtaixinwen/buneyiaowen/201405/t20140528_131110.htm> accessed 20 September 2017.

⁴⁸ CDPF, *The Number of the Total Disabled and Different Kinds of the Disabled in China by the End of 2010* (CDPF 2012) <http://www.cdpe.org.cn/sjzx/cjrgk/201206/t20120626_387581.shtml> accessed 20 September 2017.

⁴⁹ Ministry of Environmental Protection of the People's Republic of China, *Statistical Communique on Environment 2015* (Ministry of Environment Protection 2016) <<http://www.mep.gov.cn/hjzl/zghjzkgb/lnzghjzkgb/201606/P020160602333160471955.pdf>> accessed 20 September 2017.

example, ‘among 4,778 testing spots in 203 cities, 44% had “relatively poor” underground water quality; the groundwater in another 15.7% tested as “very poor”’.⁵⁰ In this context, with the increasing social demand for fresh air, clean water and healthy food, the public requires more environmental protection.⁵¹

Furthermore, as the quality of life has been gradually improving recently, more and more Chinese citizens have been developing themselves in relation to the arts, amateur sports and other social, cultural, physical⁵² or spiritual aspects.⁵³ For instance, according to a 2013 survey of citizens aged between 20-69 in 10 provinces and cities, the percentage of citizens frequently participating in sports had amounted to 32.7% by the end of 2012.⁵⁴

However, given that China is the largest developing country in the world so far, even the general needs of most Chinese citizens for public goods cannot be satisfied by the government: the government’s public finance expenditure in the above areas is far from sufficient and consequently cannot satisfy the increasing social demand for public goods.⁵⁵

⁵⁰ Jonathan Kaiman, ‘China Says More than Half of Its Groundwater Is Polluted’ *The Guardian* (London, 23 April 2014) <<https://www.theguardian.com/environment/2014/apr/23/china-half-groundwater-polluted>> accessed 20 September 2017.

⁵¹ As a response, Chinese legislators strengthened the environmental protection law recently. Jonathan Kaiman, ‘China Strengthens Environmental Laws’ *The Guardian* (London, 25 April 2014) <<https://www.theguardian.com/environment/2014/apr/25/china-strengthens-environmental-laws-polluting-factories>> accessed 20 September 2017.

⁵² The prime minister of the Chinese government, Keqiang Li, has announced that the government will provide medical and health services, as public goods, to all citizens. China News, ‘Keqiang Li: Providing Medical and Health Services, as Public Goods, to All Citizens’ *China News* (Beijing, 28 June 2013) <<http://www.chinanews.com/gn/2013/06-28/4983175.shtml>> accessed 20 September 2017.

⁵³ For example, see Anugrah Kuma, ‘China to Have World’s Largest Christian Population by 2025, Religion Expert Says’ *The Christian Post* (Washington DC, 27 April 2014) <<http://www.christianpost.com/news/china-to-have-worlds-largest-christian-population-by-2025-religion-expert-says-118646/>> accessed 20 September 2017.

⁵⁴ Kai Zhu, ‘Mass Sports Are Gradually Developing’ *People’s Daily* (Beijing, 4 January 2014) <http://paper.people.com.cn/rmrhwb/html/2014-01/04/content_1371192.htm> accessed 20 September 2017.

⁵⁵ Hongjie Qiu, ‘A Research Report Indicates that Public Services in China Is “at a Low Level as a Whole”’ *Xinhua* (Beijing, 8 April 2007) <http://www.gov.cn/zfjs/2007-04/08/content_575303.htm> accessed 20 September 2017.

More seriously, in China, the need of the disadvantaged for public goods is much harder to meet in practice. For most ordinary citizens, although so far they can hardly influence the government's policy on public goods delivery by voting, their common demand is playing an increasingly vital role in the government agenda setting concerning public policy, which focuses on the major issues associated with the whole society and of general concern.⁵⁶ In this context, the public goods supplied by the Chinese government and 'government-controlled charities'⁵⁷ can at least satisfy the social demand of some citizens.

However, in a heterogeneous society like China, other citizens, particularly those marginalised groups whose voices cannot be reflected or efficiently reflected in the governmental policy, may not obtain the support or efficient support from the government in terms of quantity and quality of public goods delivery.⁵⁸

1.3.1.2 Towards a Multilevel Social Welfare System in the Future

All those problems are forcing the Chinese leadership to gradually realise the necessity of providing a supportive social welfare system in developing the market economy.⁵⁹ However, this kind of social welfare system cannot be the same as the traditional model in the context of a planned economy. As

⁵⁶ Shaoguang Wang, *Governing the State Well: the Goals and Approaches of State Transformation* (SDX Joint Publishing Company 2007)166 (王绍光《安邦之道：国家转型的目标与途径》，三联书店 2007 年).

⁵⁷ Government-controlled charities will be defined in Chapter 2.

⁵⁸ A theory interpreting this phenomenon is Weisbrod's 'public goods theory'. According to this theory, in a democratic country, the governmental policy concerning public goods delivery is determined by the majority of the voters ('median voters'). However, different subgroups of citizens may have diverse demands of public goods ('demand heterogeneity'). Accordingly, in terms of both quantity and quality, the public goods provided by the government may not effectively satisfy the demand of citizens who are not among the median voters (government failure). Burton A. Weisbrod, 'Toward a Theory of the Voluntary Nonprofit Sector in a Three-Sector Economy' in Edmund S. Phelps (ed), *Altruism, Morality, and Economic Theory* (Russell Sage Foundation 1975) 171-195. Of course, given China does not accept a Western democratic model, the above analysis may be not suitable for China. Nevertheless, it at least points out one important fact, i.e., the government cannot sufficiently provide public goods to satisfy the demands of some subgroups.

⁵⁹ Ringen and Ngok (n 43).

a compromise, ‘a new multilevel system’⁶⁰ involving the government, market and non-profits is being established: in such a system, although the government still plays a role in social welfare delivery, ‘non-governmental sectors--including the market, NGOs, family, and individuals--are expected to fund and provide the major portion of social welfare’.⁶¹

As a matter of fact, ‘[i]n the 2000s, the government unveiled a number of initiatives that expressly identified NGOs as important partners in its efforts to address pressing social needs’.⁶² In other words, it can be reasonably believed that the increasing economic pressure is primarily motivating the Chinese government to allow for and promote the development of charities and other non-profits. Meanwhile, given the specific conditions in China, the participation of Chinese charities in public goods delivery will not only fill the gap in relieving disadvantaged groups, but also relax the financial pressure on the government to provide public goods to the whole society.

In this context, the basic trend in public goods delivery in China can be reasonably expected to be that based on the economic and social conditions: the government will further increase its public expenditure on social welfare to enhance the well-being of citizens on the one hand and gradually promote the involvement of charities and other non-profits in public goods provision on the other. This arrangement will provide a platform for charities to meet the social demand for public goods.

According to the recent official statement on the development of registered non-profits (usually called ‘social organisations’ (‘社会组织’) in China), by the end of 2015, there were about 662,000 registered non-profits, which employed more than 7.3 million employees, received donations of about 6.1 billion yuan, and mainly carried out activities in areas such as education,

⁶⁰ Zhenyao Wang and Yanhui Zhao, ‘The Collapse and Reemergence of Private Philanthropy in China, 1949-2012’ in Jennifer Ryan, Lincoln C. Chen and Tony Saich (eds), *Philanthropy for Health in China* (Indiana University Press 2014) 28-29.

⁶¹ Yan and others (n 37) 83.

⁶² Adam Chodorow, ‘Charity with Chinese Characteristics’ (2012) 30(1) *UCLA Pacific Basin Law Journal* 1, 4.

health, social services, culture, sports, environmental protection, religion and commercial and industrial development.⁶³ The following table indicates the recently increasing number of registered non-profits, a large portion of which are in fact charities.⁶⁴

Year	Associations⁶⁵	Foundations⁶⁶	Civil non-commercial units⁶⁷
2000	13.1	--	2.3
2001	12.9	--	8.2
2002	13.3	--	11.1
2003	14.2	--	12.4
2004	15.3	892	13.5
2005	17.1	975	14.8
2006	19.2	1144	16.1
2007	21.2	1340	17.4
2008	23	1597	18.2
2009	23.9	1843	19
2010	24.5	2200	19.8

⁶³ Ministry of Civil Affairs, *Statistical Communique on the Development of Social Services 2015* (Ministry of Civil Affairs 2016) <<http://www.mca.gov.cn/article/sj/tjgb/201607/20160700001136.shtml>> accessed 20 September 2017.

⁶⁴ Before the enactment of the Charity Law 2016 (China), there was no legal definition or registration procedure for charities. However, many non-profits could fall within the current scope of charities as defined by the Charity Law 2016 (China), such as some non-profits aimed at relieving poverty and enhancing education, health, environment and science. As to the legal definition of charities in this law, see CL 2016 (China), ss 3, 8 and 9.

⁶⁵ According to the Regulation on the Registration and Administration of Associations 1998 (China, revised in 2016), associations (‘社会团体’) are referred to as ‘non-profit social organisations which are voluntarily established by Chinese individuals to act according to the constitution and in the interests of their common will’. Regulation on the Registration and Administration of Associations 1998 (China, revised in 2016) (RRAA 1998 (China, revised in 2016)), s 2.

⁶⁶ In accordance with the Regulation on the Administration of Foundations 2004 (China), foundations (‘基金会’) are ‘non-profit legal persons established according to the Regulation, for the public benefit purposes by using the donations of individuals, legal persons or other organisations’. Regulation on the Administration of Foundations 2004 (China) (RAF 2004 (China)), s 2.

⁶⁷ Civil non-commercial units (‘民办非企业单位’) are ‘social organisations conducting non-profit social services, which are established by, and use the non-state owned assets of, enterprises, public institutions (‘事业单位’), associations, other forces and individuals’. Provisional Regulation on the Registration and Administration of Civil Non-commercial Units 1998 (China) (PRRACNU 1998 (China)), s 2. Civil non-commercial units are renamed by the Charity Law 2016 (China) as social service institutes (‘社会服务机构’). CL 2016 (China), s 8.

2011	25.5	2614	20.4
2012	27.1	3029	22.5
2013	28.9	3549	25.5
2014	31	4117	29.2
2015	32.9	4784	32.9

Unit: 10000 for associations and civil non-commercial units; 1 for foundations⁶⁸

Meanwhile, given the government's strict control on the establishment of non-profit organisations, which will be discussed in detail in Chapter 4, it can be assumed that the data in this table does not reflect the real number of non-profits, including independent charities, most of which until recently could not be registered in practice.

In addition, under this system, the government monopolises charitable resources and controls the majority of charities recognised by law whilst most independent charities cannot be registered and accordingly are regarded as illegal organisations, let alone being able to enjoy the tax benefits.⁶⁹ Consequently, this legal arrangement curbs the aspiration of individuals and private enterprises to form charities, to make charitable donations and to participate in the voluntary work⁷⁰ organised by charities, eventually reducing the amount of charitable resources.

Hence, after the enactment of the Charity Law 2016 (China), which allows independent organisations to register as charities, it can be reasonably expected that more and more donors and volunteers will fund or participate

⁶⁸ The data in this table was collected by the author according to several *Statistical Communiques on the Development of Social Services* issued by the Ministry of Civil Affairs, which are available on the official website of the Ministry of Civil Affairs <<http://www.mca.gov.cn/article/sj/tjgb/?>> accessed 20 September 2017.

⁶⁹ Karla W. Simon, 'The Regulation of Civil Society Organizations in China: Current Environment and Recent Developments' (2011) 9(1) *International Journal of Civil Society Law* 55. For an overview of the previous tax issues relating to charities, generally see Leon E. Irish, Dongsheng Jin and Karla W. Simon, 'China's Tax Rules for Not-for-profit Organizations' (2004) A Study Prepared for the World Bank 2004 <http://siteresources.worldbank.org/INTCHINA/1503040-1122886803058/20601839/NPO_tax_En.pdf> accessed 20 September 2017.

⁷⁰ The traditional volunteer regulations in China limit 'the ability for spontaneous volunteering to occur, much as it was needed in recent natural disasters'. Simon (n 36) 262.

in the charitable activities organised by charities, increasing charitable resources available to public goods delivery in the future. This will definitely make charities play an increasingly significant role in this area.

1.3.2 Inefficient Governance Mechanisms Leading to Frequent Charity Scandals, Lack of Public Trust, and Calls for Reform

Due to inefficient governance mechanisms, charity scandals are being frequently exposed by the media, greatly damaging the public trust and confidence in charities.⁷¹ For example, in 2013, it was found that Red Cross Poverty Alleviation Development Service Center (‘红十字会扶贫开发服务中心’) had misappropriated a charitable donation worth more than 84 million yuan (about 8.4 million pounds) for other causes.⁷² Also in 2013, Song Qingling Foundation of Henan Province was discovered by the media to have abused its charitable resources in a variety of ways. For instance, this charity spent more than 100 million yuan (about 10 million pounds) building a sculpture but immediately destroyed it.⁷³ In 2015, Jiabi Wen, the former vice-director of Red Cross Society of Sichuan Province, was sentenced to 20 years’ imprisonment for corruption.⁷⁴

Those scandals have, to a great degree, damaged the public confidence and trust in Chinese charities. Due to those frequent charity scandals, in 2011, from June to August, ‘charitable donations in China fell more than 80

⁷¹ Xiaoyong Huang and Liqiang Cai, ‘A Major Breakthrough in the Development of the Nonprofit Sector in China’ in Chien-Chung Huang and others (eds), *China’s Nonprofit Sector: Progress and Challenges* (Transaction Publishers 2014) 67-72.

⁷² See, for example, Hanliang Zheng, ‘Red Cross Society of China Recognised that It Misappropriated 84,700,000 RMB of Charitable Donations Which Should Have Been Used in the Disaster Relief of Wenchuan Earthquake’ *Radio France Internationale* (Paris, 29 April 2013) <<http://cn.rfi.fr/%E4%B8%AD%E5%9B%BD/20130429-%E4%B8%AD%E5%9B%BD%E7%BA%A2%E5%8D%81%E5%AD%97%E4%BC%9A%E6%89%BF%E8%AE%A4%E6%8C%AA%E7%94%A8%E6%B1%B6%E5%B7%9D%E8%B5%88%E7%81%BE8470%E4%B8%87%E5%B7%A8%E6%AC%BE>> accessed 20 September 2017.

⁷³ People, ‘How Deep Is the Water in the Event of Song Qingling Sculpture’ *People* (Beijing, 5 August 2013) <<http://opinion.people.com.cn/GB/363551/367637/index.html>> accessed 20 September 2017.

⁷⁴ Jian Zhang, ‘Why was the Charity Property of the Red Cross Society Changed into Private Property’ *Caijing* (Beijing, 15 September 2015) <<http://www.caijingmobile.com/wxshare/208790.html>> accessed 20 September 2017.

percent because of public mistrust'.⁷⁵ In addition, lacking trust in charities, individual donors do not play an important role in charitable donations: currently '80 percent of donations are from corporations',⁷⁶ which usually employ charitable donations as a tool to improve their reputation in order to pursue higher financial returns.⁷⁷

In the meantime, as a response to those scandals and due to the lack of public trust, recently 'the Chinese public has become much more engaged, demanding greater effectiveness, more transparency, and the control of corruption'⁷⁸ in terms of the use of charitable resources. Even an article published by one of the largest government news agencies also recognised the fact that '[w]hat people are really concerned about is finding a way of establishing a fair, transparent and reliable charitable organization'.⁷⁹ Here is a brief analysis of the major governance drawbacks in China, which will be examined in detail in the following chapters.

1.3.2.1 Inefficient Governmental Regulation⁸⁰

In terms of governmental regulation in China, one fundamental problem is that '[r]egistration standards are unjustifiably high, but there is little emphasis on overseeing [non-profit organisations'] operations and implementation.'⁸¹

⁷⁵ Adam Chodorow, 'Charity with Chinese Characteristics' (2012) 30(1) *UCLA Pacific Basin Law Journal* 1, 49; Sabrina Mao and Sui-Lee Wee, 'Donations to Charities in China Plunge after Scandals' *Reuters* (London, 8 December 2011) <<http://www.reuters.com/article/us-china-donations-idUSTRE7B70F820111208>> accessed 20 September 2017.

⁷⁶ Eileen Heisman, 'Philanthropic Leapfrog: Giving in China' *Nonprofit Quarterly* (Boston, 6 September 2013) <<https://nonprofitquarterly.org/2013/09/06/philanthropic-leapfrog-giving-in-china/>> accessed 20 September 2017.

⁷⁷ For example, see Xiufeng Chen and Li Li, 'The Rise of Corporate Social Responsibility and Charitable Foundations in China' in Chien-Chung Huang and others (eds), *China's Nonprofit Sector: Progress and Challenges* (Transaction Publishers 2014) 23-24.

⁷⁸ Lincoln C. Chen, Jennifer Ryan, and Tony Saich, 'Introduction: Philanthropy for Health in China: Distinctive Roots and Future Prospects' in Jennifer Ryan, Lincoln C. Chen and Tony Saich (eds), *Philanthropy for Health in China* (Indiana University Press 2014) 14.

⁷⁹ Junping Wang, 'How Can Red Cross Society of China Regain Public Trust?' *People's Daily* (Beijing, 6 July 2011) <<http://en.people.cn/90001/90780/91342/7431300.html>> accessed 20 September 2017.

⁸⁰ This problem will be comprehensively examined in Chapter 4.

⁸¹ Peifeng Liu, 'Nonprofit Legislation in China' in Chien-Chung Huang and others (eds), *China's*

First, regulators have not reduced all undue limitations on the establishment of independent charities. As noted above, historically, based on the traditional socialist ideology and social welfare system, all charities were either incorporated into the government or prohibited as illegal organisations. Consequently, before the carrying out of the ‘Reform and Opening Up’ policy, no charities existed that could be independent from the government. After the implementation of the new policy in 1978, no comprehensive law governing charities at the national level existed until the enactment of the Charity Law 2016 (China).

A more serious problem lies in the fact that the government built and is still maintaining a ‘dual administrative system’ (‘双重管理体制’).⁸² Although this system involves dual regulation, it should be clearly distinguished from the ‘dual regulation’ of charities in England, where some charities are regulated by both the Charity Commission and other regulators.⁸³

According to this system, regulators ‘place tremendous ideological importance on position [, and] most government efforts are focused on strictly regulating the registration process’.⁸⁴ In this context, before the enactment of the Charity Law 2016 (China) with the aim of relaxing the related limitations on the establishment of independent charities, few independent charities could be registered as legal organisations in practice. Instead, currently the majority of charities recognised and registered by the government are those affiliated to the government (government-controlled charities, i.e., quasi-government agencies),⁸⁵ which are distinguished from

Nonprofit Sector: Progress and Challenges (Transaction Publishers 2014) 81.

⁸² Xiaoguang Kang and Feng Li, ‘NGO Governance in China: Achievements and Dilemmas’ in Lisa Jordan and Peter van Tuijl (eds), *NGO Accountability: Politics, Principles and Innovations* (Earthscan 2006) 144.

⁸³ For example, charitable companies are jointly regulated by the Charity Commission and Companies House.

⁸⁴ Liu (n 81) 81.

⁸⁵ Karla W. Simon, ‘Reform of China’s Laws for NPOs: A Discussion of Issues Related to Shiye Danwei Reform’ (2005) The Forum on the Legal Framework of NPOs in China, Xiao Shan Conference <<http://unpan1.un.org/intradoc/groups/public/documents/un-dpadm/unpan042432.pdf>> accessed 20 September 2017; Project Team on ‘Reform of China’s Public Institutions and Development of China’s Non-Profit Organizations’, ‘Reform of China’s Public Institutions—Retrospect and Prospects’ (2004) 2(1) *International Journal of Civil Society Law* 7; Yunsong Ge,

independent charities in Western countries. And it remains to be seen to what extent the Charity Law 2016 (China) can change this situation in the future.

Second, regulators maintain direct control over governance issues in charities. Some basic modern regulatory principles, such as accountability and proportionality, are still not clarified by law or officially recognised by Chinese regulators, nor has there been any fundamental improvement to the relevant legal rules.

In this context, it is reasonable to expect that efficient use of charitable resources cannot be achieved due to a lack of sufficient competition, excessive control by the government over internal governance, and a lack of basic regulatory principles and rules.⁸⁶

1.3.2.2 Lack of Well-Designed Legal Rules in Respect of Internal Governance⁸⁷

Before the enactment of the Charity Law 2016 (China), there were several regulations in charge of regulating charities and other non-profits. The problem is that they focused on governmental regulation rather than on internal governance in charities. Meanwhile, although the model governing documents (‘章程示范文本’) issued by the Ministry of Civil Affairs, to some extent, provide more rules regarding internal governance, those rules are not well-designed. Even though this new law has been enacted, it has done little to improve the rules regarding internal governance.

First, there are few, if any, legal rules governing the fiduciary duties of charity trustees. In respect of the Charity Law 2016 (China), there is only one specific rule dealing with conflicts of interest, which requires that the

‘Nonprofit Organizations and the Reform of China’s Public Institutions’ (2004) 2(1) *International Journal of Civil Society Law* 27.

⁸⁶ For a detailed analysis of those problems, see the discussion in Chapter 4.

⁸⁷ This problem will be fully examined in Chapter 5.

initiators (‘发起人’), major donors (‘主要捐赠人’) and managers (‘管理人员’) of a charity cannot participate in the decision relating to their transaction with this charity and that the matters concerning the related transaction must be disclosed to the public.⁸⁸

However, this rule is insufficient in overcoming conflicts of interest in practice. For example, the managers’ scope is unclear. And there is no rule regulating the remaining managers in deciding whether to transact with those interested managers. In addition, there is no further mechanism limiting the number of managers benefiting from this transaction. All those problems may lead to managers abusing their powers.

Second, rules governing internal bodies are not well-designed. For example, there is no unified title referring to those persons in charge of a charity. According to the recently enacted Charity Law 2016 (China), there are ‘responsible persons’ (‘负责人’),⁸⁹ ‘decision-making bodies’ (‘决策机构’),⁹⁰ ‘executive bodies’ (‘执行机构’),⁹¹ ‘managers’⁹² and other terms, but who are finally responsible for the conduct of their charity is not clear.

Meanwhile, different types of charity have different internal bodies. For example, in an incorporated association, the members (‘成员; 社员; 会员’) and the board of directors (‘理事会’) are its essential internal bodies.⁹³ By contrast, the board of directors and the supervisory board (‘监事会’) are the essential internal bodies in a ‘donated legal person’ (‘捐助法人’).⁹⁴ The

⁸⁸ CL 2016 (China), s 14. A similar rule exists in the Regulation on the Administration of Foundations 2004 (China). RAF 2004 (China), s 23. In addition, the previous policy regulating foundations is the Measure for the Administration of Foundations 1988 (China) (‘基金会管理办法’), which has been repealed.

⁸⁹ CL 2016 (China), ss 9, 16, 54 and 95.

⁹⁰ CL 2016 (China), ss 11, 18 and 54.

⁹¹ CL 2016 (China), s 11.

⁹² CL 2016 (China), ss 14 and 58.

⁹³ Model Governing Document of Associations, ss 14 and 17; General Provisions of the Civil Law 2017 (China) (GPCL 2017 (China)), s 91.

⁹⁴ A donated legal person is a new organisation created by the recently enacted General Provisions of Civil Law 2017 (China). Those donated legal persons include but are not limited to foundations and social service institutes (the new name for ‘civil non-commercial units’). GPCL 2017 (China), ss 92-

existence of a range of internal bodies further increases the difficulty in identifying the charity trustees of a charity.

In addition, even though there are rules governing internal bodies in the General Provisions of the Civil Law 2017 (China), the Regulation on the Administration of Foundations 2004 (China) and the model governing documents issued by the Ministry of Civil Affairs,⁹⁵ the legal rights, duties and liabilities relating to those internal bodies are not well-designed. For example, in a charitable association, formally, its members are the authority body, but they are not required to be finally responsible for this charity, whilst most of the governance functions are performed by the board of directors, which is only regarded as the executive body.⁹⁶

Without reasonably distributing rights, duties and liabilities among internal bodies, those rules may lead to unnecessary disputes and conflicts in practice, negatively affecting the efficient use of charitable resources and the realisation of charitable purposes and public benefit pursued by a charity.

1.3.2.3 Unreasonable Supervisory Mechanisms Relating to Donors and the Public⁹⁷

First, in Chinese law, donors (‘捐赠人/赠与人’) are conferred too many rights with few duties in charity governance, which may lead to them abusing their powers. For example, in a charitable trust, apart from some rights relating to access to information,⁹⁸ the settlor has the right to ask the trustee to adjust the management methods of the trust property.⁹⁹ In addition, the settlor has the right to ask the trustee to recover the trust property or

⁹³ Regarding those organisations, see a further discussion in Chapter 5.

⁹⁵ See, for example, GPCL 2017 (China), ss 89, 91 and 93; RAF 2004 (China), ss 20-24; Model Governing Document of Associations, ss 7-29; Model Governing Document of Foundations, ss 8-28; Model Governing Document of Civil Non-commercial Units (Legal Persons), ss 10-23; Model Governing Document of Civil Non-commercial Units (Partnerships), ss 10-16.

⁹⁶ Model Governing Document of Associations, s 18.

⁹⁷ Those mechanisms will be further evaluated in Chapters 6-7 respectively.

⁹⁸ Trusts Law 2001 (China) (TL 2001 (China)), s 20.

⁹⁹ TL 2001 (China), s 21.

make compensation if the trustee violates his/her fiduciary duties.¹⁰⁰ However, the law does not provide any rule monitoring the settlor when s/he has the rights to make decisions for the trust's affairs or to supervise the trustee.

Second, there is a lack of reasonably designed public accountability mechanisms relating to accounting, reporting, auditing and information publicity. Even after the enactment of the Charity Law 2016 (China), which established one chapter relating to disclosure of information,¹⁰¹ there remains many problems in this area, such as the unclear relationship between financial reports and annual work reports,¹⁰² insufficient rules regarding remuneration of charity trustees,¹⁰³ and no differing rules concerning accounting, reporting and auditing of larger charities,¹⁰⁴ which may negatively affect the role of this new law in enhancing the public trust and confidence in charities.

1.4 Thesis Argumentation

Chapter 2 sets the scene by clarifying the scope of the key terms deployed throughout this thesis, including Chinese law, charities, charity governance and members of the governing body/charity trustees. This chapter presents a definition of each term, and discusses the reasons for this definition and the relationship between the terms and the topics explored in this thesis.

Chapter 3 provides a critical assessment of the traditional agency theory and other related economic and social theories in respect of evaluating charity governance. Combining the features of charities and the reasonable aspects of those theories, this chapter develops a more pragmatic and revised agency theory to supply a more reasonable and comprehensive guidance on

¹⁰⁰ TL 2001 (China), s 22.

¹⁰¹ CL 2016 (China), Chapter 8.

¹⁰² CL 2016 (China), s 13.

¹⁰³ *ibid.*

¹⁰⁴ Instead, this law only requires that the financial reports of charities having the public fundraising status should be audited. CL 2016 (China), s 72.

the assessment of charity governance.

On this basis, the thesis further examines the legal issues regarding charity governance from four important aspects in Chapters 4-7, i.e., governmental regulation, internal governance, third parties' supervision and public accountability. In these chapters, the thesis deploys the approaches and ideas developed in the above chapters to provide an economic and comparative analysis of the current laws, practices and problems regarding charity governance in China, and accordingly to propose the specific measures required to tackle the problems of governance in relation to Chinese charities.

Chapter 4 focuses on how to improve governmental regulation on charity trustees. Given the tradition of Chinese law in limiting the existence of independent charities whilst ignoring the building of efficient regulatory mechanisms, this chapter argues that, for Chinese regulators, the reform strategy of governmental regulation should be from strict control to efficient regulation. Based on an economic and comparative analysis of the law and practice in England and China, this chapter seeks to identify the related principles and rules in English law that can reduce the agency costs concerning governmental regulation and help China to improve its regulatory system governing charities.

Chapter 5 is concerned with the reform of internal governance mechanisms in Chinese law. This chapter focuses on two major issues, i.e., fiduciary duties and internal bodies. After a comprehensive economic and comparative analysis, this chapter explores specific measures facilitating the improvement of internal governance in Chinese charities.

Chapter 6 assesses the legal rules making charities accountable to third parties, including donors and beneficiaries, in both jurisdictions, and further offers the relevant reform strategies. This chapter clarifies the separate roles donors and beneficiaries should play in charity governance and puts forward a variety of suggestions for the reform of the legal rules governing donors

and beneficiaries in China in order to reduce the related agency costs.

Chapter 7 provides specific reform suggestions relating to legal rules regarding accountability to the public. In this chapter, public accountability mainly involves accounting, reporting, auditing and public access to information. After comparing charity law and practice in both jurisdictions, this chapter further gives suggestions for future reform in China from the perspective of reducing agency costs.

Chapter 8 summarises the core points in the previous chapters, comments on the possibility of implementing the reform suggestions of this thesis in practice, and discusses the work that remains to be carried out in the future.

Chapter 2 Setting the Scene

2.1 Introduction

To facilitate the economic and comparative study of charity governance in China, this chapter sets the scene by clarifying the scope of the key terms deployed throughout this thesis, including Chinese law, charities, charity governance and members of the governing body/charity trustees. In this context, this chapter also seeks to define those terms, give reasons for the definitions, and further point out the relationship between the terms and the topics which are to be discussed in the following chapters.

2.2 The Scope of Chinese Law Discussed in this Thesis

As noted by Jean Warburton, '[c]harity governance will not improve across the whole of the sector until the law that underpins the operation of charities is clear and easily accessible'.¹ To ensure that the governing body of a charity performs well, there must be a well-designed legal system.² However, before discussing how to improve this system, it is necessary to identify the scope of Chinese law discussed in this thesis first.

2.2.1 The Disadvantages of Defining Chinese Law in the Strict Sense

In China, the rules that can be formally regarded as laws ('法律') are those enacted by the National People's Congress or its Standing Committee,³ which definitely fall within Chinese law discussed in this thesis, the equivalent of which in England are statutes, such as the Charities Act 2011.

In this restrictive sense, there are several laws regulating charities in China, such as the Charity Law 2016 (China), the Enterprise Income Tax Law 2007

¹ Jean Warburton, 'Charities and Governance: the Role of the Law' in Debra Morris and Jean Warburton (eds), *Charities, Governance and the Law: the Way Forward* (Key Haven 2003) 273.

² See, for example, Henry Hansmann, 'The Role of Nonprofit Enterprise' (1980) 89 *Yale Law Journal* 835, 898.

³ Constitutional Law 1982 (China, revised in 2004) (CL 1982 (China, revised in 2004)), ss 62 and 67.

(China) (‘企业所得税法’), the Law on the Promotion of Privately Run Schools 2002 (China, revised in 2013) (‘民办教育促进法’), the Trusts Law 2001 (China) (‘信托法’), the Public Benefit Undertakings Donations Law 1999 (China) (‘公益事业捐赠法’),⁴ the Red Cross Society Law 1993 (China, revised in 2017) (‘红十字会法’) and the Individual Income Tax Law 1980 (China, revised in 2011) (‘个人所得税法’).⁵

However, a strict understanding of Chinese law may not facilitate the work of this thesis, because, except for a few rules provided by the recently enacted Charity Law 2016 (China), the main rules regulating charities at the national level are regulations and policies established by the State Council (‘国务院’) or other departments of the State Council, such as the Regulation on the Registration and Administration of Associations 1998 (China, revised in 2016) (‘社会团体登记管理条例’),⁶ the Provisional Regulation on the Registration and Administration of Civil Non-commercial Units 1998 (China) (‘民办非企业单位登记管理暂行条例’)⁷ and the Regulation on the Administration of Foundations 2004 (China) (‘基金会管理条例’), which regulate three types of non-profits in China.

In this context, it is impossible to have a clear understanding of the specific rules in practice if this thesis only deals with the rules enacted by the National People’s Congress or its Standing Committee.

⁴ Some Chinese scholars regard this law as the first law relating to charity undertakings since the establishment of the People’s Republic of China. Qiuguang Zhou and Guilin Zeng, *A Brief History of Charity in China* (People’s Publishing House 2006) 404 (周秋光、曾桂林: 《中国慈善简史》, 人民出版社 2006 年版).

⁵ Concerning Red Cross Society of China, see Caroline Reeves, ‘The Red Cross Society of China: Past, Present, and Future’ in Jennifer Ryan, Lincoln C. Chen and Tony Saich (eds), *Philanthropy for Health in China* (Indiana University Press 2014) 214-233.

⁶ The previous policies in this area mainly include the Provisional Measure for the Registration of Associations 1950 (China) (‘社会团体登记暂行办法’) and the Regulation on the Registration and Administration of Associations 1989 (China) (‘社会团体登记管理条例’), which have been repealed.

⁷ Although the title of the Provisional Regulation on the Registration and Administration of Civil Non-commercial Units 1998 (China) includes the word ‘Provisional’, similar to the other regulations, it has been used to regulate civil non-commercial units since its enactment.

2.2.2 Defining Chinese Law in a Wider Sense

Hence, in this thesis, the law should be understood in a wider sense and can be defined as ‘[t]he regime that orders human activities and relations through systematic application of the force of politically organized society’.⁸ In this context, all national laws enacted by Congress (in China)/Parliament (in England), regulations, other policies and model governing documents stipulated by the Ministry of Civil Affairs (the reason for including those model governing documents is given below) can fall within this definition. In respect of this definition, four issues need to be pointed out.

First, in China, there is one important difference between national laws and governmental regulations: ‘[a]dministrative regulations are always reflective of ministerial interests, while a basic law is the product of maneuvering by all of the different parties involved’.⁹

In other words, because these regulations are in reality drafted by the relevant governmental departments, they usually reflect the special interests and concerns of these departments and are mainly concerned with the procedures of governmental regulation rather than, for example, the rights, duties and liabilities among the governing body of a charity and its stakeholders. Accordingly, after the enactment of the Charity Law 2016 (China), it has become urgent for those regulations to be revised to comply with this new law’s requirement, which will be further discussed in Chapters 4-7.

Second, case law does not fall within Chinese law even in this wider sense. In England, charity law ‘comprises a very substantial body of case law upon which have been overlaid statutory provisions relating largely to matters of administration’.¹⁰ By contrast, although introducing a variety of legal rules

⁸ Bryan A. Garner, *Black’s Law Dictionary* (9th edn, West 2009) 962.

⁹ Ming Wang and others, ‘Revising the Regulations on Social Organizations’ (2014) 6 *The China Nonprofit Review* 1, 37.

¹⁰ Hubert Picarda QC, *The Law and Practice Relating to Charities* (4th edn, Bloomsbury Professional 2010) 4.

in Western countries into its domestic legal system, China is still a civil law country, where there is no case law, and, accordingly, all legal rules are stipulated in statutory laws.

In this context, even though China draws on numerous legal rules from common law countries, such as trusts law and legal rules regarding companies and financial regulation, given its civil law tradition, China has to transform the rules stipulated in case law into legal provisions in statutory laws. That is the potential value of English case law: some reasonable rules developed by case law can be incorporated into the future laws, regulations or policies in China.

Third, laws are the rules backed by the force of the state, differing from informal norms explored in Chapter 3, which ‘individuals feel obligated to follow because of an internalized sense of duty [or] because of a fear of external non-legal sanctions’.¹¹

Fourth, model governing documents issued by the Ministry of Civil Affairs are also regarded as part of Chinese law in this thesis. The reason is quite simple: ‘they are important in practice because it is supposed that the approval for the establishment of the respective NPOs will not be granted if the requirements of [those model governing documents] have not been fulfilled.’¹²

2.2.3 The Scope of Chinese Law

For the purposes of this thesis, the scope of Chinese law to be explored covers laws stipulated by the National People’s Congress or its Standing Committees, regulations, other policies and model governing documents issued by the Ministry of Civil Affairs.

¹¹ Richard H. HcAdams, ‘The Origin, Development, and Regulation of Norms’ (1997) 96 Michigan Law Review 338, 340.

¹² Thomas von Hippel and Knut B. Pißler, ‘Nonprofit Organizations in the People’s Republic of China’ in Klaus J. Hopt and Thomas von Hippel (eds), *Comparative Corporate Governance of Non-Profit Organizations* (CUP 2010) 434.

However, given the current differences in laws, regulations and policies among mainland China, Taiwan, Hong Kong and Macao, only those enacted in mainland China will be examined. In addition, although case law will also be discussed in assessing English law, it does not form part of Chinese law.

2.3 The Scope of the Term ‘Charities’ Used in this Thesis

2.3.1 Looking for a Definition of Charities that Is Acceptable in Both Jurisdictions

In England, in accordance with the Charities Act 2011, charities are defined by charitable purposes,¹³ which are made up of the purposes stipulated by charity law¹⁴ and for the public benefit.¹⁵ Those purposes include but are not limited to the relief of poverty or of those in need due to youth, age, disability or financial hardship; the advancement of education, religion, health, citizenship, community development, arts, culture, heritage, science, amateur sport, human rights, conflict resolution, equality, environmental protection, or animal welfare; and the promotion of the efficiency of the armed forces, police, fire and rescue services or ambulance services.¹⁶ And the public benefit requirement provides a standard for evaluating whether a purpose listed above is charitable or not.

With regard to Chinese law, there was no legal definition of charities until the recently enacted Charity Law 2016 (China). According to this new law, charities are defined as ‘non-profit organisations which are legally established, comply with the rules in this law, and aim to conduct charitable activities for the society’.¹⁷ Those activities include:

- (1) relieving the poor and the needy;

¹³ CA 2011, s 1(1).

¹⁴ CA 2011, s 2(1)(a).

¹⁵ CA 2011, s 2(1)(b).

¹⁶ CA 2011, s 3.

¹⁷ CL 2016 (China), s 8.

- (2) relieving the elderly, orphans, the ill, the disabled and providing special care;
- (3) alleviating damage caused by natural disasters, accidents, public health events and other emergencies;
- (4) enhancing education, science, culture, health, sports and other causes;
- (5) preventing and controlling pollution and other public hazards, and protecting and enhancing the ecological environment;
- (6) other public benefit activities complying with this law.¹⁸

Given the lack of a unified legal definition and the importance of charities in the study of the thesis, it is necessary to define the term ‘charities’ in a way that can be accepted in both jurisdictions to facilitate any further study. Taking account of the common features of charities in both jurisdictions and based on an economic analysis, in this thesis a charity is defined as ‘a non-profit organisation exclusively aiming to realise the charitable purpose/public benefit’.

On this basis, here it is necessary to further interpret the common features of charities and to make an important distinction between ‘government-controlled charities’ and ‘independent charities’ in the context of Chinese law. The relationship between those features and the topics examined in this thesis will also be discussed.

2.3.2 Common Features

2.3.2.1 Organisations

Charities form as organisations. This feature is shared by both Chinese and English charities, although the meaning of the term ‘organisation’ is not clear. In China, a charity is defined as an ‘organisation’ (‘组织’).¹⁹ But there is no further legal definition of it.

¹⁸ CL 2016 (China), s 3.

¹⁹ CL 2016, s 8.

In English law, a charity is defined as an ‘institution’,²⁰ which is further interpreted as ‘an institution whether incorporated or not, and includes a trust or undertaking’.²¹ But there is no further interpretation of the characteristics of ‘institution’. According to *Black’s Law Dictionary*, institution means ‘[a]n established organisation, esp. one of a public character, such as a facility for the treatment of mentally disabled persons’.²² And organisation is defined as ‘[a] body of persons (such as a union or corporation) formed for a common purpose’.²³

Given that there is no clear legal definition of the term ‘organisation’, in this thesis, organisations are to be understood from an economic perspective. In economics, the feature of an organisation mainly lies in its function of asset partitioning, especially ‘the shielding of the assets of the entity from claims of the creditors of the entity’s owners or managers’.²⁴ In this sense, charities, including charitable trusts, can be regarded as organisations in economic terms because of their function of separating their assets from the charity trustees’ and beneficiaries’ own assets.

Here, it is worth noting the potential relationship of this feature with the topics discussed in this thesis. In terms of charitable trusts, although they are not recognised as organisations in Chinese law,²⁵ from an economic perspective, they fall within the scope of organisations. This understanding can help clarify some internal governance issues relating to charitable trusts in Chinese law, which will be dealt with in Chapter 5.

²⁰ CA 2011, s 1(1).

²¹ CA 2011, s 9(3).

²² Garner (n 8) 869.

²³ *ibid* 1210.

²⁴ Henry Hansmann and Reinier Kraakman, ‘The Essential Role of Organizational Law’ (2000) 110 *Yale Law Journal* 387, 390.

²⁵ ‘Charitable trusts belong to public benefit trusts, and are activities through which to realise a charitable purpose, the principal entrusts his property to the trustee, who manages, disposes of the property and carries out charitable activities in the trustee’s name but in accordance with the wishes of the principal’. CL 2016 (China), s 44.

2.3.2.2 Non-Distribution Constraint

Charities are non-profit organisations. Accordingly, they must abide by the non-distribution constraint, which requires that the net income of an organisation should not be distributed ‘to individuals who exercise control over it, such as members, officers, directors, or trustees’.²⁶ This feature is shared by both Chinese and English charities.

According to Chinese law, the non-distribution constraint has been clarified as one of the basic principles of charity law,²⁷ and has also been used to define charities.²⁸ In addition, Chinese law further provides that a charity’s property cannot be distributed among its initiators, donors and members.²⁹

By contrast, in English law, the non-distribution constraint forms part of the fiduciary obligations of those running charities.³⁰ At the same time, with the continuing efforts by case law, the non-distribution constraint has been deeply rooted in, and functions as an invisible component of, the charitable purpose of any English charity.

For example, according to English case law, ‘[t]he element of unselfishness is well recognised as an aspect of charity’,³¹ and a purpose cannot be recognised as charitable if it may give beneficiaries more than incidental benefits.³² Therefore, it can be reasonably expected that any charitable purpose may include a component of altruism or unselfishness.³³ In this context, this non-distribution constraint can be identified as an objective

²⁶ Hansmann (n 2) 838; also CL 2016 (China), s 52.

²⁷ CL 2016 (China), s 4.

²⁸ CL 2016 (China), s 8.

²⁹ CL 2016 (China), s 52.

³⁰ See, for example, *Robinson v Pett* (1734) 3 P Wms 249; *Attorney General v Earl of Clarendon* (1810) 17 Ves 491; *Picarda* (n 10) 633-641.

³¹ *Incorporated Council for Law Reporting for England & Wales v Attorney General* [1972] Ch 73, 86.

³² *ibid* 87; Charity Commission, *Public Benefit: Analysis of the Law relating to Public Benefit* (Charity Commission 2013).

³³ Regarding the philosophic debate of altruism in charity law, see Matthew Harding, ‘What is the Point of Charity Law’ in Kit Barker and Darryn Jensen (eds), *Private Law: Key Encounters with Public Law* (CUP 2013) 163-170.

reflection³⁴ of this requirement.

This feature has a direct relationship with a range of topics explored in this thesis. First, the non-profit nature of charities is closely associated with the justifications for their existence, in particular compared to the for-profit nature of commercial companies. This will be dealt with when examining enterprise ownership theory in Chapter 3.

Second, the non-profit nature of charities may make charity governance more or less differ from corporate governance. For-profits are established for the private benefits (self-interest) of their owners. Although for-profits may also participate in the traditional areas of education, health care, etc., dominated by charities, for these for-profits, providing the above services is only a channel for them to realise their self-interest (through distributing the remaining assets to their owners).

By contrast, based on this non-profit nature, from an economic perspective, no party owns a charity, i.e., no one can control and obtain residual earnings from a charity.³⁵ In this respect, based on the public benefit requirement which requires charities to ‘benefit the community or a section of the community’,³⁶ charities have to comply with this rule more strictly than other non-profit organisations that may be controlled by their members. In the context of non-charitable non-profits controlled by their members, those members can effectively distribute the net earnings to themselves by subsidising the services that the non-profits provide in the future.³⁷ Accordingly, mutual benefit non-profit organisations are more similar to for-profit companies than to charities.

In this context, a range of governance mechanisms used in corporate

³⁴ By contrast, as a subjective issue, motive is ‘immaterial in determining whether a gift is charitable’. *Picarda* (n 10) 24; *Hoare v Osborne* (1866) LR 1 Eq 585, 587.

³⁵ ‘Ownership’ used here has two essential attributes, i.e., exercising of control and receipt of residual earnings. Henry Hansmann, *The Ownership of Enterprise* (Harvard University Press 1996) 11.

³⁶ *Oppenheim v Tobacco Securities Trust Co Ltd* [1951] AC 297, 305.

³⁷ Hansmann (n 35) 242.

governance cannot be directly implemented in charity governance. Therefore, in considering how to improve charity governance in China, the non-profit nature of charities should not be neglected, which will be further discussed throughout this thesis.

2.3.2.3 Exclusively Aiming to Realise the Charitable Purpose/Public Benefit

A charity exclusively aims to realise the charitable purpose/public benefit. Here, it is necessary to provide a brief analysis of charitable purposes and public benefit. First, for the purposes of this thesis, charitable purposes can be deployed to define charities in both jurisdictions. However, in contrast to English law, in which charities are defined by charitable purposes, Chinese law chooses to define charities by way of charitable activities.³⁸

Despite this, in Chinese law, there seems to be no clear distinction between ‘charitable purposes’ (‘慈善目的’) and ‘charitable activities’ (‘慈善活动’), let alone their respective roles in defining what a charity is. For example, the recently enacted Charity Law 2016 (China) uses ‘charitable aims’ (‘慈善宗旨’) to define charitable fundraising³⁹ while ‘charitable purposes’ is employed to define charitable donations, charitable trusts and charitable services.⁴⁰ In addition, this law also requires that ‘the property of a charity should, according to its governing document and donation agreements, be exclusively used for its charitable purposes’.⁴¹ Therefore, the Chinese legislators seem not to strictly distinguish the two terms. So far, there has not been sufficient academic debate on this problem in China. Accordingly, the arguments in England can bring a number of insights into the next academic study in this area.⁴² For brevity, in this thesis, the term ‘charitable purposes’ is deployed to define charities, charitable trusts and charitable

³⁸ CL 2016 (China), ss 3 and 8.

³⁹ CL 2016 (China), s 21.

⁴⁰ CL 2016 (China), ss 34, 44 and 61.

⁴¹ CL 2016 (China), s 52.

⁴² For example, see Jonathan Garton, ‘Charitable Purposes and Activities’ (2014) 67 *Current Legal Problems* 373, 373-407.

donations in both jurisdictions.

Second, public benefit can be understood as legal benefits benefiting the general public or a sufficient part of the public.⁴³ With regard to public benefit, there is no legal definition in Chinese law. Luckily, English case law has provided some rules interpreting its meaning.⁴⁴ Given the focus of this thesis on governance mechanisms and the complexity of the current rules regulating public benefit, for the purposes of this thesis, it is adequate to have a brief introduction to rather than a comprehensive analysis of public benefit.

In respect of the ‘benefit’ aspect, it must be legal.⁴⁵ Meanwhile, if the damage is given more weight than the benefit, it may not comply with the public benefit requirement.⁴⁶ In addition, this benefit should be identifiable and justified by evidence.⁴⁷

With regard to the ‘public’ aspect, the difficulty mainly lies in how to judge what comprises ‘a sufficient part’ of the public. In answering this question, English case law develops a range of detailed rules. In English law, the public benefit requirement governing a purpose may differ from that governing another;⁴⁸ and, in terms of the relief of poverty, this requirement may become so relaxed that organisations ‘which appeared otherwise to be of a private nature were held to be charitable’.⁴⁹

If a donation only aims to realise private benefits, it will not comply with

⁴³ Regarding a more detailed assessment of public benefit in English law, see, for example, Mary Syngé, *The ‘New’ Public Benefit Requirement: Making Sense of Charity Law?* (Hart Publishing 2015); Matthew Harding, *Charity Law and the Liberal State* (CUP 2014); Jonathan Garton, *Public Benefit in Charity Law* (OUP 2013).

⁴⁴ Concerning a recent case comprehensively analysing public benefit in English law, see *R (Independent Schools Council) v Charity Commission* [2012] Ch 214.

⁴⁵ *National Anti-Vivisection Society v Inland Revenue Commissioner* [1948] AC 31, 42; *Re Macduff* [1896] 2 Ch 451, 474; *Re Pinion* [1965] Ch 85, 106.

⁴⁶ *R (Independent Schools Council)* (n 44) [106].

⁴⁷ *Scottish Burial Reform and Cremation Society Ltd v Glasgow Corporation* [1968] AC 138, 146; *National Anti-Vivisection Society* (n 45); *McGovern v Attorney General* [1982] Ch 321; *Southwood v Attorney General* [2000] WTLR 1199.

⁴⁸ *Inland Revenue Commissioners v Baddeley* [1955] AC 572, 615.

⁴⁹ *Re Hobourn Aero Components Ltd’s Air Raid Distress Fund* [1946] Ch 194, 194.

the public benefit requirement.⁵⁰ By contrast, sometimes charities also supply private benefits. However, as long as the private benefits delivered by those charities belong to ‘incidental personal benefits’,⁵¹ delivering them does not violate the public benefit requirement; rather, it forms a necessary channel for those charities to satisfy this requirement.⁵²

If a purpose is aimed at mutual benefit, it may fail to be charitable,⁵³ with a few exceptions relating to the purpose of relieving poverty.⁵⁴ In addition, if beneficiaries are limited to those living in a specific region,⁵⁵ or the persons with ‘protected characteristics’ provided in the Equality Act 2010⁵⁶ (provided that this limitation also complies with the related legal rules⁵⁷), the public benefit requirement can be met. By contrast, if the beneficiaries of a purpose explicitly exclude the poor,⁵⁸ it may not comply with this requirement.⁵⁹

This feature has a close relationship with the topics dealt with in this thesis. First, the charitable purpose/public benefit pursued by a charity can distinguish it from a for-profit company and any other mutual benefit non-profit organisation, which is related to the economic justifications for charities discussed in Chapter 3.

⁵⁰ *Oppenheim* (n 36) 305-306.

⁵¹ On personal benefits (or private benefits), see Charity Commission, *Examples of Personal Benefit* (Charity Commission 2013).

⁵² *London Hospital Medical College v Inland Revenue Commissioners* [1976] 1 WLR 613, 620.

⁵³ *Waterson v Hendon BC* [1959] 1 WLR 985; *Re Clark's Trust* (1875) 1 ChD 497; *Cunnack v Edwards* [1896] 2 Ch 679; *Braithwaite v Attorney General* [1909] 1 Ch 510.

⁵⁴ *Re Hobourn Aero Components Ltd Air Raid Distress Fund* (n 49) 202; Charity Commission, *Public Benefit: The Public Benefit Requirement (PBI)* (Charity Commission 2013) 12.

⁵⁵ For example, see *Verge v Somerville* [1924] AC 496, 499.

⁵⁶ Those protected characteristics include ‘age; disability; gender reassignment; marriage and civil partnership; pregnancy and maternity; race; religion or belief; sex; sexual orientation’. Equality Act 2010 (EA 2010), s 4.

⁵⁷ For example, see EA 2010, s 193.

⁵⁸ *R (Independent Schools Council)* (n 44) [178]. As to the evaluation of ‘poor’, see *Re Clarke* [1923] 2 Ch 407; *Re Adams* [1968] Ch 80; *Re Resch* [1969] 1 AC 514; *Joseph Rowntree Memorial Trust Housing Association Ltd v Attorney General* [1983] Ch 159; *R (Independent Schools Council)* (n 44) [158]-[174]; Syngé (n 43) 86-108; Mary Syngé, ‘Poverty: An Essential Element in Charity after all’ (2011) 70 *Cambridge Law Journal* 649.

⁵⁹ *Re Hobourn Aero Components Ltd Air Raid Distress Fund* (n 49) 206-209; *Dingle v Turner* [1972] AC 601, 625.

Second, the charitable purpose/public benefit should become the final aim of the governing body in any charity, and thus forms the basic principle governing its performance. Hence, the charitable purpose/public benefit plays a vital role in charity governance, which will be further examined in the following chapters, in particular in Chapter 3.

2.3.3 An Essential Distinction: ‘Government-controlled Charities’ and ‘Independent Charities’

2.3.3.1 ‘Government-controlled Charities’

‘Government-controlled charities’ is not a legal term but a reality in China. As noted in Chapter 1, currently many Chinese charities are affiliated to the government and act as quasi-government agencies.⁶⁰ A typical example is public institutions (‘事业单位’) with charitable purposes,⁶¹ such as Song Qingling Foundation and its branches at local level.

In accordance with the Provisional Regulation on the Registration and Administration of Public Institutions 1998 (China), public institutions are social service organisations ‘which are established for the social public benefit purposes by the government or other organisations, use state assets and carry out activities concerning education, science, technology, culture and public health, etc.’.⁶² Here, it is necessary to point out that this definition cannot reflect the nature of public institutions, because charities that are founded by the government or receive governmental funding do not necessarily have to lose their independence and autonomy.

⁶⁰ Generally see Karla W. Simon, ‘Reform of China’s Laws for NPOs: A Discussion of Issues Related to Shiye Danwei Reform’ (2005) *The Forum on the Legal Framework of NPOs in China*, Xiao Shan Conference <<http://unpan1.un.org/intradoc/groups/public/documents/un-dpadm/unpan042432.pdf>> accessed 20 September 2017; Project Team on ‘Reform of China’s Public Institutions and Development of China’s Non-Profit Organizations’, ‘Reform of China’s Public Institutions—Retrospect and Prospects’ (2004) 2(1) *International Journal of Civil Society Law* 7; Yunsong Ge, ‘Nonprofit Organizations and the Reform of China’s Public Institutions’ (2004) 2(1) *International Journal of Civil Society Law* 27.

⁶¹ Of course, it is worth noting that, public institutions are not charities if they do not have exclusively charitable purposes.

⁶² Provisional Regulation on the Registration and Administration of Public Institutions 1998 (China), s 2.

As a matter of fact, apart from governmental funding, the biggest feature making those charities different from independent charities in Western countries may be that members of their governing body are usually selected and controlled by the government, leading to a lack of independent governance.⁶³

Therefore, to facilitate the study of charity governance in China, it is necessary to distinguish those charities from other independent charities in which the governing body rather than any other external stakeholder is independently responsible for the governance functions in practice.

2.3.3.2 Identifying the Core Requirements of Independence

In England, the independence of charities has been generally recognised and protected by law,⁶⁴ although recently there is a growing concern that charities are becoming controlled by the government.⁶⁵ By contrast, Chinese law does not provide any legal rule directly including the term ‘independence’, although there are rules dealing with conflicts of interest.⁶⁶

Nevertheless, for the purposes of this thesis, except for government-controlled charities, charities in both jurisdictions are independent non-profit organisations.⁶⁷ As charities do not have owners, they cannot be controlled by any party acting as if it were the owner. In this context, independence itself is aimed at guarding the charitable purpose and public benefit that a charity pursues by requiring its charity trustees to perform independently in achieving the charity’s purposes.

⁶³ It will be comprehensively analysed in Chapter 4.

⁶⁴ For example, see CA 2011, s 20; Charity Commission, *The Independence of Charities from the State (RR7)* (Charity Commission 2009).

⁶⁵ Ben Cairns, ‘The Independence of the Voluntary Sector from Government in England’ in Matthew Smerdon (eds), *The First Principle of Voluntary Action: Essays on the Independence of the Voluntary Sector from Government in Canada, England, Germany, Northern Ireland, Scotland, United States of America and Wales* (Baring Foundation 2009) 35-50; Kathryn Chan, *The Public-Private Nature of Charity Law* (Hart Publishing 2016) 126-159.

⁶⁶ CL 2016 (China), s 14.

⁶⁷ Generally, see Charity Commission (n 64); Cairns (n 65).

Accordingly, in respect of independent charities, independence can be defined as a requirement that charity trustees should govern their charity independently from their private benefits on the one hand and any undue external intervention on the other. In this respect, in contrast to the charity trustees of a charity, the governing body of a for-profit enterprise, such as the board of directors in a commercial company, is not independent from the owners, although those directors are required to make independent judgments:⁶⁸ the board of directors should act in the best interests of the owners of this for-profit enterprise.

This independent nature of charities supported by this thesis is in the first place directly related to the economic rationales for their existence (distinguished from for-profit enterprises and government-controlled charities), which will be comprehensively examined in Chapters 3-4.

At the same time, this feature is also associated with the design of governance mechanisms relating to charities (the independent decisions of charity trustees, and the level of external interventions, etc.). For example, '[f]or some charities, there are clear conflicts between public accountability and organisational autonomy'.⁶⁹ On the one hand, any action to harm the independence of a charity and its governing body in the name of accountability may finally damage the charity's best interest. On the other hand, inefficient accountability cannot benefit the realisation of the charitable purposes pursued by a charity. In this respect, the core problem is how to balance the relationship between autonomy and accountability, which will be further assessed from an economic perspective in Chapters 3-7.

2.3.4 A Further Limitation on the Scope

As noted above, the focus of the thesis is on any charity which is defined as

⁶⁸ Companies Act 2006, s 173. This will be explored at length when discussing charity members in Chapter 5.

⁶⁹ Debra Morris, 'Paying the Piper: The "Contract Culture" as Dependency Culture for Charities' in Alison Dunn (ed), *The Voluntary Sector, the State and the Law* (Hart Publishing 2000) 133.

a non-profit organisation exclusively aiming to realise the charitable purpose/public benefit. Therefore, mutual benefit organisations⁷⁰ which are non-profits (such as trade unions⁷¹ or friendly societies),⁷² and political organisations⁷³ will not be examined.

In addition, with regard to the governance in foreign charities and their branches, there is a very different regulatory system in China,⁷⁴ which involves more detailed policy and technical issues and may be not very relevant to the regulation of ordinary domestic charities. Therefore, for brevity, Chinese charities discussed in the thesis are limited to the country's domestic charities.

2.4 The Scope of Charity Governance Explored in this Thesis

2.4.1 Defining Charity Governance

‘In essence, governance is about ensuring the fit between the organization’s mission and its activities and performance’.⁷⁵ With respect to charities,

⁷⁰ Although they may also pursue a purpose listed in charity law, such as the advancement of health or education, the goods or services of those organisations are delivered to a group of beneficiaries which may be too limited to satisfy the public benefit requirement. Therefore, they cannot be recognised as charitable by law. *Re Hobourn Aero Components Ltd's Air Raid Distress Fund* (n 49); Charity Commission (n 54). Of course, as noted above, in English law, the public benefit requirement relating to the relief of poverty is very relaxed. Hence, a mutual benefit organisation with such a purpose may satisfy this requirement and thus be recognised as charitable by law.

⁷¹ *Re Amos* [1891] 3 Ch 159; *Re Mead's Trust Deed* [1961] 2 All ER 836.

⁷² *Re Clark's Trust* (n 53); *Cunnack* (n 53); *Braithwaite* (53).

⁷³ For political organisations, some of them may also pursue purposes that fall within the purposes listed in charity law, but they may not satisfy the public benefit requirement because ‘the court has no means of judging whether a proposed change in the law will or will not be for the public benefit’. *National Anti-vivisection Society* (n 45) 50; *McGovern* (n 47); *Southwood* (n 47); *R (Independent Schools Council)* (n 44); Charity Commission (n 32). In respect of the recent debates on this topic, see Christina Walton, ‘*McGovern v Attorney General: Constraints on Judicial Assessment of Charitable Benefit* (2014) 4 *Conveyancer and Property Lawyer* 317. Furthermore, regarding the recent development in this area in other common law countries, see *Aid/Watch Inc v Federal Commissioner of Taxation* [2010] HCA 42 (Australia); *Re Greenpeace of New Zealand Incorporated* [2014] NZSC 105.

⁷⁴ For example, see Law on the Administration of Activities of Overseas Non-governmental Organisations within the Territory of China 2016 (China) (‘境外非政府组织境内活动管理法’).

⁷⁵ Helmut K. Anheier, *Nonprofit Organizations: Theory, Management, Policy* (Routledge 2005) 231; also see Mike Hudson, *Managing without Profit: Leadership, Management and Governance of Third Sector Organisations* (3rd edn, Directory of Social Change 2009) 52 (which provides a classic description of the role of governance).

“‘[g]overnance’ is a commercial import from the corporate (profit) sector’.⁷⁶

In terms of corporate governance, a narrow version is usually concerned with the relationship between shareholders and managers. By contrast, a wider definition may involve ‘balancing the interests of three groups of actors: investors, managers and third parties who interact voluntarily or involuntarily with the firm’.⁷⁷

However, so far there is no legal definition of charity governance in both jurisdictions. For the purposes of this thesis, charity governance can be defined as any governance mechanism ensuring that members of the governing body in a charity perform efficiently for the charitable purpose/public benefit pursued by this charity.

2.4.2 Clarifying the Scope of the Legal Aspects of Charity Governance

In respect of the scope of the legal aspects of charity governance, a traditional understanding of charity governance (‘治理’) in China seems to be often equal to governmental regulation of charities, which is similar to the term ‘administrative management’ (‘行政管理’).⁷⁸ By contrast, in respect of English law, according to Hubert Picarda QC:

the prime fiduciary duties of [charity] trustees are to observe and not deviate from the prescribed objects unless authorised to do so and to avoid or achieve resolution of conflicts of interest. These involve not only equitable principles but also what is now modishly

⁷⁶ Greyham Dawes, ‘Charity Commission Regulation of the Charity Sector in England and Wales: the Key Role of Charity Audit Regulation’ in Klaus J. Hopt and Thomas von Hippel (eds), *Comparative Corporate Governance of Non-Profit Organizations* (CUP 2010) 879.

⁷⁷ Robert Flannigan, ‘The Economics of Fiduciary Accountability’ (2007) 32 *Delaware Journal of Corporate Law* 393, 418.

⁷⁸ For a brief introduction of the previous laws relating to charity governance in China, see Thomas von Hippel and Knut B. Pißler, ‘Nonprofit Organizations in the People’s Republic of China’ in Klaus J. Hopt and Thomas von Hippel (eds), *Comparative Corporate Governance of Non-Profit Organizations* (CUP 2010) 428-477; Karla W. Simon, ‘The Regulation of Civil Society Organizations in China’ (2011) 9(1) *International Journal of Civil Society Law* 55.

referred to as charity governance.⁷⁹

If this view is correct, it seems that, in England, charity governance mainly includes the fiduciary duties of members of the governing body (i.e., ‘charity trustees’ in English law⁸⁰) and the enforcement mechanisms relating to those duties.⁸¹

Nevertheless, from an economic perspective, according to agency theory,⁸² the aim of charity governance is to reduce the agency costs when ensuring that the performance of charity trustees in a charity complies with the charitable purpose/public benefit pursued by this charity. Accordingly, the law relating to charity governance should reduce the related agency costs when making the performance of charity trustees comply with the charitable purpose and public benefit requirement.

In this context, as to the legal aspects of charity governance, the analysis in this thesis will not only include the fiduciary duties of charity trustees and the enforcement mechanisms (which are usually limited to the parties who have the legal standing to sue charity trustees),⁸³ but also extend to other aspects benefiting the compliance by charity trustees (such as public disclosure) when necessary. In particular, four core legal aspects relating to charity governance will be examined in this thesis, i.e., governmental regulation, internal governance, supervision by third parties and public

⁷⁹ Hubert Picarda QC, ‘Harmonising Nonprofit Law in the European Union: An English Perspective and Digest’ in Klaus J. Hopt and Thomas von Hippel (eds), *Comparative Corporate Governance of Non-Profit Organizations* (CUP 2010) 186.

⁸⁰ CA 2011, s 177. In addition, the term ‘trustee’, along with ‘director’, is also widely used by American scholars. James J. Fishman, ‘Improving Charitable Accountability’ (2003) 62 *Maryland Law Review* 218, 231.

⁸¹ As regards the law governing charity governance in England, see Debra Morris and Jean Warburton (eds), *Charities, Governance and the Law: the Way Forward* (Key Haven 2003); Con Alexander and the Charities Team at Veale Wasbrough Vizards, *Charity Governance* (2nd edn, Jordan Publishing Limited 2014).

⁸² Agency theory will be explored in Chapter 3.

⁸³ In respect of a brief exploration of fiduciary duties and related enforcement mechanisms in English law, generally, see Picarda (n 79) 170-196. With regard to a similar evaluation in American law, see Henry Hansmann, ‘Reforming Nonprofit Corporation Law’ (1981) 121 *University of Pennsylvania Law Review* 497; and Rob Atkinson, ‘Unsettled Standing: Who (Else) Should Enforce the Duties of Charitable Fiduciaries?’ (1998) 23 *Journal of Corporation Law* 655.

accountability, which form the topics explored respectively in Chapters 4-7.

2.5 The Scope of Members of the Governing Body/Charity Trustees

2.5.1 Defining Members of the Governing Body/Charity Trustees

For the purpose of this thesis, members of the governing body in a charity are defined as persons who govern and are finally responsible for a charity. In English law, a legal term sharing this meaning is ‘charity trustees’, which is referred to as ‘the persons having the general control and management of the administration of a charity’.⁸⁴

By contrast, there is no united title or definition referring to the persons who govern and are finally responsible for a charity in Chinese law. As noted in Chapter 1, in the Charity Law 2016 (China), a range of legal terms, such as responsible persons,⁸⁵ decision-making bodies,⁸⁶ executive bodies⁸⁷ and managers,⁸⁸ are mentioned in its legal rules. However, neither the specific meanings of those terms nor the persons who govern and are eventually responsible for their charity are clear.

As a matter of convenience, the terms ‘members of the governing body’ and ‘charity trustees’ (for brevity, they are called ‘trustees’ in some contexts) are to be interchangeably used to refer to persons who are in charge of and have final responsibility for a charity both in England and in China.

2.5.2 Clarification of Who Falls Under the Term ‘Members of the Governing Body’

Sound charity governance has to be achieved by the good performance of charity trustees. Therefore, it is of vital importance to clarify who fall within

⁸⁴ CA 2011, s 177.

⁸⁵ CL 2016 (China), ss 9, 16, 54 and 95.

⁸⁶ CL 2016 (China), ss 11, 18 and 54.

⁸⁷ CL 2016 (China), s 11.

⁸⁸ CL 2016 (China), ss 14 and 58.

the definition of members of the governing body in a charity.

In this respect, in English law, it is comparatively clear who are the trustees of a charity. Based on the explanation of the Charity Commission, directors in a charitable company, managing trustees in a charitable trust, and committee members in a charitable unincorporated association are usually charity trustees,⁸⁹ although the identity of charity trustees may also need further clarification in some specific cases.⁹⁰

However, in Chinese law, there is no rule defining or clarifying the scope of members of the governing body. Furthermore, due to different governance structures, whether an internal body in a charity can be identified as the governing body in Chinese law needs to be examined on a case-by-case basis, which will form an important theme discussed in Chapter 5.

2.6 Conclusion

In this thesis, ‘Chinese law’ includes laws stipulated by the National People’s Congress or its Standing Committees, regulations, policies and model governing documents (enacted by the Ministry of Civil Affairs) in mainland China, but excludes case law, although case law will be discussed in assessing English law. A ‘charity’ is referred to as a non-profit organisation exclusively aiming to realise the charitable purpose/public benefit and is limited to a domestic charity. ‘Charity governance’ is defined as any governance mechanism ensuring that members of the governing body in a charity perform efficiently for the charitable purpose/public benefit pursued by their charity, and four legal aspects of charity governance, governmental regulation, internal governance, supervision by third parties and public accountability, are to be assessed in this thesis. The terms ‘members of the governing body’ and ‘charity trustees’ are interchangeably used to refer to persons who govern and are finally responsible for a charity.

⁸⁹ Charity Commission, *The Essential Trustee: What You Need to Know, What You Need to Do* (CC3) (Charity Commission 2016) 39.

⁹⁰ For example, see Charity Commission, *Inquiry Report: Greenfinch Charitable Trusts* (Charity Commission 2016) 2.

On this basis, the next chapter will develop a revised agency theory to facilitate a more comprehensive and pragmatic evaluation of charity governance in China and England.

Chapter 3 Building an Economic Framework for Evaluating Charity Governance

3.1 Introduction

This chapter presents a critical assessment of a range of major economic and social theories associated with charity governance, including the traditional agency theory, stewardship theory, crowding out theory, stakeholder theory, enterprise ownership theory and public goods theory. On this basis, combining the features of charity governance and the reasonable aspects of those theories, the thesis further develops a more pragmatic and revised agency theory to facilitate the evaluation of charity governance and to further supply a more reasonable and comprehensive guidance on how to improve charity governance.

3.2 A Critical Assessment of Major Economic and Social Theories

3.2.1 Introduction

In this section, the thesis critically examines the traditional agency theory and other relevant economic and social theories, such as stewardship theory, crowding out theory, stakeholder theory, enterprise ownership theory and public goods theory,¹ which are closely related to charity governance.

After a systematic analysis of those theories, this thesis argues that, on the one hand, the traditional agency theory is still of value in evaluating the performance of charity trustees in a limited sense, and other economic and social theories explaining the behaviours of and the mechanisms governing charity trustees also have their separate contributions in this area; but, on the other hand, the above economic and social theories cannot provide a comprehensive framework suitable for assessing the efficiency of charity

¹ Some scholars have begun to explore non-profit governance by integrating different theories. For example, see Stijn Van Puyvelde and others, 'The Governance of Nonprofit Organizations: Integrating Agency Theory with Stakeholder and Stewardship Theories' (2012) 41(3) *Nonprofit and Voluntary Sector Quarterly* 431, 431-451.

governance or helping to design the relevant governance mechanisms in a detailed manner.

3.2.2 Agency Theory

3.2.2.1 Core Ideas

According to agency theory, agency costs are directly related to a principal-agent relationship, which is different from the term ‘principal-agent relationship’ in the legal sense.

The legal definition is about duty and liability. Agents are those given a grant of authority by some principal. The principal is liable for the acts of the agent under that authority, and the agent has a duty of loyalty. In contrast to legal scholars, most economists presume that loyalty per se is impotent and focus on the contractual incentives that shape the agent’s performance.²

According to this theory, in a principal-agent relationship, because the agent usually has more information concerning his/her own intention and performance, s/he may have the motivation to perform inappropriately and harm the interest of the principal when their interests are different. For example, in a private trust, the trustee usually has more information concerning the trust property and his/her own performance relating to this property than his/her beneficiary. In this context, once their interests are different, this trustee may pursue his/her own interest instead of the best interests of the beneficiary. This phenomenon is called ‘moral hazard’. And the agency costs usually include the costs of reducing the moral hazard of agents and the residual loss due to the ineffectiveness of monitoring.³

² Richard Steinberg, ‘Principal-Agent Theory and Nonprofit Accountability’ in Klaus J. Hopt and Thomas von Hippel (eds), *Comparative Corporate Governance of Non-Profit Organizations* (CUP 2010) 76.

³ As to the agency costs, see Michael C. Jensen and William H. Meckling, ‘Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure’ (1976) 3(4) *Journal of Financial Economics* 305; Eugene F. Fama and Michael C. Jensen, ‘Agency Problems and Residual Claims’ (1983) 26 *Journal of Law & Economics* 327.

For for-profit enterprises, it is commonly recognised that their owners are the principals of the governing body, who have both the motivation and rights to supervise the governing body and reduce its moral hazard. In this context, the role of governance mechanisms is to reduce those agency costs when ensuring that the performance of the governing body complies with the interests of those owners.⁴

By contrast, there is a lack of ownership in terms of charities and other non-profit organisations. In this context, at least at first sight, it may be costly to avoid the moral hazard of the governing body and to ensure that it performs well,⁵ due to a lack of owners who both have the motivation (obtaining their residual earnings) and the right (controlling the organisation as the owners) to monitor the governing body.⁶ Accordingly, it seems to be more urgent to establish the related governance mechanisms in order to reduce the agency costs concerning ensuring compliance in charities.

3.2.2.2 Contributions and Drawbacks

Agency theory has certain contributions to make to charity governance. First, it points out the necessity for the law to control the moral hazard of charity trustees. In other words, there should be relevant governance mechanisms, such as public disclosure, fiduciary duties and governmental regulation, to solve the problems arising from severe information asymmetry. Second, agency costs need to be reduced. In English law, the rights of the parties (such as persons interested in a charity) to bring charity proceedings are limited.⁷ This legal arrangement may be interpreted as a mechanism to control unnecessary agency costs.

⁴ See, for example, Robert H. Sitkoff, 'Trust Law as Fiduciary Governance plus Asset Partitioning' in Lionel Smith (ed) *The World of the Trust* (CUP 2013) 430.

⁵ Henry Hansmann, *The Ownership of Enterprise* (Harvard University Press 1996) 238.

⁶ In respect of this concern, see, for example, Susan N. Gary, 'Regulating the Management of Charities: Trust Law, Corporate Law, and Tax Law' (1999) 21 *University of Hawaii Law Review* 593, 596; Evelyn Brody, 'The Limits of Charity Fiduciary law' (1998) 57 *Maryland Law Review* 1400, 1500.

⁷ CA 2011, ss 114-115. Regarding charity proceedings, see the discussion in Chapter 6.

However, agency theory has its own drawbacks in evaluating charity governance, including but not limited to the assumption about human nature concerning charity trustees (and executives, volunteers and other paid staff), vague accountability mechanisms and unclear performance evaluation standards.⁸ Agency theory does not supply a unified theoretical framework to resolve those problems.

First, and most fundamentally, what assumptions should people make about charity trustees in charity governance? According to the traditional agency theory, an agent is assumed to be a self-interested, rational, and financially motivated person who will pursue his/her own interest rather than the best interests of his/her owners, if there are conflicts of interest between them. And this agent is described as ‘an individual calculating likely costs and benefits, and thus seeking to attain rewards and avoid punishment, especially financial ones’.⁹ Accordingly, in corporate governance, the owners (shareholders) may align their interest with the agents (executives) by utilising performance-related salaries or other monetary motivations. This assumption is generally suitable to describe the situation in the commercial sector, where both shareholders and executives are motivated by profit.¹⁰

However, in the charitable sector, many charity trustees are volunteers who are motivated by lower-powered incentives such as altruism, love and pride.¹¹ If in practice most charity trustees were totally self-interested, then it would be impossible for the general public to trust, donate money to, or volunteer in, a charity governed by those self-interested persons. In this context, it is far away from the reality to assume that charity trustees are motivated by economic motivations to perform for a charity.

⁸ These three issues have been reported based on an empirical study. Judith L. Miller, ‘The Board as a Monitor of Organizational Activity: The Applicability of Agency Theory to Nonprofit Boards’ (2002) 12(4) *Nonprofit Management & Leadership* 429, 429-450.

⁹ Lex Donaldson and James H. Davis, ‘Stewardship Theory or Agency Theory: CEO Governance and Shareholder Returns’ (1991) 16(1) *Australian Journal of Management* 49, 51.

¹⁰ However, even in terms of this assumption in the for-profit sector, there is a totally different view. *ibid.*

¹¹ Regarding the voluntary nature of charity trustees, see the discussion in Chapter 5.

Second, in terms of charity governance, who should replace the role of owners in corporate governance? In this respect, agency theory cannot supply a satisfactory answer. Some scholars supporting agency theory take the idea of donors as owners for granted.¹² However, this view is totally different from the economic understanding of ownership: the exercising of control and receipt of residual earnings. In addition, as will be noted in Chapter 6, donors have to face a range of limitations in supervising charity trustees. Here, it is necessary to point out that donors ‘make gifts for a variety of reasons, only some of which reflect concern for the gift recipient’s general well-being’.¹³ Thus, in charity governance, it is unconvincing to identify donors as the principals of charity trustees.¹⁴

Third, how should the performance of the governing body of a charity be evaluated? A lack of ownership results in a charity having an obscure mission and unclear performance criteria to analyse and improve its performance generally and that of its trustees and executives especially.¹⁵ As a matter of fact, ‘given the complex, hard-to-define objective functions of most nonprofit organizations, it is often difficult to measure their output accurately’.¹⁶ In this context, even if donors of a charity are regarded as the principals of its charity trustees, it is always hard for those donors to evaluate the charity trustees’ performance.

According to contract failure theory, which will be discussed below, because of the lack of efficient supervision measures to enforce a contract (high monitoring costs), donors prefer to donate money to a charity rather than a

¹² Eugene F. Fama and Michael C. Jensen, ‘Separation of Ownership and Control’ (1983) 26(2) *Journal of Law & Economics* 301, 301-325; Geoffrey A. Manne, ‘Agency Costs and the Oversight of Charitable Organizations’ (1999) *Wisconsin Law Review* 227, 227-272.

¹³ Robert A. Katz, ‘Can Principal-Agent Models Help Explain Charitable Gifts and Organizations?’ (2000) *Wisconsin Law Review* 1, 3.

¹⁴ *ibid* 24-29.

¹⁵ For example, see Robert D. Herman, David O. Renz and Richard D. Heimovics, ‘Board Practices and Board Effectiveness in Local Nonprofit Organizations’ (1997) 7(4) *Nonprofit Management and Leadership* 373, 374.

¹⁶ Puyvelde and others (n 1) 442; William A. Brown, ‘Exploring the Association between Board and Organizational Performance in Nonprofit organizations’ (2005) 15 *Nonprofit Management & Leadership* 317, 317-339; Gregory O. Jobome, ‘Management Pay, Governance and Performance: the Case of Large UK Nonprofits’ (2006) 22 *Financial Accountability & Management* 331, 331-358.

commercial firm. In contrast to a for-profit enterprise, a charity which is aimed at realising the charitable purpose/public benefit and is regulated by the relevant rules such as the non-distribution constraint, can obtain more trust from donors and volunteers. In this context, the question remains about how the charity's donors can further accurately assess the performance of its charity trustees.

3.2.3 Stewardship Theory

3.2.3.1 Core Ideas

Stewardship theory is mainly associated with sociology and psychology, and is extremely different from the traditional agency theory. The most fundamental difference may lie in the assumption about human nature. Agency theory only focuses on self-interested behaviours and 'neglects the enormous amount of neural and other-regarding behaviors that exist [...] and the structures that might increase it'.¹⁷

By contrast, stewardship theory recognises a variety of non-financial motivations of agents, such as 'the need for achievement and recognition, the intrinsic satisfaction of successful performance, respect for authority and the work ethic',¹⁸ and argues that the agents have the 'tendencies to be collectively oriented and intrinsically motivated'.¹⁹ That may be why, although without sufficient supervision from shareholders, many executives working in a for-profit company, who are motivated by self-achievement, self-satisfaction, the hope to be recognised or a sense of duty, can often carry out their tasks quite well.²⁰

¹⁷ Charles Perrow, *Complex Organizations: A Critical Essay* (Random House 1986) 234.

¹⁸ Melinda M. Muth and Lex Donaldson, 'Stewardship Theory and Board Structure: A Contingency Approach' (1998) 6(1) *Corporate Governance: An International Review* 5, 6.

¹⁹ Chamu Sundaramurthy and Marianne Lewis, 'Control and Collaboration: Paradoxes of Governance' (2003) 28(3) 397, 398.

²⁰ Muth and Donaldson (n 18) 6; Amitai Etzioni, *A Comparative Analysis of Complex Organizations: On Power, Involvement and their Correlates* (Free Press 1975).

In this regard, there are two branches of stewardship theory.²¹ The first branch recognises that ‘the interests of the [agent] and the principal [may not be] aligned’,²² but argues that the agent will perform in the best interests of the principal rather than her own personal gain because ‘the agent values the effect of her actions on the utility of the principal and [...] pursuing her own objectives generate higher costs (in utility terms) than benefits’.²³ The second branch directly assumes that ‘the agent’s goals are perfectly aligned with those of the principal’.²⁴ Accordingly, in designing governance mechanisms, this theory supports empowering structures rather than control and monitoring in ensuring the sound performance of managers and executives.

3.2.3.2 Contributions and Drawbacks

In respect of charity governance, stewardship theory can at least bring the following insights: charity trustees, the majority of whom are volunteers, should be generally trusted, and, in contrast to a control and monitoring approach, a facilitative structure may perform better in promoting the efficient performance of charity trustees in realising their charity’s purpose. As a matter of fact, this idea seems to have been implemented in some common law jurisdictions: ‘[s]ince most directors are unpaid and serve out of a sense of civic duty, there is a reluctance to impose financial liabilities upon them’.²⁵

However, the biggest problem of this theory may be that it cannot completely deal with the problems of the moral hazard of charity trustees. If some basic regulatory and accountability mechanisms do not exist, it may not be able to control this moral hazard in practice.

²¹ Ralf Caers and others, ‘Principal-Agent Relationships on the Stewardship-Agency Axis’ (2006) 17(1) *Nonprofit Management & Leadership* 25, 28-29.

²² James H. Davis, F. David Schoorman and Lex Donaldson, ‘Toward a Stewardship Theory of Management’ (1997) 22(1) *Academy of Management Review* 20, 24.

²³ Caers and others (n 21) 29.

²⁴ Puyvelde and others (n 1) 436.

²⁵ James J. Fishman, ‘Improving Charitable Accountability’ (2003) 62 *Maryland Law Review* 218, 234.

3.2.4 Crowding Out Theory

3.2.4.1 Core Ideas

This theory relates to the ‘crowding out phenomenon’,²⁶ which falls within the research scope of economics and psychology. In practice, individuals usually have intrinsic (the desire to work for work’s sake) and extrinsic (the motivation forced by extrinsic intervention) motivations to do their job. And ‘the use of extrinsic incentives may crowd out intrinsic work motivation under identifiable conditions’.²⁷

In terms of charity governance, those intrinsic motivations, such as altruism, generosity, humanity, love and affection, can play an instrumental role in ensuring that charity trustees, volunteers²⁸ and other staff perform well: those motivations have ‘their own internal incentive to do the right thing and put in the time and effort necessary for effective nonprofit monitoring’.²⁹ Meanwhile, apart from their instrumental role, if it is commonly believed that those intrinsic motivations have an inherent value,³⁰ they should be cherished and maintained within charities in carrying out charitable activities.

In this respect, the law, as a typical external intervention, may affect intrinsic motivations in charity governance ‘through the promise of

²⁶ Bruno S. Frey, ‘On the Relationship between Intrinsic and Extrinsic Work Motivation’ (1997) 15 *International Journal of Industrial Organization* 427; Bruno S. Frey and Reto Jegen, ‘Motivation Crowding Theory’ (2001) 15(5) *Journal of Economic Surveys* 589; Yuval Feldman and Oren Perez, ‘How Law Changes the Environmental Mind: An Experimental Study of the Effect of Legal Norms on Moral Perceptions and Civic Enforcement’ (2009) 36 *Journal of Law & Society* 501.

²⁷ Frey (n 26) 428.

²⁸ Richard B. Freeman, ‘Working for Nothing: The Supply of Volunteer Labor’ (1997) 15 (1) *Journal of Labor Economics* 140.

²⁹ Thomas Lee Hazen and Lisa Love Hazen, ‘Punctilious and Nonprofit Corporate Governance--A Comprehensive Look at Nonprofit Directors’ Fiduciary Duties’ (2012) 14(2) *University of Pennsylvania Journal of Business Law* 347, 347.

³⁰ The approach taken by Emad H. Atiq seems to hold this view: ‘the loss of intrinsic motivation can be harmful to agents quite apart from the effect on behavioral outcomes’. Emad H. Atiq, ‘Why Motives Matter: Reframing the Crowding Out Effect of Legal Incentives’ (2014) 123 *Yale Law Journal* 1070, 1087.

monetary payments or the threat of sanction'.³¹ However, a monetary payment to, or an excessive regulatory burden on, charity trustees may harm ('crowd out') these intrinsic motivations³² and further restrain the involvement of capable volunteers substantially motivated by these factors in charity governance.

For example, a monetary payment may ultimately not 'bring in the people with the characteristics and skills charities need'.³³ Nor does an excessive legal obligation contribute to the participation of potential volunteers in charity governance. According to a previous survey by the Charity Commission, '11% of charities surveyed always have difficulties filling vacancies on the trustee body (2001: 12%). 39% of charities sometimes have difficulties filling vacancies (2001: 31%)'.³⁴ And one major reason is that many persons do not 'want the responsibility or are [not] willing to take on the legal obligations'.³⁵

3.2.4.2 Contributions and Drawbacks

In this context, crowding out theory can make a number of contributions to charity governance. First, it interprets the necessity of allowing for the existence of intrinsic motivations to assist the efficient performance of charity trustees. As a matter of fact, the core of trusteeship is 'trust' and if charity trustees are trusted they may perform better than the minimum standards required by law.³⁶ Accordingly, to reduce distrust³⁷ arising from

³¹ *ibid* 1080.

³² Noel Hyndman and Paul McDonnell, 'Governance and Charities: An Exploration of Key Themes and the Development of a Research Agenda' (2009) 25(1) *Financial Accountability & Management* 5, 16.

³³ Lord Hodgson, *Trusted and Independent: Giving Charity back to Charities-Review of the Charities Act 2006* (The Stationery Office 2012) 38.

³⁴ Charity Commission, *Start as You Mean to Go on: Trustee Recruitment and Induction (RS10)* (Charity Commission 2005) 7.

³⁵ *ibid* 24.

³⁶ Tore Ellingsen and Magnus Johannesson, 'Paying Respect' (2007) 21(4) *Journal of Economic Perspectives* 135.

³⁷ See, for example, Uri Gneezy, Stephan Meier and Pedro Rey-Biel, 'When and Why Incentives (Don't) Work to Modify Behavior' (2011) 25(4) *Journal of Economic Perspectives* 191.

control and monitoring, external regulation should be moderate and heavy legal burdens should be avoided.

Second, a monetary stipulation may crowd out the intrinsic motivations of charity trustees and lead to ineffectiveness. Therefore, in charity governance, when designing the legal and other incentives, it may be preferable to choose some social rewards other than direct monetary ones in ensuring the good performance of charity trustees.

Third, it is of value to provide a supportive framework rather than to set up an excessive regulatory system. Unnecessary or excessive regulation may negatively affect the performance of charity trustees. Hence, it may be unreasonable to only emphasise the idea that charity trustees should be loaded with more strict fiduciary duties or any other legal burden. Instead, some supportive information, training, education³⁸ or other facilitative measures should be put in place to promote their good performance.

However, similar to stewardship theory discussed above, this theory also has its own limitations. One of them is the limited function of this theory: it can only be used to complement rather than replace agency theory.

3.2.5 Stakeholder Theory

3.2.5.1 Core Ideas

In corporate governance, instead of only taking shareholders into account, stakeholder theory argues that other parties involved, such as customers, suppliers and the local community, should also be protected and valued. With respect to charity governance, this theory believes ‘that the provision of good quality information to stakeholders can enhance the legitimacy of the charity, securing stakeholders’ continuing support and organisational

³⁸ Rusell B. Korobkin and Thomas S. Ulen, ‘Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics’ (2000) 88 California Law Review 1051, 1132.

survival'.³⁹

3.2.5.2 Contributions and Drawbacks

As a matter of fact, in order to realise a charity's purpose, its charity trustees have to understand that they need to develop a good relationship with the public and other stakeholders, such as donors, of their charity. In this context, stakeholder theory makes at least the following contributions to charity governance.

First, it provides the potential candidates to supervise charity trustees. Second, the needs of stakeholders also form 'moral or philosophical guidelines for the operation and management of the [organisation]'.⁴⁰ In practice, to achieve a charity's purpose effectively and successfully, its charity trustees have to take account of and sometimes to satisfy the concerns and needs of the charity's stakeholders in performing their duties.

However, in charity governance, pure stakeholder theory itself cannot deal with the following issues. First, there is no clear definition or scope of stakeholders or key stakeholders, which may make it difficult to apply this theory in charity governance. According to Edward Freeman, a stakeholder can be 'any group or individual who can affect or is affected by the achievement of the organization's objectives'.⁴¹ By contrast, Helmut K. Anheier believes that 'stakeholders include members, trustees, employees, volunteers, clients or users, customers, funders, contractors, government, oversight agencies, community groups and watchdog organizations, etc.'.⁴² In addition, Ronald K. Mitchell, Bradley R. Agle and Donna J. Wood argue that the salience of stakeholders depends on three attributes: power,

³⁹ Ciaran Connolly, Noel Hyndman and Danielle McConville, 'Conversion Ratios, Efficiency and Obfuscation: A Study of the Impact of Changed UK Charity Accounting Requirements on External Stakeholders' (2013) 24 *Voluntas* 785, 788.

⁴⁰ Thomas Donaldson and Lee E. Preston, 'The Stakeholder Theory of the Corporation: Concepts, Evidence, and Implications' (1995) 20(1) *Academy of Management Review* 65, 71.

⁴¹ Edward Freeman, *Strategic Management: A Stakeholder Approach* (Pitman 1984) 46.

⁴² Helmut K. Anheier, *Nonprofit Organizations: Theory, Management, Policy* (Routledge 2005) 227.

legitimacy and urgency.⁴³ However, the above definitions and evaluation standards are too wide to be adopted in improving the legal rules associated with charity governance.

Second, it does not provide a reasonable solution regarding how to balance the interests between a charity and its stakeholders or among the stakeholders themselves. In some situations, '[o]ne stakeholder's mission drift might be another's appropriate responsiveness, and each of these conflicting characterizations is correct from that constituent's perspective'.⁴⁴ In this respect, the idea supporting that stakeholders, such as donors and beneficiaries, should be regarded as the principals of charity trustees in charity governance seems to ignore the potential tension between the best interests of a charity and the private interests of its stakeholders.

3.2.6 Enterprise Ownership Theory

3.2.6.1 Core Ideas

Enterprise ownership theory follows the transaction costs tradition⁴⁵ which was founded by Ronald Coase, one of the founders of the modern school of law and economics.⁴⁶ Coase points out 'that the operation of a market costs something and that, by forming an organization and allowing some authority (an "entrepreneur") to direct the resources, certain marketing costs are saved'.⁴⁷ Accordingly, 'in social life, structuring the law so as to reduce transactions costs is generally beneficial'.⁴⁸

⁴³ Ronald K. Mitchell, Bradley R. Agle and Donna J. Wood, 'Toward A Theory of Stakeholder Identification and Saliency: Defining the Principle of Who and What Really Counts' (1997) 22(4) *Academy of Management Review* 853, 853–886.

⁴⁴ Evelyn Brody, 'Accountability and Public Trust' in Lester M. Salamon (ed), *The State of Nonprofit America* (Aspen Institute & Brookings Institute Press 2002) 472.

⁴⁵ Concerning transaction costs, generally, see Oliver E. Williamson, *The Mechanisms of Governance* (OUP 1996).

⁴⁶ Richard Posner, *The Economics of Justice* (Harvard University Press 1983) 4.

⁴⁷ Ronald Coase, *The Firm, the Market and the Law* (The University of Chicago Press 1988) 40. Of course, different scholars may have different descriptions of transaction costs.

⁴⁸ Martin Ricketts, *The Economics of Business Enterprise: An Introduction to Economic Organisation and the Theory of the Firm* (Edward Elgar Publishing Limited 2002) 431.

In other words, organisations are established as an alternative mechanism to a market to reduce the transaction costs, such as the costs of search, information, bargaining, decision, policing and enforcement, incurred in an economic exchange.⁴⁹ However, because organisations also have their own internal administrative costs, when those costs are higher than the transaction costs incurred in a market, organisations will or should not emerge in this area.

On this basis, Henry Hansmann creates an ‘enterprise ownership theory’. According to this theory, ‘patron’ is a term referring to any person having a contractual relationship with a firm.⁵⁰ In a nutshell, ‘the efficient assignment of ownership minimizes the sum, over all the patrons of firms, of the costs of market contracting and the costs of ownership’.⁵¹ Accordingly, the most efficient ownership of firms will emerge and dominate most industries sooner or later. In this context, market contracting means that the patron can determine the firm’s activities by implementing the contractual relationship or ending it to build a new one with others, while ownership means that the patron can determine the firm’s activities by utilising its internal governance mechanisms.⁵²

In terms of charities, it is worth noting that, charities discussed in this theory are usually limited to independent charities.⁵³ In this respect, this theory seems to be a further development of Hansmann’s contract failure theory.⁵⁴ According to contract failure theory, individuals and entities who want to donate their property to benefit the public (we call them donors here)⁵⁵ can choose for-profits or charities to carry out their charitable activities. The reason for them to donate to charities lies in contract failure. Its basic idea is

⁴⁹ Carl J. Dahlman, ‘The Problem of Externality’ (1979) 22 (1) *Journal of Law & Economics* 141.

⁵⁰ Hansmann (n 5) 12.

⁵¹ *ibid* 47.

⁵² *ibid* 19-20.

⁵³ In terms of government-controlled charities in China, there will be a comparative assessment of those charities and independent charities in Chapter 4.

⁵⁴ Regarding the contract failure theory, see Henry Hansmann, ‘The Role of Nonprofit Enterprise’ (1980) 89 *Yale Law Journal* 835, 835-901.

⁵⁵ Sometimes volunteers can also be regarded as donors because they donate their services, time, information and energy to charity, although here only donors of money and other assets are explored.

as follows.

In the context of severe information asymmetry between customers and suppliers in some specific circumstances (such as separation between purchasers and users of services, provision of public goods, price discrimination, implicit loans, and complex personal services), because for-profits are aimed at maximising the private benefits of their owners and accordingly are likely to be motivated to betray the trust of consumers, high costs exist from supervising the performance of those for-profits to control their moral hazard.

As a result, consumers may be more likely to deal with non-profits instead of for-profits. This is particularly true for charitable donors⁵⁶ and volunteers. Take volunteers for example: '[w]here these volunteers believe that their effort left service quantity or quality unaffected and merely raised the profits of the proprietor or the shareholders, their commitment would presumably rapidly wane'.⁵⁷

According to enterprise ownership theory, which is a further development of contract failure theory, when market contracting costs and ownership costs are both extremely high, the patrons may choose to establish or fund a non-profit firm. Following this logic, the existence of charities is the result of economising the sum of market contracting costs and ownership costs in conducting charitable activities. The following discussion provides a basic interpretation of this argument with a focus on the features of charities.

First, accordingly to Hansmann, there are high market contracting costs which force donors to donate property to non-profits, especially to charities (as justified by his contract failure theory). For organisations that are mainly or partly funded by donations, due to the existence of severe information asymmetry, it is usually very expensive for donors and the general public to

⁵⁶ From an economic point of view, a charitable donation can be regarded as a contract, through which donors purchase goods and services from charities to benefit the public.

⁵⁷ Ricketts (n 48) 389.

supervise the performance of those organisations in carrying out charitable activities (high market contracting costs).

In this context, if those organisations are non-profits, the absence of owners gives donors the assurance that they can trust (at least to some extent) and donate money to them.⁵⁸ In particular, in contrast to other mutual benefit non-profits, the charitable purpose/public benefit and other accountability mechanisms in relation to charities can facilitate them to gain more trust from and thus reduce the market contract costs of donors and the general public.

Secondly, in terms of Hansmann' argument that, given the large number of donors, allowing them to own their donated organisation would be too costly (high ownership costs),⁵⁹ it is necessary to point out that this theory does not deal with the situation that the ownership costs may not be high due to the small number of donors. In this respect, it is worth noting that, even if the number of donors is limited in practice (such as a charitable trust which only has several settlors), allowing those donors to act as the owners of this organisation may reduce their supervisory costs, but will lead to the continuing existence of high market contracting costs, because this organisation owned by the donors is in essence a for-profit enterprise.

Thirdly, in *The Ownership of Enterprise*, Hansmann does emphasise that the managerial agency costs relating to non-profits appear to be relatively modest.⁶⁰ In charity governance, one interpretation of this argument may be that, given the charitable purposes and public benefit pursued by a charity, it

⁵⁸ In some situations or at some stages, charities may not be the most efficient form through which to provide public goods, especially for commercial charities, which mainly rely on fees or sales of goods and service. Henry Hansmann, 'The Economic Role of Commercial Nonprofits: The Evolution of the Savings Bank Industry' in Helmut K. Anheier and Wolfgang Seibel (eds), *The Third Sector: Comparative Studies of Nonprofit Organizations* (Walter de Gruyter 1990) 65-76. However, in this context, even without direct or indirect subsidies (such as the government grant and tax exemption), commercial charities may still have comparative advantages than for-profits: their characteristic of non-profit distribution can help them reduce the market contracting costs and 'remain in operation at [their] current scale as long as [their] revenues are sufficient to cover depreciation---that is, sufficient to earn just a zero net rate of return'. Hansmann (n 5) 240.

⁵⁹ Hansmann (n 5) 228.

⁶⁰ *ibid* 245.

may attract more trustworthy persons who are motivated by non-financial motivations to act as its charity trustees,⁶¹ which will reduce those charity trustees' moral hazard and the related monitoring costs.

3.2.6.2 Contributions and Drawbacks

For the purposes of this thesis, the major contribution of this theory is to demonstrate that the existence of independent charities is beneficial to reducing the related costs in ensuring that charity trustees perform well. Firstly, independent charities help reduce the monitoring costs (one vital component of the 'market contracting costs' used by Hansmann) of the general public and donors. In terms of charities, there exist a range of governance mechanisms, such as the charitable purpose/public benefit, voluntary nature of charity trustees,⁶² fiduciary duties and other accountability mechanisms.⁶³ Those mechanisms, as a whole, can be regarded as a mandate term between a charity's trustees and its financial supporters to ensure that 'donations are used effectively and are not easily expropriated'.⁶⁴

As a result, the general public and donors trust charities more than for-profit companies in public goods delivery. For many members of the general public, only knowing that an organisation is a charity means that they give it their trust and confidence,⁶⁵ reducing the supervisory costs of donors, volunteers and the public.

Secondly, independent charities help reduce the costs arising from the governing body's and other staff's moral hazard in a charity. Given the

⁶¹ Gerhard Speckhacher, 'Nonprofit Versus Corporate Governance: An Economic Approach' (2008) 18(3) *Nonprofit Management & Leadership* 295, 314.

⁶² This can be a good signal to the outside world that members of the governing body 'are motivated to take their decision control task seriously'. For example, see Fama and Jensen (n 12) 319.

⁶³ In respect of any further discussion of accountability relating to charity trustees, see Chapters 4-7.

⁶⁴ See, for example, Fama and Jensen (n 3) 344; Steinberg (n 2) 85; Michael Chesterman, *Charities, Trusts and Social Welfare* (Weidenfeld & Nicolson 1979) 102; Henry Hansmann, 'Reforming Nonprofit Corporation Law' (1981) 129 *University of Pennsylvania Law Review* 497, 507.

⁶⁵ In contrast to for-profits, 'the primary function of a nonprofit is to serve as an organization that patrons can trust'. Hansmann (n 64) 518.

charitable purposes and public benefit independent charities aim to achieve, those charities have the potential to attract ‘committed employees and voluntary workers since the lack of equity holders is an indication to them that their selflessness will not enrich someone else’.⁶⁶ In other words, in contrast to for-profits, the charitable purposes of a charity are attractive to trustworthy persons to act as its charity trustees or other staff. For example, in England, charity trustees are usually volunteers and motivated by non-financial motivations.⁶⁷ This arrangement, to some degree, reduces the possibility of charity trustees experiencing moral hazard, and accordingly ‘allows low cost control of agency problems’.⁶⁸

Thirdly, this theory emphasises the important role of voluntary financial supporters in supervising charity trustees in a charity. It indicates that the existence of a charity is to satisfy the information needs and concern of its charitable contributors that charitable resources will be efficiently used for the charity’s purposes. In this context, on the one hand, even if they do not have any right relating to internal governance, the charitable contributors of a charity can still supervise its charity trustees indirectly through contract mechanisms. On the other hand, in considering which stakeholders should be given extra rights by law to supervise the charity trustees, those charitable contributors cannot be ignored.

However, although this theory contributes a great deal to justifying the existence of independent charities, it explains little about how to further improve charity governance after the establishment of a charity.⁶⁹

⁶⁶ Speckhacher (n 61) 314; Susan Rose-Ackerman, ‘Altruism, Nonprofits and Economic Theory’ (1996) 34 *Journal of Economic Literature* 701, 701-728.

⁶⁷ Generally, see Bengt Holmstrom and Paul Milgrom, ‘The Firm as an Incentive System’ (1994) 84(4) *The American Economic Review* 972, 972-991; Edward L. Glaeser and Andrei Shleifer, ‘Not-for-profit Entrepreneurs’ (2001) 81 *Journal of Public Economics* 99, 99–115; Bengt Holmstrom and Paul Milgrom, ‘Multitask Principal-Agent Analyses: Incentive Contracts, Asset Ownership, and Job Design’ (1991) 7 *Journal of Law, Economics & Organization* 24, 24-52.

⁶⁸ Fama and Jensen (n 3) 344.

⁶⁹ Mihir A. Desai and Robert J. Yetman, ‘Constraining Managers without Owners: Governance of the Not-for-Profit Enterprise’ (2006) <<http://ssrn.com/abstract=661301>> accessed 20 September 2017.

3.2.7 Public Goods Theory

3.2.7.1 Core Ideas

Here, the term ‘public goods’ is an economic definition and ‘goods’ can be referred to all goods and services in their daily sense. From an economic perspective, goods can be divided into pure private goods, pure public goods and quasi-public goods.

Pure private goods have two basic features: rivalry and excludability. Rivalry means that ‘individual use does limit and can even exhaust potential use by others’,⁷⁰ while excludability requires that ‘once produced only consumers with property rights can benefit, and others can be prevented from benefiting at no or little cost’.⁷¹ A typical example of pure private goods is food.

As to pure public goods, they have two totally different characteristics, i.e., non-rivalry (‘individual use does not reduce the amount available for use by users or potential customers’)⁷² and non-excludability (‘once produced consumers cannot be prevented from benefiting except at great cost’).⁷³ National defence is a typical example.

Between pure private goods and pure public goods there are quasi-public goods, which can be further divided into non-excludable but rival quasi-public goods (such as fishing in a sea) and excludable but non-rival quasi-public goods (such as museums and theatres).

The core idea behind this theory is as follows. In economics, the term ‘free-rider’ refers to somebody who benefits from the goods, services and other resources without paying for the cost. With respect to public goods, due to the free-rider problem, the market cannot supply an efficient amount of

⁷⁰ Anheier (n 42) 118.

⁷¹ *ibid.*

⁷² *ibid* 117.

⁷³ *ibid.*

public goods ('market failure'). Accordingly, the government can overcome this problem by collecting tax.⁷⁴

3.2.7.2 Contributions and Drawbacks

In terms of charity governance, ensuring the sound performance of charity trustees can be regarded as a public good:⁷⁵ any individual can benefit from, but does not need to pay for, the good performance of charity trustees in achieving their charity's purposes and benefiting the general public. Therefore, due to the free-rider phenomenon, there may be insufficient individuals willing to ensure the compliance of charity trustees through accountability and supportive mechanisms. In this context, this theory can be used to justify why the government is usually the principal enforcer of fiduciary duties of charity trustees in charity governance whilst private parties may also have the right to supervise charity trustees, but only under limited conditions and situations.

However, this theory also has its drawbacks. First, it cannot provide a reasonable approach in terms of how to make charity trustees perform well for their charity's mission and thus cannot supply detailed strategies for designing governance mechanisms. Second, it cannot answer how to evaluate the performance of charity trustees. Third, this theory cannot justify which private party, along with governmental regulators, should have the right, or have what forms of right, to supervise charity trustees.

3.2.8 Summary

Given the features of charities, although the traditional agency theory can still play a role in evaluating the performance of charity trustees, such as reducing moral hazard and agency costs, some of its drawbacks should be

⁷⁴ Burton A. Weisbrod, 'Toward a Theory of the Voluntary Nonprofit Sector in a Three-Sector Economy' in Edmund S. Phelps (ed), *Altruism, Morality, and Economic Theory* (Russell Sage Foundation 1975) 171-195.

⁷⁵ Rob Atkinson, 'Unsettled Standing: Who (Else) Should Enforce the Duties of Charitable Fiduciaries?' (1998) 23 *Journal of Corporation Law* 655, 693.

addressed accordingly. In this respect, although stewardship theory, crowding out theory, stakeholder theory, enterprise ownership theory and public goods theory cannot provide a comprehensive framework evaluating charity governance, they may help revise the traditional agency theory to make it adapt to the special conditions relating to charity governance (such as a lack of owners and the voluntary nature of charity trustees).

3.3 Developing a Revised Agency Theory

3.3.1 Introduction

In this section, the thesis seeks to develop a revised agency theory which incorporates the reasonable aspects of the above theories and provides a more comprehensive, pragmatic and targeted approach to facilitating the assessment of charity governance. Based on this revised agency theory, charity trustees are the agents whilst the charitable purpose/public benefit is regarded as the principal, with ‘key stakeholders’ (who voluntarily provide charitable resources but who are not the charity trustees) and ‘other selected stakeholders’ (by operation of law) as the supervisors ensuring that those charity trustees comply with their duties to realise the charitable purpose/public benefit of their charity.

The following discussion seeks to justify why the principal-agent relationship in charity governance should be transformed into a relationship which involves the charitable purpose/public benefit (as the principal), ‘key stakeholders’ and ‘other selected stakeholders’ on behalf of the charitable purpose/public benefit (as the supervisors), and charity trustees (as the agents), and to explain how each of them should be understood. On this basis, it further lists the components of agency costs in charity governance and recommends general measures to reduce those costs.

3.3.2 Regarding the Charitable Purpose/Public Benefit as the Principal in Charity Governance

In this revised agency theory, the thesis argues that the charitable purpose/public benefit should be regarded as the principal of charity trustees in charity governance. The reasons are as follows.

3.3.2.1 ‘Mission-driven’ Governance

First, charity governance is ‘mission-driven’ governance, in which the charitable purpose/public benefit lays the foundation for the existence and development of any charity. According to Helmut K. Anheier, ‘[t]he mission is the principal purpose of the organization, and the very reason for its existence’.⁷⁶ In terms of charities, we can regard the charitable purpose of a charity as its mission.

In contrast to for-profit companies ‘which are ultimately about financial profit, nonprofit governance and management are ultimately about the organization’s mission. Put simply, nonprofit organizations are mission-driven rather than profit-driven’.⁷⁷ Therefore, in the charitable sector, ‘mission-driven’ governance replaces ‘profit-driven’ governance, and accordingly the charitable purpose/public benefit determines the specific aims and current and future development of a charity.

3.3.2.2 The Fundamental Standard Regulating Charity Trustees

Second, following the first point, the charitable purpose/public benefit acts as the fundamental standard to guide and constrain the conduct of charity trustees. Although, due to a lack of ownership, no party (including the government) has the same right as shareholders do in commercial companies to control and obtain the residual earnings of charities, it does not mean that charity trustees can do whatever they want to do. Instead,

⁷⁶ Anheier (n 42) 176.

⁷⁷ *ibid* 226.

charity trustees have to govern their charity and develop its relationship with the outside world exclusively for the charitable purposes and to satisfy the public benefit requirement. In this respect, charity trustees perform their fiduciary duties to no party rather than the charitable purpose/public benefit that their charity pursues.

On this basis, it is clear that charity trustees should be independent from any other stakeholder in making decisions for their charity. As noted in Chapter 2, independence can be further divided into two aspects, i.e., charity trustees should not perform for their own personal gain; and charity trustees should not be controlled by other parties, to ensure that they perform in the best interests of their charity. In both cases, the lack of independence will lead to moral hazard and violate the charitable purpose and public benefit that the relevant charity pursues. Reflected in the law, charity trustees should have the duty to observe the objects and avoid and manage conflicts of interest,⁷⁸ which will be further discussed in Chapters 4-5.

3.3.2.3 The Rule Guiding and Constraining Some Stakeholders

Third, associated with the above two points, the charitable purpose/public benefit also plays a role in guiding and constraining the conduct of some stakeholders of a charity. For example, if a donation is not for a charitable purpose or does not comply with the public benefit requirement, it will not become a valid charitable donation, and thus cannot enjoy the relevant tax benefits.⁷⁹

In addition, although some stakeholders have the right to supervise the performance of charity trustees in charity governance, they cannot damage the charitable purpose/public benefit that their charity pursues, or force the charity trustees to violate their fiduciary duties. In other words, in terms of

⁷⁸ Peter Luxton, 'Conflicts of Interest in Charity Law' in Alison Dunn (ed), *The Voluntary Sector, the State and the Law* (Hart Publishing 2000) 227-240; Charity Commission, *Conflicts of Interest: A Guide for Charity Trustees* (CC29) (Charity Commission 2014).

⁷⁹ See, for example, Oonagh Breen, 'EU Regulation of Charitable Organisations: the Politics of Legally Enabling Civil Society' (2008) 10(3) *The International Journal of Not-for-Profit Law* 50, 57.

charity governance, any person who has the right to make charity trustees accountable should at least respect the charitable purpose/public benefit, and any action damaging the charitable purpose/public benefit in the name of accountability should not be allowed by law.

3.3.2.4 Summary

Therefore, the thesis argues that, in charity governance, the charitable purpose/public benefit should replace the role of owners in corporate governance and act as the principal of charity trustees.⁸⁰ Accordingly, charity trustees are responsible for ensuring that their performance complies with the charitable purpose/public benefit⁸¹ that their charity aims to deliver.

Nevertheless, even if it is stipulated in detail in the governing document, the charitable purpose/public benefit is still too abstract to provide sufficient guidance to direct or regulate the performance of charity trustees. Hence, in order to improve charity governance, it is necessary to identify the charitable purpose/public benefit and to make it more specific, measurable and attainable. This arrangement ‘will facilitate performance measurement and ease of comparability’,⁸² strengthen accountability,⁸³ and assist stakeholders in understanding and evaluating the operational achievement of charity trustees.⁸⁴

Furthermore, the charitable purpose/public benefit cannot itself supervise and enforce the fiduciary and other duties of charity trustees. In this context, if no individual or organisation has the power/right to explain the meaning of the charitable purpose/public benefit and regulate the conduct of charity

⁸⁰ Of course, in the thesis, both ‘principal’ and ‘agent’ are used from the perspective of economics.

⁸¹ In the guidance of the Charity Commission, the public benefit requirement should be complied with in all the following aspects: to be a charity, to operate as a charity and to report on a charity’s work. Charity Commission, *Public Benefit: The Public Benefit Requirement (PBI)* (Charity Commission 2013). Furthermore, charity law also stipulates a host of legal rules to ensure the public nature of charities, such as the cy-pres doctrine.

⁸² Ciaran Connolly and Noel Hyndman, *Performance Reporting by UK Charities: Approaches, Difficulties and Current Practice* (The Institute of Chartered Accountants of Scotland 2003) 24.

⁸³ *ibid* 20.

⁸⁴ Speckhacher (n 61) 315.

trustees, even severe charitable abuse such as conflicts of interest, fraud and extreme carelessness will not be avoided in practice. Therefore, to protect the best interests of a charity, it is necessary to authorise some individuals or organisations with the power/right to supervise its charity trustees;⁸⁵ such candidates usually fall within the scope of the charity's stakeholders (in the widest sense).

3.3.3 Designating 'Key Stakeholders' and 'Other Selected Stakeholders' as the Supervisors on behalf of the Charitable Purpose/Public Benefit

In this revised agency theory, the thesis defines 'key stakeholders' of charity trustees and 'other selected stakeholders', regards them as the supervisors on behalf of the charitable purpose/public benefit to monitor the charity trustees, and further explores the basic approach to designing the specific rights and duties of those supervisors in charity governance.

3.3.3.1 Defining 'Key Stakeholders' and 'Other Selected Stakeholders'

The term 'supervisor' can be defined as any person who has the right to make charity trustees accountable for the charitable purpose/public benefit in a direct (such as the right to enforce their fiduciary duties) or indirect (such as public access to information) manner. To efficiently protect and realise the charitable purpose/public benefit that a charity pursues, some of its stakeholders have to be conferred the rights on behalf of the charitable purpose/public benefit to supervise the charity trustees' performance. In this context, the thesis distinguishes two types of stakeholders of a charity who can be regarded as the supervisors having the rights to monitor its charity trustees.

First, 'key stakeholders', i.e., persons who are not the trustees of a charity but who voluntarily contribute charitable resources (such as donations, voluntary work and tax benefits) to this charity. Accordingly, donors

⁸⁵ Kenneth L. Karst, 'The Efficiency of the Charitable Dollar: An Unfulfilled State Responsibility' (1960) 73(3) Harvard Law Review 433, 437.

(including the government, grant-making foundations, for-profit companies and individuals),⁸⁶ volunteers, governmental regulators (representing the interest of the whole community or the public) and the general public⁸⁷ can be regarded as the key stakeholders of a charity.

In this respect, the thesis follows Hansmann's enterprise ownership theory and argues that the existence of a charity is to satisfy the following concerns and information needs of persons providing charitable resources to it: the charity trustees of this charity can efficiently perform their duties to realise the charitable purpose/public benefit.

In this context, to protect the concerns and information needs of those key stakeholders, on the one hand, they can supervise the charity trustees' performance through the contract mechanism: those key stakeholders can enforce or end the contract (in economics) with their charity.⁸⁸ For example, if a charity's trustees do not perform well, its donor can end his/her financial support. On the other hand, to further satisfy and protect those concerns, the law may give a range of extra legal rights to those stakeholders to supervise the charity trustees, such as public access to information, and regulatory powers of governmental regulators.

From the perspective of agency theory, clarifying key stakeholders of a charity as the supervisors on behalf of the charitable purpose/public benefit can not only help reduce the charity trustees' moral hazard, but also reduce the supervisory costs of those key stakeholders in ensuring that the charity trustees comply with their duties. For example, the difficulty for key

⁸⁶ According to an investigation of the key stakeholders of annual reports and accounts by Ciaran Connolly, Noel Hyndman and Danielle McConville, 'the consensus was that funders were the key or primary stakeholders and they should be the main audience for the charity reports and accounts'. Ciaran Connolly, Noel Hyndman and Danielle McConville, 'UK Charity Accounting: An Exercise in Widening Stakeholder Engagement' (2013) 45 *The British Accounting Review* 58, 63.

⁸⁷ 'The government's sizable financial support for the non-profit sector vests the taxpaying public with a reasonable expectation that charitable assets should be used to advance socially beneficial objectives.' Reid Kress Weisbord and Peter DeScioli, 'The Effects of Donor Standing on Philanthropy: Insights from the Psychology of Gift-Giving' (2009/10) 45 *Gonzaga Law Review* 225, 227; Evelyn Brody, 'Whose Public? Parochialism and Paternalism in State Charity Law Enforcement' (2004) 79 *Indiana Law Journal* 937, 1035.

⁸⁸ Hansmann (n 5) 19.

stakeholders to supervise charity trustees will be reduced by empowering public access to information contained in charity accounts and reports or conferring other types of supervisory rights.

However, although their views and experience are quite useful for the improvement of the quality of services or goods provided by a charity, beneficiaries are not regarded as its key stakeholders in the thesis.⁸⁹ Unless they have to pay for the products or services provided by this charity, beneficiaries cannot influence its charity trustees' performance through any contract mechanism. In the meantime, although charities are established to achieve charitable purposes and to benefit the public, their existence is aimed at meeting the information needs and concerns of charitable contributors rather than those of beneficiaries in terms of efficient use of charitable resources. In this context, beneficiaries are only regarded as a channel for a charity to realise its charitable purpose/public benefit.

Second, 'other selected stakeholders' of a charity who have the right to make the charity trustees accountable for the charitable purpose/public benefit by operation of law, whether they provide charitable resources to this charity in practice or not (although they may donate in practice). For example, 'trust supervisors' ('信托监察人') in a Chinese charitable trust⁹⁰ and external auditors of a charity have the rights to supervise the charity's trustees, whether they donate any asset to it or not. In this respect, it is worth noting that, for the purposes of this thesis, if the law designs a special governance mechanism requiring self-regulation of charity trustees, the charity trustees themselves in this context can be regarded as falling with the scope of 'other selected stakeholders'.

For those selected stakeholders of a charity, the reason for them to enjoy the rights to monitor its charity trustees on behalf of the charitable

⁸⁹ Of course, when beneficiaries are also donors or part of the general public, they can become key stakeholders as defined in this thesis. However, in this context, they are regarded as key stakeholders not because of their role as beneficiaries, but due to their function as donors or members of the general public.

⁹⁰ Regarding 'trust supervisors' in Chinese law, see the discussion in Chapter 5.

purpose/public benefit is not because they donate assets to or act as volunteers to this charity. Instead, those supervisory rights enjoyed by the selected stakeholders are directly given by operation of law.

From an economic perspective, if governance mechanisms relating to those selected stakeholders work well in practice, they can control the moral hazard of charity trustees on the one hand and reduce the monitoring costs of key stakeholders noted above on the other. Of course, key stakeholders themselves may also play such a role. For example, if the government can efficiently regulate charity trustees, it will control both those charity trustees' moral hazard and the monitoring costs of other key stakeholders.

3.3.3.2 Reasonably Distributing the Rights and Duties of those Stakeholders in Supervising Charity Trustees

Given that the charitable purpose/public benefit itself cannot monitor charity trustees, it needs stakeholders to supervise them in performing their fiduciary duties. After clarifying key stakeholders and other selected stakeholders as the supervisors on behalf of the charitable purpose/public benefit, it is necessary to explore how to design the legal rules relating to the rights and duties of those stakeholders in charity governance. In this respect, several points need to be discussed here.

First, the moral hazard of those stakeholders themselves should not be neglected. In the context of charity governance, the aim of allowing some stakeholders to make charity trustees accountable is not to help those stakeholders to pursue their personal gain, but to protect the charitable purpose/public benefit. As noted above, in charity governance, no party has the same rights as those enjoyed by shareholders in a for-profit company. However, in practice, some stakeholders may make use of their supervisory rights to realise their own private benefits.⁹¹

⁹¹ See the discussion in the following chapters.

Thus, to reduce the moral hazard of those stakeholders in supervising charity trustees, the law should make it clear that, as the supervisors on behalf of the charitable purpose/public benefit, they should not violate the charitable purpose/public benefit of a charity or damage the fiduciary duties of any charity trustee. Meanwhile, the scope of 'selected stakeholders' should also be reasonably limited in order to reduce unnecessary costs relating to those stakeholders' moral hazard.

Second, apart from the stakeholders' moral hazard, the other monitoring costs should also be taken into account. For example, numerous preferences and interests among donors, volunteers, regulators and the general public may negatively affect the performance of charity trustees in realising the charitable purpose/public benefit.⁹² Therefore, to control those monitoring costs, the law should reasonably limit the forms of those stakeholders' supervisory rights and the scope of those selected stakeholders.

For example, apart from governmental regulators, the scope of stakeholders who have the right to enforce the fiduciary duties of charity trustees directly should be limited. As noted above, if ensuring charity trustees to comply with the charitable purpose/public benefit can be regarded as a public good,⁹³ to overcome the free-rider problem, the government is able to enforce the fiduciary duties of charity trustees.

However, to decide whether other stakeholders (key stakeholders or other selected stakeholders) can have the right to enforce fiduciary duties, it is necessary to have a comprehensive evaluation of the relevant agency costs, which will be explored in the following chapters. In this regard, it is apparent that, although the general public falls within the scope of key

⁹² In fact, the accountability of charities to their stakeholders meets a host of problems both in theory and in practice. Generally, see Diana Leat, 'Voluntary Organizations and Accountability: Theory and Practice' in Helmut K. Anheier and Wolfgang Seibel (eds), *The Third Sector: Comparative Studies of Nonprofit Organizations* (Walter de Gruyter 1990) 141-153.

⁹³ Atkinson (n 75) 693. In this context, although very obscure, a legal rule in Chinese law really hits the nail on the head: 'the donated property received by public benefit social organisations and any value added to it are the public property of the community, which is protected by national laws, and any organisation or individual cannot encroach upon, divert for other purposes, or cause damage to it'. Public Benefit Undertakings Donations Law 1999 (China) (PBUDL 1999 (China)), s 7.

stakeholders defined in this chapter, it cannot be cost-effective to empower each member of the community to enforce the fiduciary duties of charity trustees.

Meanwhile, in practice, stakeholders may have a range of other rights to supervise charity trustees. For example, the general public usually has the right to have access to the relevant information relating to a charity (such as its charity accounts and annual reports).⁹⁴ Furthermore, many donors, including grant-making foundations, for-profit companies or even individuals, can further monitor charity trustees directly by signing a 'donation contract'.⁹⁵ In this context, legislators should take agency costs into account in legal reform.

3.3.3.3 Summary

In summary, incorporating enterprise ownership theory and stakeholder theory together with the idea of identifying the charitable purpose/public benefit as the principal of charity trustees, this revised agency theory refines the role of key stakeholders (persons who are not the charity trustees but who voluntarily provide charitable resources) and other selected stakeholders (by operation of law) as the supervisors monitoring the charity trustees to ensure compliance with the charitable purpose/public benefit.

With respect to the rights and duties of those stakeholders, this revised agency theory argues that the moral hazard of stakeholders and other monitoring costs should be taken into account in designing the relevant legal rules. To control those costs, those stakeholders can neither violate the charitable purpose/public benefit pursued by charities, nor force charity trustees to breach their fiduciary duties. In addition, the forms of those

⁹⁴ Generally, see Noel Hyndman and Danielle McMahon, 'The Evolution of the UK Charity Statement of Recommended Practice: the Influence of Key Stakeholders' (2010) 28 *European Management Journal* 455.

⁹⁵ In English law it may sound strange to put 'donation' and 'contract' together. By contrast, a type of contract called the 'donation contract' does exist in Chinese Law. CL 1999 (China), ss 185-195. As to the role of donors in charity governance, see the discussion in Chapter 6.

stakeholders' rights and the scope of 'other selected stakeholders' should be carefully designed or reasonably limited.

For example, in terms of the rights to enforce the fiduciary duties of charity trustees, taking into account the public goods theory, this revised agency theory argues that it can be regarded as a public good to make charity trustees perform well. Accordingly, to overcome the free-rider problem, governmental regulators should have the power to supervise and enforce the fiduciary duties of charity trustees. Meanwhile, the rights of other stakeholders to directly enforce fiduciary duties should be limited. In addition, given governmental regulation may not efficiently make charity trustees perform well, the law can also give other private parties (including key stakeholders and other selected stakeholders) different forms of supervisory rights in specific legal contexts, based on a systematic consideration of the relevant agency costs.

3.3.4 Recognising Charity Trustees as Persons between Agents and Partners

Even according to the traditional agency theory, there is no debate on the view that charity trustees are regarded as the agents. Accordingly, the thesis still regards charity trustees as the agents who are responsible for the general control and management of a charity. However, given the total differences between agency theory and stewardship theory/crowding out theory, here it is necessary to discuss the assumption about human nature relating to charity trustees.

3.3.4.1 The Assumption about Human Nature Relating to Charity Trustees

In the commercial sector, it is reasonable to assume that both shareholders and executives are motivated to make profits. By contrast, in terms of the charitable sector, based on their voluntary or quasi-voluntary (less paid) nature, the persons choosing to act as charity trustees can be reasonably

assumed to be motivated by non-financial motivations, by and large.

Nevertheless, there are several exceptions to this assumption. For example, because of the charitable status and the relevant benefits a charity brings, some persons seeking to act as its charity trustees may use this charity as a channel to carry out illegal activities, such as funding terrorism or tax evasion,⁹⁶ although in reality the number may be quite small.

In addition, after becoming the charity trustees of a charity, when facing situations (such as conflicts of interest) that can bring great private benefits to those charity trustees but may damage the charitable purpose/public benefit of the charity (the best interests of the charity), the possibility for the trustees to be motivated by self-interested motivations may become much higher: even if they cannot directly obtain remuneration from their charity, those charity trustees may in practice 'enjoy profits distributed as nonfinancial private perquisites, such as first-class travel to exotic locations and architectural wonders for headquarters'.⁹⁷

On this basis, in terms of the assumption about human nature concerning charity trustees, a more compromised but pragmatic standpoint should be put in place: charity trustees (and, in a wider sense, other volunteers and lower-paid executives and staff) are generally altruistic persons and are willing to realise the charitable purpose/public benefit out of their intrinsic motivations or based on the social norms; however, without an effective legal control, some of them may pursue their own interests instead of the best interests of their charity or may sometimes not perform as efficiently as possible.⁹⁸

According to this assumption, charity trustees can be generally trusted by

⁹⁶ A typical example in this respect is the charity scandal relating to the Cup Trust. Committee of Public Accounts, *Charity Commission: the Cup Trust and Tax Avoidance (Seventh Report of Session 2013-14)* (The Stationery Office 2013).

⁹⁷ Steinberg (n 2) 87.

⁹⁸ As a matter of fact, this assumption reflects the tension between different motivations inherent in people's minds.

the public but need to be regulated under some special circumstances where it is highly possible for them to pursue their own interests instead of the best interests of a charity, or to carry out their duties inefficiently.⁹⁹

3.3.4.2 The Relevant Strategies

In this context, charity trustees should be given more facilitative support. In view of the fact that voluntary charity trustees with the relevant skills, experience and knowledge are of vital importance to the success of a charity, efficient recruitment policies and methods should be put in place to ensure that capable persons can be selected as charity trustees. And the training and other facilitative support can also assist charity trustees in efficiently performing their duties. Meanwhile, a minimum legal and regulatory system should be implemented to tackle serious events relating to the moral hazard of charity trustees.

3.3.5 Evaluating Charity Governance: Types of Agency Costs

3.3.5.1 Introduction: Expanding the Contents of Agency Costs in Relation to Charity Governance

Traditionally, in respect of agency costs, different scholars may have different views about the specific content. According to Michael C. Jensen and William H. Meckling, agency costs include '(1) the monitoring expenditures of the principal, (2) the bonding expenditures by the agent, and (3) the residual loss'.¹⁰⁰ From the point of view of Henry Hansmann, agency costs are 'the sum of the costs incurred in monitoring and the costs of managerial opportunism that result from the failure or inability to monitor with complete effectiveness',¹⁰¹ in which the monitoring costs in fact

⁹⁹ Hyndman and McDonnell (n 32) 23. For an analysis of the practice of charity governance from the perspectives of the traditional agency theory, stewardship theory and stakeholder theory, see Rowena Sinclair, Keith Hooper and Samir Ayoub, 'Perspectives of Accountability in Charities in New Zealand' (2013) 14(4) *Journal of Asia-Pacific Business* 312, 312-335.

¹⁰⁰ Jensen and Meckling (n 3) 308.

¹⁰¹ Hansmann (n 5) 38.

include the above costs of (1) and (2).

However, for the purposes of the thesis, agency costs include not only the costs of avoiding the charity trustees' moral hazard (along with the residual loss regarding the charity trustees' moral hazard, which is not efficiently controlled) but also the costs of assisting them in their sound performance (and the residual loss concerning inefficient use of charitable resources due to a lack of facilitative environment and necessary support). Meanwhile, the costs relating to co-ordinating supervisors, the costs due to the moral hazard of supervisors and the costs of the negative influence of external intervention, etc., which have not received sufficient attention, will be incorporated into the content of agency costs in the revised agency theory. Those expanded agency costs can benefit a more comprehensive cost/benefit analysis when considering the issues concerning how to improve charity governance.

Accordingly, in this thesis, agency costs relating to charity governance include the monitoring costs and the residual loss (such as the costs arising from misconduct by charity trustees due to insufficient regulation and supervision, or the costs relating to inefficient use of charitable resources due to a lack of support from external stakeholders). Combining the above theories and the unique characteristics of independent charities, the thesis argues that the monitoring costs mainly include the following aspects, which should be taken into account and balanced when designing the relevant legal and regulatory mechanisms associated with charity governance.

3.3.5.2 The Costs Relating to Co-ordinating Supervisors and their Collective Decision-making Process

First, the monitoring costs include the costs relating to co-ordinating supervisors and their collective decision-making process.¹⁰² Unless otherwise specified, throughout the thesis, supervisors are regarded as

¹⁰² These costs are highly stressed by Henry Hansmann. Hansmann (n 5) 39-44.

individuals/organisations that have the right to make charity trustees accountable for the charitable purpose/public benefit. In addition, collective decision mainly focuses on membership charities while co-ordination principally stresses the co-operation between different governmental regulators (such as the Charity Commission and HMRC).

For example, although lacking ownership, in a membership charity where there are a host of members with the right to vote, if the interests and preferences of those members are very diverse, it will be too costly to exchange information and ideas and to balance those different interests and preferences. Accordingly, members may not make an efficient decision concerning charity governance.¹⁰³ As noted by the Charity Commission, '[d]isputes and disagreements [...] within the membership can be costly and time consuming, and a diversion of charitable resources'.¹⁰⁴

3.3.5.3 The Costs of Supervision, Support and Enforcement

Second, the monitoring costs include the costs of supervision, support and enforcement. For instance, the government has to deploy time, money and human resources, etc., to supervise, to supply the relevant guidance and facilitative support to, and to enforce the fiduciary duties of, charity trustees. In particular when facing budgetary cuts, it has become an urgent task for regulators to control those costs.

3.3.5.4 The Costs of the Moral Hazard of Supervisors Themselves

Third, the monitoring costs comprise the costs of the supervisors' moral hazard. The traditional agency theory does not challenge who should be the principal but may 'simply assert that some party has the power to dictate contract terms'.¹⁰⁵ However, as argued above, in charity governance, charity trustees should realise the charitable purpose/public benefit rather than the

¹⁰³ Charity Commission, *Membership Charities (RS7)* (Charity Commission 2004).

¹⁰⁴ *ibid* 11.

¹⁰⁵ Steinberg (n 2) 81.

private benefits of any stakeholder.

Accordingly, stakeholders cannot be regarded as the principals of charity trustees. Therefore, in supervising the trustees of a charity, once the interests of the charity's stakeholders conflict with the charitable purpose/public benefit that it pursues, it is necessary to control those stakeholders' moral hazard. In particular, given that the charitable purpose/public benefit cannot itself directly control the charity's trustees, those costs should be paid special attention.

For example, although a charity's donors do not have its ownership, they can supervise its charity trustees by acting as the charity's members, through the rights authorised in its governing document or just by ending their donations. However, '[w]hereas pure altruists wholly adopt the public interest, impure altruists pursue self-interested objectives that might (or might not) conflict with the public interest'.¹⁰⁶ In several circumstances, donors may take advantage of a charity to pursue their private benefits, resulting in damage to that charity's independence and, finally, to the public confidence and trust.

In addition, sometimes, the requirements of a funder conflict with the charitable purposes or fiduciary duties of the governing body of a charity, although the funder is not totally aimed at benefiting him or herself. For example, a contract by a charity which is located in London may restrict 'the charity to providing community care facilities to mental patients coming from one hospital, to the exclusion of other mental patients from other hospitals who have links with that city'.¹⁰⁷ This contract may violate the public benefit requirement governing this charity.

More extremely, some donors may take advantage of charities as a channel to launder money or fund terrorists; some government officers may take

¹⁰⁶ Weisbord and DeScioli (n 87) 236.

¹⁰⁷ Debra Morris and Karen Atkinton, 'Charities Biting the Hand that Feeds: Relationships with Their Funders' in Debra Morris and Jean Warburton (eds), *Charities, Governance and the Law: the Way Forward* (Key Haven 2003) 200.

bribes when registering an organisation as a charity, deciding whether to provide tax benefits¹⁰⁸ or helping to conceal the illegal acts of charity trustees; some funders may force a charity to only trade with their relatives.

In those situations, if the supervisors pursue their own personal gain in the name of accountability, the charitable purpose/public benefit pursued by a charity and the public, the government, volunteers and donors will suffer a loss. Therefore, the right of supervisors in making charity trustees accountable should also be limited to a reasonable extent. To cope with those problems, some effective measures, such as defining the scope of the right/power and clarifying the procedure of exercising this right/power, should be put in place.

3.3.5.5 The Costs of the Negative Effects of External Intervention

Fourth, the monitoring costs contain the costs of the negative effects of external intervention. These costs are usually ignored by the traditional agency theory, but are highly stressed by crowding out theory.¹⁰⁹ For example, an excessive regulation may neither ensure the more efficient performance of charity trustees nor encourage capable persons to act as charity trustees. Moreover, external accountability may force a charity's trustees to use more charitable resources to satisfy the accountability requirements rather than to directly carry out its charitable purposes. Accordingly, more costs in ensuring compliance may mean that fewer charitable resources are used directly in the mission of charities. In this context, excessive regulation could be isolated from the original intention of regulators and other supervisors.

In addition, a more singular problem in this respect is the costs of conflicts or disputes between supervisors and charity trustees, which may not be related to illegal or immoral activities. For example, in respect of a charity's

¹⁰⁸ For example, see Faizul Latif Chowdhury, *Corrupt Bureaucracy and Privatization of Tax Enforcement* (Pathak Shamabesh 2006).

¹⁰⁹ Frey (n 26).

internal management affairs, some of the supervisors may have preferences or views that differ from those of the charity trustees. In this context, the so-called ‘supervision’ is, as a matter of fact, not associated with ensuring the better performance of the charity trustees, but is a pure conflict which will have no positive effect on charity governance.

And, when litigation is involved, ‘[f]or the disputing charity, it can divert energy, time and resources away from its primary task and can damage its public image. It can also have a very real financial cost in litigation and lost revenue’.¹¹⁰ Accordingly, legal suits which are in the name of accountability but in reality are only linked to pure conflicts, are too costly to be brought. They are not beneficial to the realisation of the charitable purpose/public benefit¹¹¹ that a charity pursues or to maintaining a good relationship between the charity’s stakeholders and its charity trustees.¹¹²

Hence, from the perspective of reducing the monitoring costs, instead of legal suits between charities, charity trustees and the relevant stakeholders, some clear internal dispute resolution mechanisms,¹¹³ external mechanisms to deal with complaints and alternative dispute resolutions (ADRs) should be put in place.¹¹⁴ However, the precondition of using these dispute resolutions is that the relevant conflicts or disputes are not of serious concern. If they are very severe, then, instead of the above dispute resolutions, some legal enforcement mechanisms will be essential to tackle them.¹¹⁵

¹¹⁰ Debra Morris, *Disputes in the Charitable Sector* (Charity Law Unit of University of Liverpool 2003) 1.

¹¹¹ *British Diabetic Association v Diabetic Society Ltd* [1996] FSR 1, 5-6.

¹¹² Generally, see Charity Commission, *Conflicts in a Charity: Statement of Approach* (Charity Commission 2008); Morris (n 110).

¹¹³ Peter Luxton, *The Law of Charities* (OUP 2001) 534.

¹¹⁴ Morris (n 110).

¹¹⁵ *ibid* 5.

3.3.6 Improving Charity Governance: Drawing the Boundary between Law and Other Mechanisms

From an economic perspective, the measures taken to improve charity governance should be cost-effective. In this context, well-designed legal duties and enforcement mechanisms should be put in place to control the serious moral hazard of charity trustees and reduce excessive monitoring costs. Meanwhile, intrinsic motivations (such as altruism and love), informal norms (such as moral sanctions)¹¹⁶ and structural support (such as facilitative training, information provision and clear guidance) are also very important to reduce agency costs: intrinsic motivations and informal norms are usually self-enforced and thus cost-effective whilst structural support may result in costs but can, to some degree, be compensated by a better performance and output from charity trustees.

Therefore, by incorporating the above theoretical framework, the thesis argues that, to ensure charity trustees to perform efficiently to realise the charitable purpose/public benefit of their charity, there should be reasonably designed legal and regulatory mechanisms governing those charity trustees, combined with intrinsic motivations, informal norms and structural support.

3.3.6.1 Reasonably Designed Legal and Regulatory Mechanisms

Charity governance is governance within the law. The law is essential in protecting the right of citizens to establish charities, avoiding the moral hazard of charity trustees and defining the rights, duties and liabilities of charity trustees and their stakeholders.

From an economic perspective, the law, as an important institutional arrangement relating to charity governance, should help reduce the whole agency costs in ensuring compliance. In this respect, neither a lack of legal rules nor excessive legal burdens may contribute to the reduction of the

¹¹⁶ In respect of the discussion of the role of norms in charity governance, see Fishman (n 25) 242-255.

whole agency costs. Accordingly, with respect to the legal rules relating to charity governance, they should be well-designed to control the serious moral hazard of charity trustees on the one hand and to avoid excessive monitoring costs on the other. In other words, the legal arrangement should be maintained to the level of controlling severe situations such as conflicts of interest, fault and excessive carelessness, and leave scope for the lower-power incentives and norms to play a role in improving charity governance.¹¹⁷

First, the law should focus on designing reasonable standards of fiduciary duties and other supervision and enforcement mechanisms in order to reduce the costs relating to the severe moral hazard of charity trustees.

Second, the law should also have its own limits in promoting sound charity governance. When developing the legal rules associated with charity governance in China, it is worth noting that, '[a]ttributing problems only to inadequate laws and regulations would be an oversimplification.'¹¹⁸ To reduce the relevant agency costs, the law is essential in setting up and implementing legal rules governing the duties of charity trustees and the relevant accountability mechanisms, but should also facilitate a wide scope for other mechanisms, such as the intrinsic motivations of charity trustees, informal norms, training and other structural support, to play a role.

For example, although key stakeholders and other selected stakeholders acting as supervisors can make charity trustees accountable in a range of ways, to reduce the costs of the supervisors' moral hazard, the supervisory costs and other monitoring costs, the law should limit the scope of persons who have the rights to directly enforce the fiduciary duties of charity trustees.

¹¹⁷ As many commentators suggest, 'the law has played a relatively minor role in the evolution of board structure and behavior; market and other social forces are far more important'. Donald C. Langevoort, 'The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability' (2001) 89 *Georgetown Law Journal* 797, 800.

¹¹⁸ Peifeng Liu, 'Nonprofit Legislation in China' in Chien-Chung Huang and others (eds), *China's Nonprofit Sector: Progress and Challenges* (Transaction Publishers 2014) 83.

In addition, in effectively curbing the severe misconduct or mismanagement of charity trustees, the legal and regulatory system should reduce the high costs relating to the negative effects of external intervention. In this respect, for a voluntary charity trustee, as long as his/her decisions are reasonable and honest, s/he should not be hindered by charity regulators or punished by law.¹¹⁹ Meanwhile, as to those legal and regulatory mechanisms focusing on the serious moral hazard of charity trustees, truly altruistic charity trustees can be reasonably expected not to regard this kind of legal control as severe external intervention so that their intrinsic motivations may be ‘crowded out’.

3.3.6.2 Intrinsic Motivations

In terms of intrinsic motivations, it is of vital importance to allow intrinsic motivations, such as a sense of responsibility, honour, altruism, love and affection, to motivate charity trustees to perform well.¹²⁰ Associated with this, for every charity, it is critically important to implement an appropriate selection policy for potential charity trustees¹²¹ in order to attract truly altruistic, skilled, experienced and capable persons.

For charity trustees who are more or less motivated by those intrinsic motivations, the possibility of moral hazard and the related monitoring costs may be low. In this respect, it is critical and urgent for China to encourage the development of a voluntary spirit.

3.3.6.3 Informal Norms

With respect to informal norms, they are different from legal rules. These norms are informal rules ‘that individuals feel obligated to follow because of an internalized sense of duty [or] because of a fear of external non-legal

¹¹⁹ Brody (n 87) 976.

¹²⁰ Steinberg (n 2) 81-82.

¹²¹ Puyvelde and others (n 1) 444.

sanctions'.¹²² For example, in England, there exist some codes of conduct¹²³ that have been developed and recommended by the charitable sector itself, which can facilitate the efficient performance of charity trustees without any legal sanction.

More importantly, many informal norms in charity governance are self-enforced and accordingly help reduce the monitoring costs. Therefore, they 'may be far more important than legal sanctions in causing [charity trustees] to adhere to their fiduciary responsibilities'.¹²⁴ That may form an important reason for the Public Administration and Constitutional Affairs Committee to emphasise good practices in dealing with the recent fundraising controversy in the UK: 'the [Charity] Commission and regulators should assist the sector in developing a more ethical fundraising culture, and to make sure that bad practices are not tolerated'.¹²⁵

3.3.6.4 Facilitative Support

As regards facilitative support, the reason why, in many situations, a charity's trustees are not performing as efficiently as possible is not due to a lack of intrinsic motivations or legal and social constraints, but because of the unclear mission or lack of knowledge and sufficient skills in dealing with the charity's affairs. Therefore, in charity governance, there is a phenomenon which is quite similar to corporate governance: the vital problem 'is not the manager who consciously violates his trust, but the manager who does his best but whose best is not good enough'.¹²⁶

¹²² Richard H. H. Adams, 'The Origin, Development, and Regulation of Norms' (1997) 96 Michigan Law Review 338, 340; Richard A. Posner, 'Social Norms and the Law: An Economic Approach' (1997) 87(2) The American Economic Review 365, 365.

¹²³ For example, see The Governance Code Steering Group, *Good Governance: A Code for the Voluntary and Community Sector* (2nd edn, The Governance Code Steering Group 2010); Charity Governance Code Steering Group, *Charity Governance Code for Larger Charities* (Charity Governance Code Steering Group 2017); Charity Governance Code Steering Group, *Charity Governance Code for Smaller Charities* (Charity Governance Code Steering Group 2017).

¹²⁴ Hansmann (n 54) 875.

¹²⁵ Public Administration and Constitutional Affairs Committee, *The 2015 Charity Fundraising Controversy: Lessons for Trustees, the Charity Commission, and Regulators* (Third Report of Session 2015-16, HC431) (The Stationery Office 2016) 3.

¹²⁶ Melvin Aron Eisenberg, 'New Modes of Discourse in the Corporate Law Literature' (1984) 52

In this context, similar to the commercial sector where ‘imitation of standard managerial practices may suffice for relatively successful performance’,¹²⁷ facilitative support in charity governance is quite necessary, such as training, information provision and practical guidance on the specific aspects of charity governance (either supplied by regulators, umbrella bodies, watchdog agencies, the media or a charity itself).¹²⁸ This will assist charity trustees in efficiently performing their duties.

3.3.7 Summary

In terms of this revised agency theory, charity trustees act as the agents; the charitable purpose/public benefit plays the role of the principal; and persons (excluding the charity trustees) voluntarily providing charitable resources (‘key stakeholders’) and other selected stakeholders by operation of law are regarded as the supervisors ensuring that the charity trustees efficiently realise the charitable purpose/public benefit pursued by their charity.

In this context, agency costs are still the standards by which to evaluate charity governance, whilst the content of those costs extends to the costs relating to co-ordinating the supervisors and their collective decision-making process; the costs of supervision, support and enforcement; the costs of the supervisors’ moral hazard; the costs of the negative effects of external intervention (the above four forms of costs are called the ‘monitoring costs’ in this thesis); and the residual loss (arising from insufficient accountability or support). And the aim of charity governance is to reduce those agency costs accordingly.

On this basis, the general measures reducing agency costs in relation to charity governance should mainly include a reasonably designed legal system relating to the legal duties of charity trustees and their enforcement mechanisms, combined with intrinsic motivations, informal norms and

George Washington Law Review 582, 590.

¹²⁷ Hansmann (n 5) 38.

¹²⁸ Generally, see Lord Hodgson (n 33) 34-41, which focuses on ‘supporting the essential contribution of trustees’.

structural support.

3.4 Conclusion

The traditional agency theory cannot effectively explain or evaluate charity governance. To make it adapt to the conditions in the context of charity governance, it should be incorporated with other theories, such as stewardship theory, crowding out theory, stakeholder theory, enterprise ownership theory and public goods theory, in evaluating charity governance.

Taking into account the features of charities, this chapter has developed a revised version of agency theory. According to this theory, in a charity, its charity trustees are recognised as the agents (but the assumption about those charity trustees' human nature has been changed in a more pragmatic manner), the charitable purpose/public benefit plays the role of the principal, and the key stakeholders (persons who are not the charity trustees but who provide charitable resources to this charity, such as the government, donors, volunteers, and the general public) and other selected stakeholders by operation of law (whether those selected stakeholders donate assets to this charity or not) act as the supervisors on behalf of the charitable purpose/public benefit.

According to this revised agency theory, agency costs continue their role in evaluating charity governance. The contents of agency costs in the context of charity governance include the monitoring costs and the residual loss. However, the monitoring costs should be further extended to the costs relating to co-ordinating the supervisors and their collective decision-making process; the costs of supervision, support and enforcement; the costs of the supervisors' moral hazard; and the costs of the negative effects of external intervention. The residual loss includes the costs of the charity trustees' moral hazard due to inefficient accountability and the costs regarding inefficient use of charitable resources because of insufficient support. Accordingly, charity governance should help reduce or strike a balance between the above costs in ensuring compliance by charity trustees.

In realising this goal, the law is essential in setting up and implementing rules governing the duties of charity trustees and the relevant accountability mechanisms, but should allow for other governance mechanisms to play a role in helping to reduce agency costs, such as intrinsic motivations of charity trustees, informal norms, training and other structural support.

Accordingly, in the following chapters, the thesis will make use of the analytical framework developed in this chapter to examine the relevant problems of laws and policies regarding governmental regulation, internal governance, accountability to third parties and public accountability in England and China, and to further discover a set of feasible ways to transform Chinese law and practice in this area.

Chapter 4 Promoting Efficient Governmental Regulation

4.1 Introduction

In this chapter, the thesis will take an economic and comparative approach assessing governmental regulation on charity trustees and further offer a range of reform measures facilitating efficient governmental regulation in China.

As noted in Chapter 3, ensuring compliance by charity trustees can be regarded as a public good. In this context, in supervising and supporting charity trustees efficiently, governmental regulation can reduce the whole monitoring costs of the society. According to Oliver E. Williamson, in terms of the commercial sector, some transactions cannot occur in circumstances that lack an effective protection mechanism, ‘because it is not cost-effective for the parties to craft transaction-specific governance in [those] circumstances’.¹

Similarly, in the charitable sector, if the government performs well in ensuring the compliance of charity trustees so that the public confidence in the charitable sector is maintained,² it will greatly reduce the whole monitoring costs of donors, volunteers, the public and any other private parties. Accordingly, ‘the extent of charity donation is likely to increase as a donor will become more confident that his/her donation is going towards its intended purpose’.³

However, governmental regulation has its own monitoring costs which should be further reduced. According to the revised agency theory developed in Chapter 3, these costs mainly include the costs relating to co-

¹ Oliver E. Williamson, *The Mechanisms of Governance* (OUP 1996) 267.

² Joel L. Fleishman, ‘Public Trust in Not-for-Profit Organizations and the Need for Regulatory Reform’ in Charles T. Clotfelter and Thomas Ehrlich (eds), *Philanthropy and the Nonprofit Sector in a Changing America* (Indiana University Press 1999) 177.

³ Noel Hyndman and Paul McDonnell, ‘Governance and Charities: An Exploration of Key Themes and the Development of a Research Agenda’ (2009) 25(1) *Financial Accountability & Management* 5, 14.

ordinating regulators, the costs of supervision, support and enforcement, the costs of the regulators' moral hazard (those regulators or their staff may pursue their private benefits in the name of accountability) and the costs of the negative effects of external intervention.

Taking account of those costs, this chapter will analyse two major problems respectively. First, whether the law should respect and protect the independent governance of charity trustees. Second, how efficient governmental regulation can be achieved.

Based on this revised agency theory, this chapter argues that Chinese law should respect and protect the independent governance of charity trustees and further build or improve a range of legal and regulatory mechanisms regarding co-operative, proportionate and accountable regulation and balancing the regulatory and supportive functions of regulators to achieve efficient governmental regulation. A comprehensive economic analysis along with a comparative study of English law and practice will be carried out to support those arguments and to further recommend more detailed reform strategies in improving Chinese law and practice.

4.2 Promoting the Independent Governance of Charity Trustees in China

4.2.1 Introduction

In Chinese law, a vital problem relating to the governing body of a charity is lack of independence: the establishment of independent charities is strictly limited and the government has direct control over legally registered or recognised charities. To tackle this problem, the thesis will compare the regulatory approaches in both jurisdictions and further assess which one performs better in reducing the agency costs relating to governmental regulation.

4.2.2 Comparing the Regulatory Approaches in Both Jurisdictions

The comparative analysis of the regulatory approaches dealing with independent governance in England and China can be further divided into two parts, the issues relating to independent governance at the establishing stage and those at the daily operational stage.

4.2.2.1 The Regulatory Approaches at the Establishing Stage

In England, the basic regulatory approach relating to independent governance at the establishing stage can be concluded as allowing the establishment and development of charities and reducing any excessive limitation on registration. For example, in practice non-profit organisations with charitable purposes provided by law should be registered as charities in England.⁴ In addition, organisations with charitable purposes provided by law, which, according to the Charities Act 2011, do not need to register--such as those ‘whose gross income does not exceed £5,000’⁵--can still be recognised as charities in English law.

By contrast, in China, the government’s approach is to strictly restrict the establishment and existence of non-profits, including charities. In this respect, there is a dual administrative system⁶ which greatly limits the establishment of independent charities, leading to there being few registered independent charities in practice.

In China, the dual administrative system means that, before registering as a non-profit organisation, an organisation has to find a professional administrative unit⁷ (‘业务主管单位’) to be responsible for the direct

⁴ CA 2011, s 30.

⁵ *ibid.*

⁶ Xiaoguang Kang and Feng Li, ‘NGO Governance in China: Achievements and Dilemmas’ in Lisa Jordan and Peter van Tuijl (eds), *NGO Accountability: Politics, Principles and Innovations* (Earthscan 2006) 144.

⁷ In the context of Chinese law, the reason for using the term ‘units’ (‘单位’) rather than ‘governmental departments’ is due to the fact that, except for governmental departments, some public institutions (‘事业单位’) and other organisations authorised by the government to assume certain

supervision of this organisation,⁸ to allow it to further apply for registration in the department of civil affairs (‘民政部门’, for the purposes of the thesis, ‘the department of civil affairs’ refers to the Ministry of Civil Affairs or any of its branches at local level), the registration and administration regulator (‘登记管理机关’). Those professional administrative units include but are not limited to governmental departments and public institutions.

Only after a unit agrees to become the professional administrative unit of this organisation and all the required documents are submitted, can this organisation continue to apply to the Ministry of Civil Affairs or one of its branches to become a legally recognised non-profit organisation. The main problem is that both the units functioning as professional administrative units and the department of civil affairs are the branches/departments of the government or the organisations controlled by the government that have the absolute power to decide whether to become the organisation’s professional administrative unit or to register it as a non-profit organisation.⁹ In this context, for independent charities:

the biggest institutional restriction is the difficulty of official registration, which represents a barrier for them in raising funds, seeking tax exemption, receiving legal protection, gaining public recognition, and carrying out activities smoothly.¹⁰

Under such a system, most independent charities cannot obtain legal status as non-profits from the government.¹¹ Accordingly, although some independent charities may continue to apply as non-profits, others choose

public functions are also acting as regulators of charities and other non-profit organisations.

⁸ Kang and Li (n 6) 144.

⁹ Jillian Ashley and Pengyu He, ‘Opening One Eye and Closing the Other: the Legal and Regulatory Environment for “Grassroots” NPOs in China Today’ (2008) 26 *Boston University International Law Journal* 29, 32.

¹⁰ Wang Zhenyao and Zhao Yanhui, ‘The Collapse and Reemergence of Private Philanthropy in China, 1949-2012’ in Jennifer Ryan, Lincoln C. Chen and Tony Saich (eds), *Philanthropy for Health in China* (Indiana University Press 2014) 34. In this respect, it is worth noting that, not all non-profits can receive tax benefits in England either.

¹¹ Karla W. Simon, *Civil Society in China: The Legal Framework from Ancient Times to the ‘New Reform Era’* (OUP 2013) 244-245.

alternative methods to survive. Here is a further analysis of three main methods taken by charities in practice, i.e., directly applying to register as non-profits (foundations, associations or civil non-commercial units), being attached to other legal organisations (‘挂靠’) ¹² or being registered as for-profit companies.

First, some charities seek to register with governmental regulators as non-profits, but similar to the application process for Japanese non-profits, ‘[t]he application process is known to be very complicated and time-consuming.’¹³ Even if a small number of independent charities succeed in obtaining legal status due to the urgent social need and their character that is deemed to pose no threat to the government’s authority,¹⁴ the costs may be very high.

For example, One Foundation (‘壹基金’), a charitable foundation initialled by Lianjie Li (a famous movie star), could not obtain legal status for a long time. After two years’ efforts, Li succeeded in co-operating with Red Cross Society of China (a typical government-controlled charity) and One Foundation became ‘Lianjie Li One Foundation Project of Red Cross Society of China’ in 2007. However, this meant that One Foundation could only operate under the control of Red Cross Society of China. This was the case until 2008 when, with the support of Red Cross Society of China and the department of civil affairs in Shanghai, One Foundation finally became incorporated.¹⁵

In this case, it is necessary to point out that the huge social influence of Lianjie Li and the special support from the government played a vital role in the success of this registration. Despite this, it took several years for him to

¹² Interestingly, there is a similar phenomenon in England: ‘inability to access grant funding without a registration number can lead to charities “sharing” registration numbers or larger organisations applying for funds on behalf of smaller ones.’ Lord Hodgson, *Trusted and Independent: Giving Charity back to Charities-Review of the Charities Act 2006* (The Stationery Office 2012) 54.

¹³ Nobuko Kawashima, ‘Governance of Nonprofit Organizations: Missing Chain of Accountability in Nonprofit Corporation Law in Japan and Arguments for Reform in the U.S.’ (2006) 24 *UCLA Pacific Basin Law Journal* 81, 89.

¹⁴ For example, some charitable foundations (‘基金会’).

¹⁵ Concerning the development of One Foundation, see its official website: <<http://www.onefoundation.cn/>> accessed 20 September 2017.

establish One Foundation as an incorporated charity. Therefore, it is reasonable to imagine that it is too difficult for most ordinary people to register a non-profit.

Second, for charities which choose the form of ‘挂靠’ (being attached to another legal organisation), it is very likely that they will be controlled by the sponsor unit (‘挂靠单位’) to which they are attached, leading to a lack of independent governance. Moreover, under the influence of the government or other external pressure, they might face the risk of being expelled at any time by their sponsor unit.

For example, Women’s Legal Research and Service Center at Peking University, the first public benefit organisation¹⁶ aimed at providing legal aid to and conducting research about the relevant legal issues of women in China, was closed by Peking University several years ago, to which it had been attached. One of the reasons why the university closed it was that this organisation received overseas funding and tackled some sensitive cases.¹⁷ After this event, its founder established another public benefit organisation, Beijing Zhongze Women’s Legal Counseling and Service Center, which was forced by the government to shut down operations recently.¹⁸

Third, some charities choose to register as for-profit companies with the department of industrial and commercial administration (‘工商部门’), such as Beijing Star and Rain Educational Research Institute (‘星星雨教育研究所’), which is the first non-profit educational organisation helping children with autism in China. Such charities experience several problems in practice. In contrast to the situation in England, where charitable companies do exist,

¹⁶ It is worth noting that, before the enactment of the Charity Law 2016 (China), the term ‘public benefit organisation’ (‘公益组织’) rather than ‘charity’ (‘慈善组织’) was more frequently used in practice.

¹⁷ Yu Gao, ‘The Former Women’s Legal Research and Service Center of Peking University Responds to the Event of Being Closed’ *Caixin* (Beijing, 2 April 2010) <<http://china.caixin.com/2010-04-02/100131464.html>> accessed 20 September 2017.

¹⁸ Didi Kirsten Tatlow, ‘China Is Said to Force Closing of Women’s Legal Aid Center’ *The New York Times* (New York, 29 January 2016) <http://www.nytimes.com/2016/01/30/world/asia/beijing-women-legal-aid-guo-jianmei.html?_r=0> accessed 20 September 2017.

all companies should be for-profit legal persons in China.¹⁹ Therefore, the for-profit nature and the related structure of companies in China might result in inefficiency and ineffectiveness²⁰ for those organisations aimed at achieving charitable purposes. For example, charities registered as companies could neither obtain tax benefits enjoyed by some registered non-profits nor have the right to raise funds from the public. In addition, this arrangement may also increase the moral hazard of their charity trustees due to a lack of mandatory legal requirements on the non-distribution constraint.

Nevertheless, at the operational level, with regard to grass-root charities which are beneficial to the community, share the same or similar purposes with the government and never challenge the authority of the government, regulators usually chooses to carry out an informal policy called ‘open an eye, and close the other one’ (‘睁一只眼闭一只眼’), indicating both great flexibility and uncertainty in policy preferences.²¹ This legal framework has restricted and negatively affected the healthy development of independent charities.

Realising those problems, on March 16th 2016, the Charity Law 2016 (China) was passed by the National People’s Congress.²² It has been officially recognised as the first comprehensive charity law since the establishment of the PRC.²³ This new law unifies the rules governing charity, and provides a range of rules relating to charitable activities, charities, charitable

¹⁹ Company Law 1993 (China, revised in 2013), ss 3-4.

²⁰ Chao Guo and others, ‘Civil Society, Chinese Style: the Rise of the Non-profit Sector in Post-Mao China’ *Nonprofit Quarterly* (Boston, 25 October 2012) <<http://nonprofitquarterly.org/2012/10/25/civil-society-chinese-style-the-rise-of-the-nonprofit-sector-in-post-mao-china/>> accessed 20 September 2017.

²¹ Goshen Deng, ‘The Hidden Rules Governing China’s Unregistered NGOs: Management and Consequences’ (2010) 10 *The China Review* 183.

²² As a matter of fact, the government had proposed a draft charity law for a long period. Regarding the previous process of drafting charity law, see Mulan Zhang, ‘Charity Law Is Being Redrafted 9 Years Later’ *China Philanthropy Times* (Beijing, 14 May 2014) <<http://www.gongyishibao.com/html/yaowen/6463.html>> accessed 20 September 2017; International Center for Civil Society Law, ‘Comments on the Draft Charity Law for the People’s Republic of China’ (2007) 5(1) *International Journal of Civil Society Law* 12, 12-27 (which provides an introduction to the previously unpublished draft charity law in China).

²³ Jinchao Guo, ‘China Enacted Its First Charity Law and Opens the Era of Governing “Charity” by Law’ *China News* (Beijing, 16 March 2016) <<http://www.chinanews.com/gn/2016/03-16/7799495.shtml>> accessed 20 September 2017.

fundraising, charitable donations, charitable trusts, charity property, charitable services, disclosure of information, supportive measures, charity regulation and legal responsibilities.

From the perspective of reducing the limitations on the establishment of independent charities, the main contribution of this new law is that it defines charities, and clarifies their main regulators,²⁴ registration conditions and procedures,²⁵ making it possible for more independent charities to be recognised and protected by law.

First, the law defines charities. In the strict sense, there was no charity in China before the enactment of the Charity Law 2016 (China). Due to the lack of a unified definition of charities, organisations with charitable purposes could not be recognised as charities by law, although, in practice, some ‘public benefit trusts’ (‘公益信托’)²⁶ and foundations²⁷--both of which had public benefit purposes²⁸--might fall within the scope of ‘charities’.

To facilitate independent organisations to acquire charitable status, the recently enacted Charity Law 2016 (China) defines charities as legally established non-profit organisations which comply with this law and aim to carry out charitable activities benefiting the society.²⁹

Second, after the enactment of the Charity Law 2016 (China), non-profits

²⁴ CL 2016 (China), s 10.

²⁵ For example, see CL 2016 (China), ss 9-10.

²⁶ Before the enactment of the CL 2016 (China), public benefit trusts were regulated by the Trusts Law 2001 (China). In addition, technically, charitable trusts are not recognised as charities in Chinese law even after the enactment of the Charity Law 2016 (China).

²⁷ According to the Regulation on the Administration of Foundations 2004 (China), foundations are non-profit legal persons established for the public benefit purposes. RAF 2004 (China), s 2.

²⁸ As a matter of fact, before the enactment of this new law, the term ‘charity’ (‘慈善’)/‘charitable purposes’ (‘慈善目的’) was rarely used in legal rules. Instead, ‘public benefit’ (‘公益/公共利益’) and ‘public benefit purposes’ (‘公益/公共利益目的’) were widely mentioned in a range of laws and regulations. For example, see PBUDL 1999 (China); TL 2001 (China), s 60; RAF 2004 (China), s 2. After the implementation of this new law, a new problem arose related to how to understand the relationship between charitable purposes and public benefit purposes. Regarding this problem, see Dejian Li, *Research on Charity Law in the United Kingdom* (Law Press 2017) (李德健: 《英国慈善法研究》, 法律出版社 2017 年版).

²⁹ CL 2016 (China), s 8.

complying with the requirements and conditions provided in this law have the right to register as charities with the department of civil affairs.³⁰ However, this new law does not deal with the problems relating to the ‘dual administrative system’, so it remains to be seen whether this traditional system will be abandoned or continue to exist in practice.

Third, to promote the development of charitable trusts in China, the law clarifies the department of civil affairs as their regulator and further reduces the requirements on their establishment. Before the enactment of the Charity Law 2016 (China), the Trusts Law 2001 (China) did not even identify the governmental regulator responsible for registration and regulation of public benefit trusts.³¹ In practice, different governmental departments usually announced that it was other departments who were responsible for the registration and regulation of those public benefit trusts.³² Consequently, after this form of trust was introduced into China, it was rarely used.

To tackle this issue, the Charity Law 2016 (China) clarifies the department of civil affairs as the governmental regulator of charitable trusts.³³ Meanwhile, this new law only requires charity trustees to file charitable trust documents and other documents with the department of civil affairs, which is expected to be a simpler procedure than the registration procedure applying to other charities.³⁴

Nevertheless, although this new law, to some extent, reduces the limitations on the establishment of independent charities, given that the related regulations, policies and practices are not fundamentally changed, it remains to be seen whether and when the new rules in the Charity Law 2016 (China) can be put in practice.

³⁰ CL 2016 (China), s 10.

³¹ Yinglu Li, ‘*Charitable Trusts in China*’ (2014) 20(4) *Trusts and Trustees* 345, 348.

³² *ibid* 346.

³³ CL 2016 (China), s 45. Meanwhile, this new law provides that ‘charitable trusts belong to public benefit trusts’. CL 2016 (China), s 44.

³⁴ CL 2016 (China), s 45.

4.2.2.2 The Regulatory Approaches at the Daily Operational Stage

In England, the Charities Act 2011 respects and protects the independent governance of charity trustees by making it clear that this Act does not authorise the Charity Commission ‘(a) to exercise functions corresponding to those of a charity trustee in relation to a charity, or (b) otherwise to be directly involved in the administration of a charity’.³⁵ Meanwhile, even the Charity Commission itself issues guidance on how to protect the independent governance of charity trustees, such as ‘*The Independence of Charities from the State (RR7)*’.³⁶

By contrast, under the traditional regulatory system, Chinese regulators maintain direct control over the governance issues of a charity, resulting in charity trustees having a comparatively weak position in governing their charity. The recently enacted Charity Law 2016 (China) seems not to seek to resolve this problem: it does not make it clear whether this system will be removed or relaxed.

Under this ‘dual administrative system’, independent governance in a charity cannot be protected: currently, the participation of professional administrative units ‘in the day-to-day running of NPOs effectively prevents any political activity or other activities by NPOs which in the view of the Chinese government pose a challenge to its own power or the unity of the country’.³⁷ In this context, the governing body of a Chinese charity (such as the board of directors in a foundation) cannot play the same independent and core role as English charity trustees have in terms of ‘the general control and management of the administration of a charity’.³⁸

³⁵ CA 2011, s 20. For a general discussion of legal issues regarding independence and autonomy in charity governance, see Evelyn Brody, ‘Governing the Nonprofit Organization: Accommodating Autonomy in Organizational Law’ (2008) 46 Canadian Business Law Journal 343.

³⁶ Charity Commission, *The Independence of Charities from the State (RR7)* (Charity Commission 2009).

³⁷ Thomas von Hippel and Knut B. Pißler, ‘Nonprofit Organizations in the People’s Republic of China’ in Klaus J. Hopt and Thomas von Hippel (eds), *Comparative Corporate Governance of Non-Profit Organizations* (CUP 2010) 475.

³⁸ CA 2011, s 177.

Under this system, the professional administrative units of charities, usually including the Communist Party of China, ‘democratic parties’,³⁹ governmental regulators at all levels, organisations affiliated to them and the branches of the above organisations, play a supervisory role in both the internal and external governance of those charities.⁴⁰ In practice, professional administrative units can frequently exercise the power to select members of the governing body and a range of other powers in deciding the internal affairs of a charity. By contrast, although the Charity Commission has similar powers (such as the powers to suspend, appoint and remove charity trustees, to appoint an interim manager, and to direct specified action to be taken or application of charity property),⁴¹ it can only exercise those powers when serious events (such as ‘misconduct or mismanagement in the administration of’⁴² a charity) occur.⁴³

In this context, in respect of Chinese charities, ‘a board in its real sense does not exist, neither in [government-controlled charities], nor independent [charities]’⁴⁴ which are lucky enough to be registered due to a good relationship with the government.⁴⁵ Given the government’s strict control of those charities, independent governance cannot be guaranteed in practice.

4.2.3 An Economic Analysis of the Current Regulatory Approaches in Both Jurisdictions

In contrast to English law, which respects and protects the independent governance of charities, regulators in China still maintains strict restrictions

³⁹ In mainland China, apart from the Communist Party of China as the governing party, there are still eight democratic parties (‘民主党派’) as the parties participating in the governmental decision-making process (‘参政党’). The Communist Party of China, these democratic parties and other social forces make up ‘the multi-party cooperation and political consultation system’ (‘多党合作政治协商’).

⁴⁰ Hippel and Pißler (n 37) 455.

⁴¹ CA 2011, ss 76-85.

⁴² CA 2011, s 76.

⁴³ CA 2011, ss 76-87.

⁴⁴ Kang and Li (n 6) 136. By comparison with registered charities, unregistered grass-root charities usually have a true governing body. However, because these charities are regarded as illegal organisations by law, the independence of their governing body will not be guaranteed.

⁴⁵ ‘[Charities] that the government is not happy with cannot even register legally.’ Kang and Li (n 6) 137.

on the establishment of charities and the governance function of their charity trustees. This arrangement not only reflects the government's unhealthy and destructive attitude towards non-profits,⁴⁶ but also leads to higher agency costs relating to charity regulation in China.

4.2.3.1 Costs of the Moral Hazard of Regulators and Charity Trustees

Under the regulatory system in China, regulators can limit competition by restricting the establishment of independent charities,⁴⁷ and replace or control charity trustees in governing a charity, making regulators themselves act as charity trustees in all but name. In this context, without sufficient competition and efficient regulation, regulators/charity trustees usually do not have a strong motivation to efficiently use charitable resources, to quickly respond to the current social needs, and to prevent and fight against corruption,⁴⁸ leading to high costs relating to the governmental regulators' and charity trustees' moral hazard.

As a consequence, the phenomena relating to corruption and misappropriation relating to the government and government-controlled charities in public goods delivery are very serious. For example, '[i]n the 2010/11 Global Corruption Barometer, close to one in ten people surveyed in China reported that they had paid a bribe for a public service in the previous 12 months.'⁴⁹ And Liangyu Chen, the former top officer in Shanghai City, was ultimately imprisoned in 2008 because of a scandal

⁴⁶ Peifeng Liu, 'Nonprofit Legislation in China' in Chien-Chung Huang and others (eds), *China's Nonprofit Sector: Progress and Challenges* (Transaction Publishers 2014) 81.

⁴⁷ In practice, based on the government monopoly of charitable resources, government-controlled charities receive the majority of charitable donations. Yue Pan and Yajun Zhou, 'Ministry of Civil Affairs Recognised that 60 % of Charitable Donations Were Received by the Government and Government-controlled Charities' *People's Daily* (Beijing, 16 February 2012) <<http://news.qq.com/a/20120216/000170.htm>> accessed 20 September 2017.

⁴⁸ See, for example, Yongguang Xu, 'Towards A Healthier Philanthropy Reforming China's Philanthropic Sector' in Jennifer Ryan, Lincoln C. Chen and Tony Saich (eds), *Philanthropy for Health in China* (Indiana University Press 2014) 271.

⁴⁹ Transparency International, 'Fighting Corruption in China' (2012) <http://www.transparency.org/news/feature/fighting_corruption_in_china> accessed 20 September 2017.

relating to pension misappropriation.⁵⁰ In 2013, under great pressure from donors, one officer from Red Cross Poverty Alleviation Development Service Center had to admit that a charitable donation worth more than 84 million yuan had had been misappropriated for other causes.⁵¹ In 2015, one former vice-director of Red Cross Society of Sichuan Province was sentenced to 20 years' imprisonment for corruption.⁵² Recently, the minister and several vice-ministers of the Ministry of Civil Affairs, as the main charity regulator at the national level, were directly removed from office due to institutional corruption within this ministry.⁵³

By contrast, in England, the law allows charities to be registered, reduces any excessive limitation on their registration, and avoids direct participation by the Charity Commission in the internal governance of a charity. This legal arrangement can help reduce the costs associated with the Charity Commission's and charity trustees' moral hazard.

First, because the Charity Commission does not directly participate in the internal governance of any charity, the possibility of conflicts of interest due to the co-existence of the regulatory role of the regulator and its role as a charity trustee has been greatly reduced. That may be one important reason why there is very little corruption reported in the Commission, although there are a range of criticisms concerning its inefficiency in performing its functions.⁵⁴

⁵⁰ The Economist, 'Hu Jintao Sticks Out His Elbows and Fires Shanghai's Party Chief' *The Economist* (London, 28 September 2006) <<http://www.economist.com/node/7971021>> accessed 20 September 2017.

⁵¹ Hanliang Zheng, 'Red Cross Society of China Recognised that It Misappropriated 84,700,000 RMB of Charitable Donations Which Should Have Been Used in the Disaster Relief of Wenchuan Earthquake' *Radio France Internationale* (Paris, 29 April 2013) <<http://cn.rfi.fr/%E4%B8%AD%E5%9B%BD/20130429-%E4%B8%AD%E5%9B%BD%E7%BA%A2%E5%8D%81%E5%AD%97%E4%BC%9A%E6%89%BF%E8%AE%A4%E6%8C%AA%E7%94%A8%E6%B1%B6%E5%B7%9D%E8%B5%88%E7%81%BE8470%E4%B8%87%E5%B7%A8%E6%AC%BE>> accessed 20 September 2017.

⁵² Jian Zhang, 'Why was the Charity Property of the Red Cross Society Changed into Private Property' *Caijing* (Beijing, 15 September 2015) <<http://www.caijingmobile.com/wxshare/208790.html>> accessed 20 September 2017.

⁵³ Rujun Wen, 'Minister and Vice Ministers of the Ministry of Civil Affairs Were Reduced to a Much Lower Rank' (Legal Evening News, 9 February 2017) <http://news.ifeng.com/a/20170209/50666399_0.shtml> accessed 20 September 2017.

⁵⁴ National Audit Office, *The Regulatory Effectiveness of the Charity Commission (Session 2013-2014)*,

Second, the Charity Commission does not set excessive limitations on the establishment of charities, which can ensure a more satisfactory competitive environment and encourage volunteers to act as charity trustees, reducing the charity trustees' moral hazard. On the one hand, charities have to compete with each other to obtain support from donors, volunteers and the general public, which forces their charity trustees to perform better for them.⁵⁵ On the other hand, the participation of a large number of volunteers who are motivated by non-monetary factors in charity governance will also help reduce the charity trustees' moral hazard. Accordingly, in English charities, these costs can be reasonably expected to be lower than those in China.

4.2.3.2 Supervisory Costs Placed on the General Public and Donors

In China, due to the inefficient governmental regulation, the general public and ordinary donors cannot depend on government regulators to ensure sound charity governance, further leading to higher supervisory costs because they have to make use of other methods to supervise the performance of charity trustees. Hence, directly associated with the first point, the general public and donors have, to a great degree, lost confidence and trust in government-controlled charities.⁵⁶ A typical example is that several years ago 'charitable donations in China fell more than 80 percent because of public mistrust'⁵⁷ arising from a range of charity scandals, as

HC 813) (The Stationery Office 2013); Public Administration and Constitutional Affairs Committee, *The Collapse of Kids Company: Lessons for Charity Trustees, Professional Firms, the Charity Commission, and Whitehall (Fourth Report of Session 2015-16, HC 433)* (The Stationery Office 2016).

⁵⁵ Of course, in contrast to the restrictive approach in China, a relaxed approach in England has already led to another problem: 'there are too many charities competing for too few funds'. Charity Commission, *Collaborative Working and Mergers (RS4)* (Charity Commission 2003) 1. However, given the initial stage of the charitable sector in China, this problem should not be a strong argument supporting the limitations on the establishment of charities.

⁵⁶ By contrast, in England, for many citizens, 'knowing that an organisation is a charity is often enough to give the public confidence to donate money to it'. Cabinet Office Strategy Unit, *Private Action, Public Benefit: A Review of Charities and the Wider Not-For-Profit Sector* (Cabinet Office Strategy Unit 2002) 14. However, there are also charitable scandals in England, such as the Cup Trust and Comic Relief, although they do not occur as frequently as those arising in China. For example, see Declan Lawn, 'Comic Relief Money Invested in Arms and Tobacco Shares' *BBC* (London, 10 December 2013) <<http://www.bbc.co.uk/news/uk-25273024>> accessed 20 September 2017.

⁵⁷ Adam Chodorow, 'Charity with Chinese Characteristics' (2012) 30(1) *UCLA Pacific Basin Law*

noted in Chapter 1.

This distrust may also explain why in China most donations are from companies⁵⁸ rather than individuals. In modern society, commercial companies can indirectly promote their economic benefit through charitable donations.⁵⁹ However, this may not apply to the general public and ordinary donors, who lack confidence and trust in charities. Instead, the general public is calling for more accountability to ensure efficient use of charitable resources.⁶⁰

In contrast to charity regulators in China, the Charity Commission does not directly participate in the internal governance issues of charities, let alone strictly control the whole charitable sector. Instead, it takes a risk-based and accountable approach in ensuring that charity trustees comply with legal and regulatory requirements, which is more efficient in promoting the sound performance of charity trustees, as discussed in the following section of this chapter.

Accordingly, a large number of donors and the general public can choose to trust the Charity Commission rather than to further supervise the performance of charity trustee on their own. For example, a recent survey carried out on behalf of the Charity Commission found that ‘60% of the public believe that charities are regulated effectively’.⁶¹ This will definitely help reduce the supervisory costs of those key stakeholders.

Journal 1, 49; Sabrina Mao and Sui-Lee Wee, ‘Donations to Charities in China Plunge after Scandals’ *Reuters* (London, 8 December 2011) <<http://www.reuters.com/article/us-china-donations-idUSTRE7B70F820111208>> accessed 20 September 2017.

⁵⁸ Eileen Heisman, ‘Philanthropic Leapfrog: Giving in China’ *Nonprofit Quarterly* (Boston, 6 September 2013) <<https://nonprofitquarterly.org/2013/09/06/philanthropic-leapfrog-giving-in-china/>> accessed 20 September 2017.

⁵⁹ For example, see Xiufeng Chen and Li Li, ‘The Rise of Corporate Social Responsibility and Charitable Foundations in China’ in Chien-Chung Huang and others (eds), *China’s Nonprofit Sector: Progress and Challenges* (Transaction Publishers 2014) 23-24.

⁶⁰ Lincoln C. Chen, Jennifer Ryan, and Tony Saich, ‘Introduction: Philanthropy for Health in China: Distinctive Roots and Future Prospects’ in Jennifer Ryan, Lincoln C. Chen and Tony Saich (eds), *Philanthropy for Health in China* (Indiana University Press 2014) 14.

⁶¹ Populus, *Public Trust and Confidence in Charities* (Populus 2016) 39.

4.2.3.3 Costs of the Negative Effects of External Intervention

In China, the strong governmental control over the internal affairs of a charity may limit the voluntary spirit of capable persons to act as charity trustees or the current charity trustees to actively perform their duties in the best interests of their charity. It may lead to high costs relating to the negative effects of external intervention.

For charity trustees in government-controlled charities, charitable activities are mainly performed in order to carry out the tasks assigned by their higher administrative authority rather than to realise their own altruistic pursuits. This may not stimulate their non-monetary motivation in order to efficiently use charitable resources to benefit the public. Meanwhile, for independent charities which are lucky enough to be registered, given the excessive control by the government over their internal governance issues, their charity trustees' non-monetary motivation may also be hurt frequently in practice, negatively affecting the charity trustees' efficiency in realising the charitable purposes that those charities pursue.

Although it is hard to evaluate the costs of the negative effects of governmental control on the performance of current charity trustees, there is an official report about the number of volunteers in China, which may, to some degree, reflect the negative effects of excessive governmental control.

According to the '*Statistical Communique on the Development of Social Services 2015*' issued by the Ministry of Civil Affairs, in China, a country with a population of more than 1.3 billion, there were less than 9.4 million persons participating in voluntary work in 2015.⁶² Here, it is worth noting that, the real number of volunteers was even much less than 9.4 million, because if a volunteer participated in charitable activities three times a year, it would be reflected as three persons in this official report. Among them,

⁶² Ministry of Civil Affairs, *Statistical Communique on the Development of Social Services 2015* (Ministry of Civil Affairs 2016) <<http://www.mca.gov.cn/article/sj/tjgb/201607/20160700001136.shtml>> accessed 20 September 2017.

the number of persons choosing to act as charity trustees can be reasonably expected to be much smaller.

By contrast, the English regulatory approach to allowing the establishment of charities and to further protecting their independent governance can encourage capable volunteers to act as charity trustees and enable them to actively govern their charities, reducing the costs of the negative effects of external intervention.

Although it is difficult to accurately evaluate the role of charity trustees' non-monetary motivations in ensuring their high-quality performance, we can at least assess the efficiency of English law in reducing the costs of the negative effects of governmental regulation partly through the proportion of individuals participating in charitable activities. According to the '*UK Civil Society Almanac 2017*', 27% people volunteer at least once a month and 41% people act as volunteers at least once a year.⁶³

4.2.4 'Giving Charity Back to Charities'⁶⁴

From an economic perspective, ensuring independent governance will facilitate a reduction in agency costs, as analysed above. For example, in contrast to government-controlled charities, to exist and further its charitable purpose, the charity trustees of any independent charity have to compete in attracting donations and voluntary participation. Accordingly, they must enhance the efficient use of charitable resources and become more accountable, transparent and user-oriented to maintain their charity's reputation, which will help reduce their own moral hazard.

Meanwhile, independent governance guaranteed by fiduciary duties and other accountability and transparency mechanisms will further reduce the supervisory costs of donors, volunteers and the general public; the moral

⁶³ NCVO, '*UK Civil Society Almanac 2017*' (NCVO 2017) <<https://data.ncvo.org.uk/a/almanac17/fast-facts-6/>> accessed 20 September 2017.

⁶⁴ See, for example, Lord Hodgson (n 12).

hazard of regulators that do not directly control the internal governance issues of a charity; and the costs of the negative effects of external intervention. Hence, China should draw on the experience of English law, protecting the independent governance of charity trustees at the operational stage and promoting the establishment of independent charities.

4.2.4.1 Protecting the Independent Governance of Charity Trustees

First, in the future legal reform, the laws or regulations in this area should allow charity trustees to govern their charities independently. In doing so, they should require that a governing body consisting of more private individuals (rather than governmental officers) be responsible for the general control and management of its charity.⁶⁵ Furthermore, even if sometimes there are local authority trustees in a charity, Chinese law should make it clear that similar to English law, those charity trustees have the duty to manage the conflicts of interest and act in the best interests of the charity.⁶⁶

Second, the law should reduce the situations in which regulators can have direct control over the internal governance issues of any charity. In this respect, Chinese law should draw on the experience of English law, providing that, ‘unless the situation is so serious as to amount to a possible breach of the law’,⁶⁷ any governmental regulator should not play the role of the governing body or directly manage and control the affairs of a charity, as required by the Charities Act 2011.⁶⁸

⁶⁵ On this basis, some supportive measures should be put in place to help select, and strengthen the capacity and skills of, members of the governing body to perform their duties. For example, see Charity Commission, *Trustee Recruitment, Selection and Induction (RS1)* (Charity Commission 2002); Charity Commission, *Trustee Board: People and Skills* (Charity Commission 2014).

⁶⁶ Charity Commission, *Local Authorities as Charity Trustees* (Charity Commission 2013).

⁶⁷ Lord Hodgson (n 12) 45. Of course, even in England, the Charity Commission may sometimes excessively intervene in the independent decisions of charity trustees in terms of how to realise the charitable purpose of their charity. For example, recently, the Commission required several charities to stop funding CAGE, a campaign group, but finally withdrew its requirement. Randeep Ramesh, ‘Charities Can Fund Cage Campaign Group, Commission Agrees’ *Guardian* (London, 21 October 2015) <<https://www.theguardian.com/society/2015/oct/21/charities-can-fund-controversial-pressure-group-cage-court-finds>> accessed 1 June 2017.

⁶⁸ CA 2011, s 20; Charity Commission (n 36). In addition, in terms of private law (which governs

4.2.4.2 Reducing the Current Legal and Regulatory Rules Limiting the Establishment of Independent Charities

As noted above, the recently enacted Charity Law 2016 (China) has, to some degree, reduced the previous limitations on the establishment of independent charities. Despite this, given that some of the relevant regulations have not been changed according to this new law, there remains a need for legal reform in this area in order to reflect or implement the spirit or requirements of the Charity Law 2016 (China) and to help reduce the agency costs concerning charity regulation.

First, the law should further clarify the procedures related to setting up charities. Here, it is worth noting that, ‘the more difficult it is to qualify for charitable status the harder it will be for the [regulator] to force institutions to register as charities and become subject to its regulation’,⁶⁹ which may increase the charity trustees’ moral hazard in those organisations.

Therefore, the law should provide that, for organisations conforming to the required conditions, the department of civil affairs should register them as charities, and should not delay or refuse to register without any legal reason. The Charity Law 2016 (China) confirms this point:

organisations satisfying the requirements provided by this law should apply to be registered and the registration should be disclosed to the public; organisations not satisfying the requirements provided by this law cannot be registered, but should

contract, tort, property, private organisations, family, etc.), China mainly learns the relevant theory and legislation from Germany and Japan. With regard to organisation law, there is a basic principle governing this area; that is, the ‘principle of the autonomy of associations’ (Thomas von Hippel, ‘Nonprofit Organizations in Germany’ in Klaus J. Hopt and Thomas von Hippel (eds), *Comparative Corporate Governance of Non-Profit Organizations* (CUP 2010) 214.), which means that, in principle, an organisation itself should decide its own internal affairs and any other party should not intervene. Therefore, even according to the ideas of private law in China, the future law should also allow and protect the independent governance of charities rather than maintain direct control by the government or its branches.

⁶⁹ Robert Meakin, *The Law of Charitable Status: Maintenance and Removal* (CUP 2008) 197.

be given the reason in writing.⁷⁰

However, because some of the requirements in this new law are very abstract (for example, having necessary property),⁷¹ the department of civil affairs still has too much discretion in practice. Therefore, given that the Charity Law 2016 (China) empowers the State Council (the central government) to enact the specific rules relating to the organisational structures of charities and the registration and regulation issues,⁷² the relevant regulations enacted by the State Council should make the requirements as clear as possible, to ‘avoid introducing measures which increase bureaucracy and discourage people from forming [charities]’.⁷³

Second, the relevant regulations and policies negatively affecting the fairness and transparency of registration should be abandoned. Due to lack of laws governing the application procedures, the previous process was not transparent and fair. In this context, only organisations that had a close or good relationship with the government could register as non-profits. According to the spirit of this new law, the government should make a decision on whether to register an organisation as a charity according to a unified, fair and transparent procedure, rather than based on its relationship with the government (such as political and/or personal ties with the government⁷⁴).

In this respect, the ‘one region, one organisation’ policy stipulated by several regulations should be abandoned. Currently, there is a rule concerning the strictest competition limitation, i.e., if an organisation exists in an administrative region, other organisations with the same or similar purposes will not be allowed to register.⁷⁵ The government can use this

⁷⁰ CL 2016 (China), s 10.

⁷¹ As to the requirements on the establishment of charities, see CL 2016 (China), s 9.

⁷² CL 2016 (China), s 20.

⁷³ Cabinet Office Strategy Unit (n 56) 30.

⁷⁴ Concerning the implication of the relationship between charities and government, see, for example, Xueyong Zhan and Shui-Yan Tang, ‘Understanding the Implications of Government Ties for Nonprofit Operations and Functions’ (2015) 76(1) Public Administration Review 131.

⁷⁵ For example, see RRAA 1998 (China, revised in 2016), s 13; PRRACNU 1998 (China), s 11.

requirement as a good excuse to refuse a registration application if there is a government-controlled charity with similar purposes in the same area.

Therefore, although the Charity Law 2016 (China) does not deal with this problem, for the purposes of promoting the establishment of independent charities, the thesis argues that the policy of ‘one region, one organisation’ should be totally abandoned. Accordingly, as long as charities comply with the requirements stipulated by laws and regulations, they should be registered or recognised by law.

Third, it is of value to change the current ‘no registration, no legality’ policy. In England, a non-profit organisation is not illegal unless it carries out some illegal activities.⁷⁶ By contrast, in China, the positive right of citizens to establish non-profits (such as foundations, associations and civil non-commercial units) is generally denied by the government,⁷⁷ which reflects ‘the general scepticism [of the government] toward privately initiated NPOs’.⁷⁸ And legally established non-profits are usually identified as ‘an arm of the government’.⁷⁹ The three regulations⁸⁰ governing associations, civil non-commercial units and foundations do not provide any legal remedy when governmental regulators refuse to register an organisation.⁸¹

In this context, there is one informal principle relating to the registration of

Interestingly, in England, there are concerns that there are too many charities all doing the same thing. Chris Green, ‘There Are Too Many Charities Doing the Same Work, Claims Charity Commission Chief Executive’ *Independent* (London, 25 June 2014) <www.independent.co.uk/news/uk/home-news/there-are-too-many-charities-doing-the-same-work-claims-charity-commission-chief-executive-9562997.html> accessed 20 September 2017.

⁷⁶ Of course, a legal organisation may not necessarily benefit from the advantages of charitable status, e.g., the Church of Scientology.

⁷⁷ Hippel and Pißler (n 37) 435, 440, 442 and 445.

⁷⁸ *ibid* 475.

⁷⁹ Guosheng Deng, ‘The Development of China’s Nonprofit Sector since 1995’ in Chien-Chung Huang and others (eds), *China’s Nonprofit Sector: Progress and Challenges* (Transaction Publishers 2014) 9.

⁸⁰ As noted in Chapter 2, the three regulations are the Regulation on the Registration and Administration of Associations 1998 (China, revised in 2016), the Provisional Regulation on the Registration and Administration of Civil Non-commercial Units 1998 (China), and the Regulation on the Administration of Foundations 2004 (China).

⁸¹ According to the Constitutional Law 1982 (China, revised in 2004), citizens have the right of association. CL 1982 (China, revised in 2004), s 35. However, if this right is not confirmed in a specific legal area (such as civil law or administrative law), it cannot be protected in practice.

non-profit organisations, including charities: ‘no registration, no legality’. Independent non-profit organisations which cannot be registered will be regarded as illegal organisations. According to the Temporary Measure Prohibiting Illegal Social Organisations 2000 (China) (‘取缔非法民间组织暂行办法’), illegal organisations should be prohibited and their property and other documents should be expropriated.⁸²

On this basis, this ‘no registration, no legality’ policy is implemented selectively in practice: regulators turn ‘a blind eye to the majority of illegal NGOs according to the “no banning, no recognition, no intervention” rule’ in practice.⁸³ However, this policy, even if selectively implemented, puts unregistered non-profits at high risk, greatly damaging their reputation and negatively influencing their normal activities.

After the enactment of the Charity Law 2016 (China), this policy was relaxed, at least in the charitable sector. According to this new law, registration is still necessary if an organisation wants to be recognised as a charity. However, for other non-profit organisations carrying out charitable activities, the Charity Law 2016 (China) recognises their legality,⁸⁴ although they cannot refer to themselves as a charity when conducting activities.

Accordingly, the relevant governmental regulations and policies in this area should comply with this new rule of the Charity Law 2016 (China), changing the ‘no registration, no legality’ policy respectively. This change can help some independent charities which cannot satisfy the strict requirements and conditions on charity registration to continue to carry out charitable activities as legal non-profit organisations, although technically

⁸² Temporary Measure Prohibiting Illegal Social Organisations 2000 (China), ss 9-10.

⁸³ Guosheng Deng, ‘The Hidden Rules Governing China’s Unregistered NGOs: Management and Consequences’ (2010) 10 *The China Review* 183.

⁸⁴ According to the Charity Law 2016 (China), ‘other organisations which are not charities can conduct charitable activities within their capacity’. CL 2016 (China), s 111; Internal Affairs Office of the Internal and Judicial Affairs Committee of the National People’s Congress and the Department of Policy and Law of the Ministry of Civil Affairs (eds), *Q & A relating to the Charity Law of the People’s Republic of China* (China Legal Publishing House 2016) 230-232 (全国人大内部司法委员会内务室、民政部政策法规司编著：《中华人民共和国慈善法学习问答》，中国法制出版社 2016 年版).

they are not recognised by law as ‘charities’ without registration.

4.3 Clarifying and Implementing the Basic Regulatory Principles

4.3.1 Introduction

In respect of governmental regulation, Chinese regulators usually focus on the strict registration procedure rather than efficient regulation.⁸⁵ In this context, although the recently enacted Charity Law 2016 (China) has relaxed the related limitations on the establishment of independent charities, as regards efficient governmental regulation, in contrast to English law, even some basic modern regulatory principles, such as accountability, transparency and proportionality, are still not clarified by law or officially recognised by Chinese regulators.

Therefore, to promote efficient regulation in order to reduce the agency costs in ensuring compliance, this chapter argues that those principles, such as proportionality and accountability, should be recognised and implemented by Chinese regulators. At the same time, following the same logic, this chapter also recommends that cooperative regulation and a balance between support and regulation should also be implemented by Chinese law and regulators. Accordingly, in terms of the improvement of specific regulatory mechanisms, both the experience and lessons in England can facilitate China in its further reform.

4.3.2 Establishing Collaborative Regulatory Mechanisms

In terms of governmental regulation, the costs relating to co-ordinating regulators are obvious in practice. Although there is a main regulator of charities, such as the Charity Commission, governing charities, other regulators are still playing a more or less active role in some specific aspects of charity regulation. In practice, charity trustees are usually monitored by

⁸⁵ Liu (n 46) 81.

different regulators, such as administrative regulation by the Charity Commission (in England and Wales) and the Ministry of Civil Affairs (in mainland China), judicial regulation by the courts, self-regulation by the charitable sector itself or legal proceedings by the Attorney General.⁸⁶

In England, the Charity Commission is the independent regulator of charities⁸⁷ whilst the Attorney General can supervise charities by participating in the relevant suits.⁸⁸ In addition, the tax authority (HMRC) can, to some extent, monitor the performance of charity trustees. In the meantime, in respect of an ‘exempt charity’,⁸⁹ its ‘principal regulator’ in English charity law⁹⁰ rather than the Charity Commission is directly responsible for doing ‘all that [this regulator] reasonably can to meet the compliance objective in relation to the charity’.⁹¹

Similarly, although the Charity Law 2016 (China) clarifies that the department of civil affairs is in charge of the charity undertakings and the regulation of charities and charitable activities in China,⁹² under the ‘dual administrative system’, a variety of professional administrative units are also responsible for charity regulation in some specific aspects.

In this context, if different regulators do not share the relevant information

⁸⁶ Kathryn Chan, ‘The Role of the Attorney General in Charity Proceedings in Canada and in England and Wales’ (2011) 89(2) Canadian Bar Review 373; Mary Synge, ‘The Attorney General and the Charity Commission: One Rule without Reason?’ (2016) Public Law 409.

⁸⁷ CA 2011, ss 13-20.

⁸⁸ CA 2011, ss 113-114.

⁸⁹ CA 2011, s 22 and sch 3; Charity Commission, *Exempt Charities* (CC23) (Charity Commission 2017).

⁹⁰ CA 2011, s 25.

⁹¹ CA 2011, s 26.

⁹² CL 2016 (China), s 6. It may have a historic basis: ‘The Nationalist government created the Ministry of Internal Affairs and the Bureau of Civil Affairs in 1927 and charged them with organizing relief for the poor and managing the activities of philanthropies.’ Xiulan Zhang and Lu Zhang, ‘Medicine with A Mission: Chinese Roots and Foreign Engagement in Health Philanthropy’ in Jennifer Ryan, Lincoln C. Chen and Tony Saich (eds), *Philanthropy for Health in China* (Indiana University Press 2014) 91-92; Xinzhong Yu, *Plague and Society of Southern China in Qing Dynasty: A Study of the History of Health and Society* (Renmin University of China 2003) 249-255 (余新忠: 《清代江南的瘟疫与社会——一项医疗社会史的研究》, 中国人民大学出版社 2003 年). In this respect, the Ministry of Civil Affairs seems to be similar to the Charity Commission. However, the areas that this ministry regulates are wider than those of the Charity Commission, such as administration of social organisations, registration of marriage, management of social services, etc.

and co-operate with each other, the whole regulation will not be efficient.⁹³ Hence, to reduce the co-ordination costs arising from the conflicts and disputes between regulators, it is necessary for China to strengthen the co-operation among those regulators in terms of the regulatory standards and procedures.

4.3.2.1 Examining the Conflicts between Different Regulators in Regulating Charity Trustees

Currently, neither Chinese law nor English law provides the principle of collaboration and in practice some conflicts between different regulators exist in both jurisdictions. First, sometimes there is a lack of clarity regarding the powers and duties of different regulators. Take the charity scandal relating to Kids Company, for example. As a registered charity aimed at supporting vulnerable children and young people, Kids Company had to be closed because of its long-term poor financial management, the bad performance of its charity trustees in governing this charity, and the government's continuing financial support, which lacked sufficient scrutiny.⁹⁴ In respect of this charity scandal, it was found that 'responsibilities [of regulating the funding to Kids Company] were passed between departments like a hot potato'.⁹⁵

Second, one regulator's regulatory function may not be recognised or respected by other regulators. For example, in China, in 2013, Song Qingling Foundation of Henan Province was discovered by the media to have abused its charitable resources. Under pressure from the public, the local government set up a task force to investigate this charity. However, as the registration and administration regulator monitoring this charity, the

⁹³ For example, the inadequate sharing of information between the Charity Commission and HMRC has been criticised by the National Audit Office and the Committee of Public Accounts. National Audit Office (n 54) 44; Committee of Public Accounts, *Gift Aid and Other Tax Reliefs on Charitable Donations (Forty-first Report of Session 2013-14, HC835)* (The Stationery Office 2014) 6.

⁹⁴ See, for example, Committee of Public Accounts, *The Government's Funding of Kids Company (Eighth Report of Session 2015-16, HC504)* (The Stationery Office 2015); Public Administration and Constitutional Affairs Committee (n 54).

⁹⁵ Committee of Public Accounts (n 94) 3.

department of civil affairs in Henan Province did not participate in this task force,⁹⁶ and thus lost the opportunity to assess and evaluate the charity's performance.⁹⁷

Third, different standards or inefficient co-operative supervisory mechanisms exist among regulators. For example, in England, both the Charity Commission and the tax authority 'have failed to pass on information about some of the charities where they have identified significant non-charitable activity'.⁹⁸ In addition, there is a minor separation between the standards recognising charitable status and those offering tax benefits, which require that charities applying for tax benefits have to satisfy the management requirements ('the fit and proper persons test').⁹⁹

More seriously, in contrast to charity regulation in England, because a large number of professional administrative units exist in China, and different units usually have different standards and regulatory procedures, charity regulation is of low efficiency and effectiveness ('政出多门效率低下').¹⁰⁰

This regulatory system itself may greatly increase the co-ordination costs in charity governance. For example, in the case of Song Qingling Foundation of Henan Province, before the result of the task force's investigation was disclosed, the department of civil affairs in Henan Province had published

⁹⁶ People, 'How Deep Is the Water in the Event of Song Qingling Sculpture' *People* (Beijing, 5th August 2013) <<http://opinion.people.com.cn/GB/363551/367637/>> accessed 20 September 2017.

⁹⁷ It was criticised by some scholars, who argued that 'the department of civil affairs, as the registration and administrative regulator, should take part in the investigation of this foundation'. People, 'The Department of Civil Affairs Actually Was Not the Member of the Task Force' *People* (Beijing, 2 August 2013) <<http://society.people.com.cn/n/2013/0802/c1008-22421054-2.html>> accessed 20 September 2017.

⁹⁸ National Audit Office (n 54) 44. Also see Committee of Public Accounts (n 93) 6; Public Administration and Constitutional Affairs Committee, *The 2015 Charity Fundraising Controversy: Lessons for Trustees, the Charity Commission, and Regulators (Third Report of Session 2015-2016, HC431)* (The Stationery Office 2016) 3.

⁹⁹ Finance Act 2010, sch 6, pt 1; HM Revenue & Customs, *Guidance on the Fit and Proper Persons Test* (HM Revenue & Customs 2014). Concerning a recent analysis of charity taxation in England, generally, see Debra Morris, 'Recent Developments in Charity Taxation in the United Kingdom: the Law Gives and the Law Takes Away' in Matthew Harding, Ann O'Connell and Miranda Stewart (eds), *Not-for-profit Law: Theoretical and Comparative Perspectives* (CUP 2014) 254-275.

¹⁰⁰ Ming Wang and others, 'Revising the Regulations on Social Organizations' (2014) 6 *The China Nonprofit Review* 1, 20-24.

the result relating to the annual examination of this charity and had found no drawback regarding this charity's governance and management.¹⁰¹ The problem is that the department of civil affairs chose to carry out the annual examination based on the incomplete information it had, ignoring the investigation of the task force.

4.3.2.2 Reducing the Co-ordination Costs in Regulating Charity Trustees

In practice, a number of good methods already exist to tackle the possible conflicts between regulators in China in order to reduce the co-ordination costs. For example, several relevant governmental departments choose to jointly issue guiding advice dealing with some specific requirements for charities.¹⁰² However, some more efficient co-operative regulatory mechanisms need to be put in place.

First, Chinese law should clarify the regulatory functions held by different regulators and their power and duty. This is a precondition of any further co-operation between different regulators.

Second, Chinese law should further establish a range of co-operative supervisory mechanisms. To avoid repeated regulation in the same area by different regulators and to enhance the regulatory efficiency, it is of value to establish a range of co-operative supervisory mechanisms among those regulators, such as 'joint registration', which can 'not only reduce the burden on charities but also streamline processes between [regulators]'.¹⁰³

Furthermore, Chinese law should improve co-operative mechanisms facilitating the transfer of information among regulators.¹⁰⁴ In this respect,

¹⁰¹ People (n 96).

¹⁰² For example, see the Circular on Management Issues concerning NPOs' Eligibility of Tax Deduction (Caishui [2009] No. 123) ('《关于非营利组织免税资格认定管理有关问题的通知》(财税[2009]13号)'), which is issued by the Ministry of Finance and the State Administration of Taxation.

¹⁰³ Lord Hodgson (n 12) 52.

¹⁰⁴ For example, see CA 2011, ss 54-59.

the Charity Law 2016 (China) seems to treat this requirement seriously: the department of civil affairs above the county level should establish a charity information sharing mechanism with other departments.¹⁰⁵ However, to make this rule work in practice, the law or any related governmental policies should further clarify the contents, procedures, methods and other major issues relating to information to be shared between different regulators.

In this respect, the various memoranda of understanding¹⁰⁶ built by the Charity Commission and a range of other regulators are really insightful and worth considering by the Ministry of Civil Affairs in developing its co-operative strategy. Take the Memorandum of Understanding between the Charity Commission and the Fundraising Regulator, for example.

This memorandum clarifies and details its own purpose, the respective roles and functions of the Charity Commission and the Fundraising Regulator, the requirements and procedures relating to disclosure of information, the referral process, liaison at both strategic and operational levels, and other related matters.¹⁰⁷ This will, to some extent, avoid conflicts between the Commission and the Fundraising Regulator and accordingly reduce the co-ordination costs in monitoring charity trustees.¹⁰⁸

4.3.3 Stimulating a Proportional and Accountable Regulatory Approach

Governmental regulation cannot be efficient if the costs of supervision and enforcement, the costs of the regulators' moral hazard and the costs of the negative effects of external intervention are not controlled in practice. The costs of supervision and enforcement require that regulators should be

¹⁰⁵ CL 2016 (China), s 78.

¹⁰⁶ Those memoranda of understanding are available at <<https://www.gov.uk/government/collections/memoranda-of-understanding-with-the-charity-commission>> accessed 20th September 2017.

¹⁰⁷ Charity Commission, *Memorandum of Understanding: the Charity Commission and the Fundraising Regulator* (Charity Commission 2016).

¹⁰⁸ In respect of a comprehensive analysis of the problems concerning information sharing in England, see Law Commission, *Data Sharing between Public Bodies: A Scoping Report (Law Com No 351)* (Law Commission, 2014).

efficient in monitoring and facilitating the carrying out of duties by charity trustees. No matter which regulator is mainly responsible for supervising charity trustees, it has to control those costs in ensuring compliance.

Meanwhile, in respect of the costs of the regulators' moral hazard and the costs of the negative effects of external intervention, the excessive regulatory powers held by regulators and unreasonable administrative procedures may not only lead to abuse of power by the regulators, but also negatively affect the performance of charity trustees, resulting in inefficient use of charitable resources.

Hence, to reduce the regulators' moral hazard, the supervisory costs and the costs of the negative effects of external intervention, it is necessary to take a proportional and accountable¹⁰⁹ regulatory approach in supervising charity trustees.

In this respect, in England, the Charities Act 2011 directly stipulates that one of the Charity Commission's general duties is that '[i]n performing its functions the Commission must, so far as relevant, have regard to the principles of best regulatory practice',¹¹⁰ including proportionality and accountability.

By contrast, although the Charity Law 2016 (China) has built a general regulatory framework governing charities and charitable activities,¹¹¹ it does little, if anything, to design a range of proportional and accountable mechanisms to tackle the issues relating to charity regulation. As a matter of fact, this law does not even mention the general regulatory principles (such as proportionality and accountability) regulators should follow in performing their duties. Therefore, it is of value to explore how to improve Chinese law in this respect with a comparative study of English law and practice.

¹⁰⁹ For example, see Cabinet Office Strategy Unit (n 56) 71; Charity Commission, *Regulatory Work: Charity Commission* (Charity Commission 2013).

¹¹⁰ CA 2011, s 16.

¹¹¹ For example, see CL 2016 (China), Chapter 10 (supervision and administration).

4.3.3.1 Taking a Proportional Regulatory Approach

Currently, both China and England are facing problems relating to proportionality; this is particularly the case in China, where there is a long history of strict governmental control over the internal affairs of charities. In China, in terms of Song Qingling Foundation of Henan Province mentioned above, the government set up a task force to investigate it for several years,¹¹² but the result of the investigation has not been disclosed to the general public so far. As a matter of fact, the recent and frequent charity scandals in China which led to a huge drop in donations¹¹³ may also confirm that governmental regulators do not perform their regulatory functions properly.

In England, sometimes the performance of the Charity Commission, as the independent regulator of charities, and other regulators, is also not as satisfactory as expected in practice: they either do too much or too little in monitoring charities and their charity trustees. For instance, in March 2015, the Charity Commission forced two charities to stop funding CAGE, which is a non-charitable organisation.¹¹⁴ This action can be regarded as a direct intervention in the decision-making of charity trustees in relation to the use of charitable resources. However, the Commission reversed its position after the relevant judicial review was withdrawn.¹¹⁵

By contrast, in an official report concerning the recent charity scandal related to Kids Company, it was found that '[d]espite repeated warnings and concerns about Kids Company's financial situation and the impact it was achieving, [the governmental] funding to the charity continued and was

¹¹² People (n 96).

¹¹³ Sabrina Mao and Sui-Lee Wee, 'Donations to Charities in China Plunge after Scandals' *Reuters* (London, 8th December 2011) <<http://www.reuters.com/article/us-china-donations-idUSTRE7B70F820111208>> accessed 20 September 2017.

¹¹⁴ Charity Commission, *Charity Commission Statement: Charities Funding CAGE* (Charity Commission 2015).

¹¹⁵ Randeep Ramesh, 'Charities Can Fund Cage Campaign Group, Commission Agrees' *Guardian* (London, 21 October 2015) <<https://www.theguardian.com/society/2015/oct/21/charities-can-fund-controversial-pressure-group-cage-court-finds>> accessed 20 September 2017.

never seriously questioned, let alone stopped'.¹¹⁶

In response to those problems, it is necessary to build a proportional regulatory approach to supervising the performance of charity trustees, efficiently reducing the costs of the charity trustees' moral hazard, the supervisory costs and the costs of the negative effects of external intervention, such as 'actions that might [...] discourage responsible volunteers from serving on boards'.¹¹⁷ In this respect, in contrast to Chinese law and regulators, both English law and the Charity Commission have more well-designed mechanisms in place to implement this principle.

For example, according to the recently enacted Charities (Protection and Social Investment) Act 2016, the Charity Commission has the power to issue official warnings to a charity trustee 'who it considers has committed a breach of trust or duty or other misconduct or mismanagement in that capacity'.¹¹⁸ By contrast, charity trustees undertaking money laundering, terrorism or other specific serious offences will be automatically disqualified.¹¹⁹

In addition, the Charity Commission adopts a proportional and risk-based regulatory approach in monitoring the performance of charity trustees.¹²⁰ This approach requires that, before monitoring a charity or a special group of the charitable sector, the Commission should assess the risk of misconduct and mismanagement proactively. And, in handling the relevant risks or abuses in charity governance, the Commission should take the most effective response according to the nature and level of those risks.¹²¹

¹¹⁶ Public Administration and Constitutional Affairs Committee (n 54) 3.

¹¹⁷ Panel on the Nonprofit Sector, *Strengthening Transparency, Governance, Accountability of Charitable Organizations: A Final Report to Congress and the Nonprofit Sector* (Independent Sector 2005) 22.

¹¹⁸ Charities (Protection and Social Investment) Act 2016 (CPSIA 2016), s 1. Of course, for charity trustees, to perform their fiduciary duties, they themselves should also carry out risk management. Charity Commission, *Charities and Risk Management* (Charity Commission 2010).

¹¹⁹ CPSIA 2016, s 9.

¹²⁰ For example, see Charity Commission, *Risk Framework: Charity Commission* (Charity Commission 2013).

¹²¹ For example, see Charity Commission, *Tackling Abuse and Mismanagement: 2014-2015* (Charity Commission 2015); Charity Commission, *Regulatory Work: Charity Commission* (Charity

Here, it is worth noting that, although it takes a risk-based approach to monitoring charity trustees, the Charity Commission does not always perform well in practice, as noted above. However, it is necessary to point out that its recently bad performance cannot be used to deny the function of proportionality in ensuring efficient governmental regulation. It only indicates that the Commission does not always accurately adopt this regulatory principle or strictly follow its risk-based approach.

Hence, given that charity regulation in China is in its initial stage, it is urgent for China to draw on the principle of proportionality developed by English law and the proportional and risk-based approach adopted by the Charity Commission to help reduce the agency costs arising from governmental regulation.

4.3.3.2 Strengthening Accountability Mechanisms in Relation to Charity Regulators

As Evelyn Brody points out, without transparency, it is ‘impossible to assess whether regulators truly improve charity governance’.¹²² This also ‘makes it hard to judge [...] whether regulators are motivated by their own or the public’s interest’.¹²³

More seriously, apart from the issues relating to regulatory efficiency, severe corruption is troubling Chinese charity regulators in the country’s transitional period. In this respect, a very famous example is related to Yu Pengnian, a billionaire and philanthropist who donated all his wealth (about 9.3 billion yuan) to charity. He donated 10 imported Mitsubishi ambulances to a hospital, but those ambulances were finally taken by some local

Commission 2013); Charity Commission, *How the Charity Commission Ensures Charities Meet Their Legal Requirements* (Charity Commission 2013); Charity Commission (n 120); Charity Commission, *Strategy for Charity Fraud, Financial Crime and Financial Abuse* (Charity Commission 2013); Charity Commission, *Strategy for Dealing with Safeguarding Issues in Charities* (Charity Commission 2013); Charity Commission, *Counter-terrorism Strategy* (Charity Commission 2008).

¹²² Evelyn Brody, ‘Accountability and Public Trust’ in Lester M. Salamon (ed), *The State of Nonprofit America* (Aspen Institute & Brookings Institute Press 2002) 480.

¹²³ Evelyn Brody, ‘Whose Public? Parochialism and Paternalism in State Charity Law Enforcement’ (2004) 79 *Indiana Law Journal* 937, 950.

governmental officers for their own private use.¹²⁴ Another well-known example is that recently the minister and several vice-ministers of the Ministry of Civil Affairs were removed from office due to institutional corruption within this ministry.¹²⁵

Therefore, to reduce the costs of the government's moral hazard and to improve regulatory efficiency (in order to reduce the costs of the charity trustees' moral hazard, the costs of the negative effects of governmental regulation, and the supervisory costs), it is also necessary to build some sound accountability mechanisms to ensure that regulators themselves efficiently perform their duty to regulate charity trustees. In this respect, China can learn quite a lot from English law and practice.

First, China should strengthen the rules concerning disclosure of information regarding charity regulation. In this respect, the mechanisms relating to disclosure of information about how governmental regulators perform their duty should be put in place. The Charity Law 2016 (China) has made progress in this area, requiring that the department of civil affairs and other related departments at the county level or above should disclose the results of the examination and evaluation of charities and charitable trusts, the results of the commendations and penalties of charities, other organisations and individuals, and other related information in a timely manner.¹²⁶

However, in contrast to the Charity Commission, which publishes a complete version of its reports, decisions, alerts and statements on its official website¹²⁷ in time to enable the public to understand and supervise what it has done, further work needs to be carried out by the Ministry of Civil Affairs and its branches at local level.

¹²⁴ Guanchazhe, 'The First Chinese Who Donated All His Wealth, 9.3 Billion Yuan, to Charity, Died at the Age of 93' *Guanchazhe* (Shanghai, 4 May 2015) <http://www.guancha.cn/society/2015_05_04_318324_s.shtml> accessed 20 September 2017.

¹²⁵ Wen (n 53).

¹²⁶ CL 2016 (China), s 70.

¹²⁷ Charity Commission, *Charity Commission Reports, Decisions, Alerts and Statements* (Charity Commission 2013).

Meanwhile, English law further requires the Charity Commission to hold an annual public meeting, which can attract registered charities to discuss the contents of its annual report and put questions to the Charity Commission.¹²⁸ This arrangement provides a great opportunity for charities and their charity trustees to make the charity regulator accountable, and thus it is worth considering in implementing the principle of accountability in the Chinese charity regulatory system.

Second, Chinese law should further provide legal remedies that are easily accessible to charity trustees and other stakeholders. In contrast to its strict control over the development of charities, the law does not perform well in ‘safeguarding the rights of those who try to form and register organizations or work in them’.¹²⁹ In tackling the above problems, it is of use to strengthen the judiciary supervision of regulators’ performance by providing cost-effective legal remedies to charity trustees and other related parties when bringing a legal suit against the regulators.

In this respect, the ‘Charity Tribunal’ provides a good example about holding regulators accountable. It was created by the Charities Act 2006 as a cost-effective independent tribunal to ‘form part of the accountability framework for [the Charity Commission] as a modern regulator’.¹³⁰

The other policy objective of this Tribunal is to clarify and develop charity law in this area to keep up with the development in society.¹³¹ Although this Tribunal is still in its initial stage and accordingly has many problems to overcome, such as the limited scope of its jurisdiction, its inaccessibility for

¹²⁸ CA 2011, sch 1, para 12.

¹²⁹ Mark Sidel, ‘The Shifting Balance of Philanthropic Policies and Regulations in China’ in Jennifer Ryan, Lincoln C. Chen and Tony Saich (eds), *Philanthropy for Health in China* (Indiana University Press 2014) 44.

¹³⁰ Alison McKenna, ‘Should the Charity Tribunal Be Reformed’ (2011-12) 14 *The Charity Law & Practice Review* 1, 2. By virtue of the Transfer of Functions of the Charity Tribunal Order 2009, SI 2009/1834, the functions of this Tribunal have been transferred to the First-tier Tribunal and the Upper Tribunal. Transfer of Functions of the Charity Tribunal Order 2009, SI 2009/1834, para 2.

¹³¹ Debra Morris, ‘The First-tier Tribunal (Charity): Enhanced Access to Justice for Charities or a Case of David versus Goliath?’ (2010) 29(4) *Civil Justice Quarterly* 491, 492-493.

ordinary individuals, and the too short time limit for bringing lawsuits,¹³² China can learn the basic idea behind it.

For example, China can establish a special tribunal inside each court, principally dealing with cases relating to charity regulation, which can strengthen the efficiency of judiciary supervision.¹³³ Meanwhile, similar to the second objective for establishing the Charity Tribunal, this arrangement can strengthen the role of judges in explaining and clarifying the definitions relating to charitable purposes, public benefit and other related terms. In China, this arrangement can further avoid or at least reduce the possibility of governmental regulators abusing their discretion and provide more authoritative guidance on the performance of charity trustees in a special case, especially in the context of the lack of case law and detailed statutory rules guiding the practice.

4.3.4 Balancing the Supportive Function with the Regulatory Function

To control the costs of the negative effects of external intervention and to ensure efficient utilisation of charitable resources (in order to reduce the residual loss), it is of value for regulators to play a more supportive role in charity governance, especially given that the charitable sector in China is still in its initial stage. However, the relevant costs of governmental support should also be taken into account in designing the supportive mechanisms.

4.3.4.1 Allowing Regulators to Play a More Supportive Role in Charity Governance

In terms of charity regulation, the government in China commonly takes administrative measures, such as investigations, punishments and removal

¹³² Lord Hodgson (n 12) 80-86; *ibid*; McKenna (n 130); Alison McKenna, 'Applications to the First-tier Tribunal (Charity) by "Persons Affected" by the Charity Commission's Decision' (2013-2014) 16 *The Charity Law & Practice Review* 147.

¹³³ As a matter of fact, there are precedents in establishing a special tribunal dealing with a specific legal area in China. For example, in 2014, the Supreme Court of China set up the Environmental and Resources Tribunal to exclusively deal with cases involving environmental law.

from registration, to monitor and enforce the duties of charity trustees.¹³⁴ In addition, in China there exists no system similar to the Attorney General. Unless there are cases concerning criminal acts in which the Procuratorate (‘检察机关’)¹³⁵ should intervene, regulators usually enforce the duties of the governing body of charities without legal suits.¹³⁶

For example, in respect of charitable trusts, regulators can approve the resignation of charity trustees,¹³⁷ check the management affairs of trust property, approve the report on the trust management of charity trustees,¹³⁸ change charity trustees who breach their fiduciary duties,¹³⁹ change the terms of the trust document in accordance with the trust’s purpose,¹⁴⁰ receive the termination report of charity trustees¹⁴¹ and approve the liquidation report of charity trustees.¹⁴²

However, the above regulatory mechanisms only form part of the functions of governmental regulators. Sometimes those regulators also play a supportive role in facilitating charity governance. In this respect, the laws in both jurisdictions have paid special attention to the regulators’ supportive function.

In China, the recently enacted Charity Law 2016 (China) provides one chapter regulating the supportive measures relating to charities and charitable activities.¹⁴³ In England, according to the Charities Act 2011, one general function of the Charity Commission is ‘[e]ncouraging and

¹³⁴ For example, see CL 2016 (China), Chapters 10-11.

¹³⁵ It is quite similar to the Crown Prosecution Service in England and Wales. The official website of the Procuratorate is <<http://www.spp.gov.cn/>> 20 September 2017.

¹³⁶ One exception may be that according to the recently enacted General Provisions of Civil Law 2017 (China), if the decision-making procedure of the decision-making body, executive body or legal representative of a donated legal person violates the laws, administrative regulations, or its governing document, or the contents of the decision do not comply with the governing document, the regulators can appeal to the court to revoke this decision. GPCL 2017 (China), s 94.

¹³⁷ TL 2001 (China), s 66.

¹³⁸ TL 2001 (China), s 67. The thesis will discuss charity reporting in Chapter 8.

¹³⁹ TL 2001 (China), s 68.

¹⁴⁰ TL 2001 (China), s 69.

¹⁴¹ TL 2001 (China), s 70.

¹⁴² TL 2001 (China), s 71.

¹⁴³ CL 2016 (China), Chapter 9.

facilitating the better administration of charities’,¹⁴⁴ and the performance of the Commission must contribute to encouraging ‘(a) all forms of charitable giving, and (b) voluntary participation in charity work’.¹⁴⁵

However, in England, there are totally different views on the roles that charity regulators should play in practice. As noted by the NCVO’s Charity Law Reform Advisory Group, some people argue that ‘the Charity Commission [cannot] be both enforcer and supporter’.¹⁴⁶ By contrast, others believe that ‘the encouragement of good practice but a harsh line on failures to meet minimum standards is the best means of securing compliance without stifling the voluntary effort that government is seeking to promote’.¹⁴⁷

From the perspective of reducing the agency costs of charity governance, the thesis takes the second view. In the charitable sector, if the government plays a totally regulatory role, this may restrain the motivation of charity trustees and volunteers to contribute to charity, and thus bring high costs relating to the negative effects of external intervention, in particular when the charity regulation is very intense and strict.¹⁴⁸ Therefore, in charity governance, although there should be a legal framework that can help reduce the costs of the charity trustees’ moral hazard, its requirements have to be minimum in order to reduce the unnecessary costs of the negative effects of external intervention and supervisory costs.¹⁴⁹

Meanwhile, it is also necessary to further reduce the residual loss due to inefficient support from the government. In particular in China, given that the charitable sector is still in its initial stage, this supportive role seems to

¹⁴⁴ CA 2011, s 15.

¹⁴⁵ CA 2011, s 16.

¹⁴⁶ NCVO Charity Law Reform Advisory Group, *For the Public Benefit?: A Consultation Document on Charity Law Reform* (NCVO 2001) 27.

¹⁴⁷ *ibid.*

¹⁴⁸ Of course, for charities such as Kids Company, where a large proportion of their funding comes from the government, a strengthened regulation is usually understandable and acceptable by their charity trustees. If the charity trustees do not accept those regulatory requirements and conditions, they can choose to refuse the financial support from the government.

¹⁴⁹ This is associated with the principle of proportionality discussed above.

be more urgent and important than it is in England. Accordingly, in most situations, in order to make charity trustees perform well and attract more persons to act as charity trustees, Chinese regulators should play a supportive role along with a regulatory one, which may be more efficient and effective in ensuring the good performance of charity trustees.¹⁵⁰

Therefore, in the future, Chinese regulators should strengthen their supportive function in helping charity trustees to perform their duties and ensuring sound governance in practice.¹⁵¹ As a matter of fact, the Charity Law 2016 (China) requires that the relevant departments should provide charities and trustees of charitable trusts with information relating to the charitable demand, and guide and help them to carry out charitable activities.¹⁵²

In this respect, Chinese regulators can draw on the experience of the Charity Commission, which has done a great deal in support of charity trustees. For example, ‘to help [charity trustees run their] charity effectively’,¹⁵³ the Commission issues detailed operational guidance, supplies the relevant information and advice and uses its legal power to facilitate the administration of a charity (such as making schemes). In particular, in contrast to detailed guidance issued by the Charity Commission,¹⁵⁴ guidance from the Ministry of Civil Affairs is rare.¹⁵⁵

Accordingly, Chinese regulators should develop the contents of their guidance to maximise their supportive function. In this respect, the recommendations to the Charity Commission made in the report *‘Trusted and Independent: Giving Charity back to Charities-Review of the Charities*

¹⁵⁰ For example, see James J. Fishman, ‘Improving Charitable Accountability’ (2003) 62 Maryland Law Review 218, 248.

¹⁵¹ Brody (n 123) 947.

¹⁵² CL 2016 (China), s 77.

¹⁵³ Charity Commission, *The Essential Trustees: What You Need to Know (CC3)* (Charity Commission 2016) 3.

¹⁵⁴ It is available at <<https://www.gov.uk/government/organisations/charity-commission>> (accessed 20 September 2017).

¹⁵⁵ Currently, there are only some regulatory rules listed on its official website: <http://www.mca.gov.cn/article/gk/fg/shzzgl/> (accessed 20 September 2017).

Act 2006 are also very suitable for the improvement of guidance in China. For example, there should be ‘user-friendly, practical guidance on the legal position and of the [regulator]’s power to intervene, to help trustees understand their position and the protections available’.¹⁵⁶ Furthermore, the guidance ‘should be less legalistic, focused on practical issues and celebrate the benefits of trusteeship as well as highlighting the (still important) risks’.¹⁵⁷

In addition, as a supportive measure, the guidance issued by Chinese regulators should accurately explain the current legal requirement, and further make a clear distinction between legal and regulatory requirements and recommended practices to support the decisions that charity trustees make in governing their charities. In this respect, a lesson Chinese regulators need to learn from the Charity Commission is in relation to the previous guidance interpreting public benefit,¹⁵⁸ which was issued in 2008 and finally withdrawn due to its misinterpretation of the legal rules governing public benefit¹⁵⁹ and the relevant legal challenge.¹⁶⁰

It is worth noting that, if the guidance issued by charity regulators violates or misinterprets the rules provided by national laws, it will violate the principles of proportionality and accountability discussed above and thus bring high costs relating to the regulators’ moral hazard along with the costs of the negative effects of external intervention. At the same time, this guidance cannot play a supportive role in helping charity trustees to reduce the residual loss arising from inefficient use of charitable resources.

4.3.4.2 Reducing the Costs of Governmental Support

However, support itself may also be expensive. That is why, facing budget

¹⁵⁶ Lord Hodgson (n 12) 36.

¹⁵⁷ *ibid* 38.

¹⁵⁸ Charity Commission, *Charities and Public Benefit* (Charity Commission 2008).

¹⁵⁹ Regarding a comprehensive analysis of rules in case law and those provided by the Commission’s previous guidance governing public benefit, see Mary Synge, *The ‘New’ Public Benefit Requirement: Making Sense of Charity Law?* (Hart Publishing 2015).

¹⁶⁰ *R (Independent Schools Council) v Charity Commission* [2012] Ch 214.

cuts, the Charity Commission has to adjust its regulatory strategy to focus on its regulatory function instead of its supportive role. The recent report of the Public Administration Select Committee also confirms this point: '[t]he Cabinet Office must consider how to prioritise what is expected of the Charity Commission, so that it can function with its reduced budget. This must enable it to renew its focus on regulation as its core task.'¹⁶¹

However, based on the significance of the supportive function in charity governance, it is still necessary to provide the basic guidance, information and relevant policies to support charity trustees. In this respect, as a response to the possible incapacity of the government in supporting the performance of charity trustees, some professional organisations or umbrella organisations¹⁶² specialising in this area can play an important supportive role. Some of those organisations 'exist solely to support other charities, and better signposting to such sources of help is essential'.¹⁶³

They can co-operate with the government and charities to promote the development of the charitable sector and the good performance of charity trustees. The recently enacted Charity Law 2016 (China) also supports this idea by encouraging the establishment of umbrella organisations which 'reflect the demand of the charitable sector, promote communication among this sector, strengthen self-regulation, raise the reputation of charities and enhance the development of the charity undertakings.'¹⁶⁴

To reduce the costs of governmental support, regulators can promote professional, umbrella or industry organisations to play a more important role in support of the governance of charity trustees through training, education, advice, codes of conduct¹⁶⁵ and any other effective methods.

¹⁶¹ Public Administration Select Committee, *The Role of the Charity Commission and 'Public Benefit': Post-Legislative Scrutiny of the Charities Act 2006 (Third Report of Session 2013-14, HC76)* (The Stationery Office 2013) 13.

¹⁶² So far in China independent umbrella organisations like the NCVO are very rare, due to the government's traditional excessive control on the development of non-profits, including charities.

¹⁶³ Lord Hodgson (n 12) 47.

¹⁶⁴ CL 2016 (China), s 19.

¹⁶⁵ For example, see Charity Governance Code Steering Group, *Charity Governance Code for Larger*

4.4 Conclusion

This chapter has presented an economic and comparative analysis of governmental regulation on charity trustees in both jurisdictions, with a focus on two major issues, independent governance and implementation of regulatory principles.

In terms of the independent governance of charity trustees, English law allows the establishment and development of charities and reduces excessive limitations on the registration of charities at the establishing stage, and protects the independent governance of charity trustees at the daily operational stage. For example, English law protects the rights of charities to be registered, and recognises the charitable status of those organisations that have charitable purposes, but according to the Charities Act 2011, do not need to register. In addition, the Charity Commission, as the independent regulator of charities, is required by law not to directly participate in the internal governance issues of any charity.

By contrast, in China, due to the traditional regulatory system (i.e., the ‘dual administrative system’), it is difficult for independent charities to exist. For example, it is difficult for non-profits to be directly registered (as associations, foundations or civil non-commercial units). Charity trustees in organisations that choose to be attached to a legal organisation (‘挂靠’) have to give up their independence in governing the charities, and are at risk of being expelled at any time. Organisations registered as for-profit companies are facing a range of problems, such as ineffective governance structures and a lack of tax benefits. In addition, under such a system, governmental regulators can maintain direct control over a charity’s internal governance issues. In particular, the professional administrative units of charities may participate in their day-to-day operation, replacing the governance function of their charity trustees.

Charities (Charity Governance Code Steering Group 2017); Charity Governance Code Steering Group, *Charity Governance Code for Smaller Charities* (Charity Governance Code Steering Group 2017).

Although the recently enacted Charity Law 2016 (China) provides a more enabling environment for the establishment of charities by defining the term ‘charities’, by allowing non-profits complying with this new law to register as charities, and by clarifying the department of civil affairs as the regulator of charitable trusts, it does not fundamentally change the traditional regulatory system.

From the perspective of reducing agency costs, in contrast to English law, the current regulatory system in China leads to higher agency costs. First, higher costs relating to the moral hazard of regulators and charity trustees. Due to the lack of sufficient competition among charities and a strict control over charities’ internal governance issues, regulators also act as charity trustees in all but name, resulting in serious conflicts of interest and a lack of effective mechanisms ensuring the sound performance of those charities. Second, higher costs relating to the supervisory costs of the general public, donors and other stakeholders due to the inefficient governmental regulation. Third, higher cost regarding the negative effects of external intervention. This is because, even for independent charities, the altruistic spirit of their charity trustees is too constrained to promote them to actively participate in charity governance.

Therefore, to reduce those costs, it is necessary to change the current legal and regulatory rules limiting the establishment and independent governance of charities in China. For example, the law should protect the rights of charity trustees to independently govern their charity and further reduce the situations in which regulators can intervene in the internal governance issues of charities. Meanwhile, the law should detail the procedures related of setting up a charity; abandon those policies negatively affecting the fairness and transparency of registration, such as the ‘one region, one organisation’ policy; and change the ‘no registration, no legality’ policy.

With respect to regulatory principles, this chapter has discussed collaboration, proportionality, accountability and the supportive function of regulators. Firstly, in respect of collaboration, there are a range of problems

facing both China and England in dealing with the costs relating to co-ordinating regulators. Despite this, due to the existence of a range of different professional administrative units with differing standards and procedures regulating charities, the situation in China is more serious, leading to higher costs relating to co-ordinating the regulators than those in England.

To reduce those collaboration costs, Chinese law should identify the regulatory functions held by different governmental regulators and their power and duty clearly and accurately; and establish a range of co-operative supervisory mechanisms, such as joint registration and efficient co-operative mechanisms facilitating the transfer of information among those regulators. In this respect, Chinese regulators can draw on the experience of memoranda of understanding between the Charity Commission and other regulators, clarifying the contents, procedures, methods and other major issues relating to information to be shared between different regulators.

Secondly, regarding proportionality and accountability, there is no clear legal rule mentioning those principles in China. By contrast, they have been required by English law. In addition, although both China and England are facing problems regarding proportionality and accountability in practice, English law seems to be more effective in reducing the related agency costs (mainly the costs of the regulators' moral hazard, the supervisory costs and the costs of the negative effects of external intervention) through a range of governance mechanisms, such as a risk-based regulatory approach, a more complete disclosure of information and a special tribunal supervising the Charity Commission.

Therefore, Chinese law should draw on the experience of English law and the Charity Commission, taking a proportional and risk-based regulatory approach. Meanwhile, it should further strengthen the accountability of charity regulators by enhancing the rules governing disclosure of information regarding charity regulation, such as providing more detailed rules concerning the disclosed information and introducing an annual public

meeting similar to that held by the Charity Commission. Furthermore, China should establish more cost-effective legal remedies, such as the building of a special tribunal in each court, available to charity trustees and other related parties, to strengthen the accountability of charity regulators.

Thirdly, in terms of the supportive function of regulators, both English law and Chinese law take this seriously. For example, English law defines one of the Charity Commission's functions as '[e]ncouraging and facilitating the better administration of charities'.¹⁶⁶ In China, the new charity law establishes one chapter to provide rules supporting charities.¹⁶⁷ However, in practice, the Charity Commission does better than the Ministry of Civil Affairs in terms of providing a range of detailed guidance and other methods to support charity trustees in governing their charity. This can help reduce the residual loss due to inefficient use of charitable resources.

Despite this, recently, the Commission has had to focus on regulatory matters due to the budgetary limitations. However, given that China's charitable sector is still in its initial stage, the supportive role of regulators in ensuring sound charity governance is much more important than that in England. Hence, Chinese regulators should treat their supportive role very seriously and take a range of methods, such as training courses, detailed guidance, and education to support charity trustees in governing their charity. Of course, Chinese regulators should draw on the lessons learnt by the Charity Commission in this regard, which sometimes issues guidance misinterpreting the legal rules, such as the guidance on public benefit issued in 2008. It not only negatively affects the role of the Commission in supporting charity trustees but also brings the costs of the Commission's moral hazard and the unnecessary costs of the negative effects of external intervention. Meanwhile, Chinese regulators can encourage charity umbrella organisations to play a supportive role in order to reduce the costs of governmental support.

¹⁶⁶ CA 2011, s 15.

¹⁶⁷ CL 2016 (China), Chapter 9.

After justifying the necessity of protecting the independent governance of charity trustees and the ways to promote efficient governmental regulation, the next chapter will further examine how to reduce the agency costs regarding internal governance mechanisms in the context of independent governance.

Chapter 5 Transforming Internal Governance Mechanisms

5.1 Introduction

This chapter will make an economic and comparative analysis of internal governance mechanisms in England and China. This economic and comparative study can help evaluate the current legal rules and problems and further provide the related strategies to improve the future internal governance mechanisms in China.

Internal governance is of vital importance in ensuring the good performance of charity trustees: if internal governance can ensure charity trustees efficiently perform for the charitable purpose/public benefit of their charity, then it may be unnecessary to supervise them from the outside world, thus reducing the monitoring costs of key stakeholders.

In this chapter, two major problems are selected for examination, i.e., how to design the fiduciary duties of charity trustees and how to improve internal governance structures, such as supervision by charity members, accountability to supervisory boards or trust supervisors, and support by internal auditors (‘内部审计师’) and audit committees (‘审计委员会’).

Based on the revised agency theory, this chapter argues that the reform of legal rules governing the fiduciary duties of charity trustees should strike a balance between the costs of the charity trustees’ moral hazard and the key stakeholders’ supervisory costs on the one hand and the enforcement costs and the costs of the negative effects of external intervention on the other.

Meanwhile, both members and supervisory boards/trust supervisors should fall within the scope of ‘other selected stakeholders’ defined in Chapter 3, and the monitoring costs regarding accountability to members or supervisory boards/trust supervisors should be reasonably reduced. However, in contrast to members, supervisory boards/trust supervisors should be identified as part of charity trustees and thus act as a self-regulatory

mechanism of those charity trustees. In addition, charities could be encouraged to establish an internal audit, as an internal governance mechanism supporting the governance capacity of their charity trustees. A further economic and comparative study in this chapter will justify those arguments and offer the relevant measures in support of legal reform in China.

5.2 Improving the Legal Rules Relating to Fiduciary Duties

5.2.1 Introduction

In charity governance, without the existence of owners who ‘have a vested self-interest in ensuring that the public-benefit purpose is pursued and controlling governance against abuse’,¹ a range of effective mechanisms commonly accepted in corporate governance, such as market competition² and performance-related salaries,³ cannot be easily used. Hence, from an economic perspective, ‘beyond the low-powered incentives provided by informal sanctions such as reputation and pride’,⁴ fiduciary duties are extremely important in preventing the moral hazard of charity trustees and guiding them in governing their charity.

Against this background, in this section, the thesis will compare the fiduciary duties of charity trustees in both jurisdictions, evaluate which jurisdiction’s legal rules governing fiduciary duties perform better in reducing agency costs, and accordingly discuss how to improve the current rules regulating fiduciary duties in Chinese law.

¹ European Foundation Centre, *Exploring Transparency and Accountability: Regulation of Public-Benefit Foundations in Europe* (European Foundation Centre 2011) 41.

² Henry G. Manne, ‘Merger and the Market for Corporate Control’ (1965) 73 *The Journal of Political Economy* 110.

³ Eugene F. Fama, ‘Agency Problems and the Theory of the Firm’ (1980) 88 *The Journal of Political Economy* 288.

⁴ Henry Hansmann, ‘The Economics of Nonprofit Organizations’ in Klaus J. Hopt and Thomas von Hippel (eds), *Comparative Corporate Governance of Non-Profit Organizations* (CUP 2010) 68.

5.2.2 Comparing the Rules Governing Fiduciary Duties in England and China

5.2.2.1 Clarifying the Scope of Fiduciary Duties

Fiduciary duties⁵ derive from English trusts law, and have become the main duties restraining charity trustees in charity law. ‘A fiduciary is someone who has undertaken to act for or on behalf of another in a particular matter in circumstances which give rise to a relationship of trust and confidence.’⁶ Accordingly, fiduciary duties require ‘that a person in a fiduciary position should promote exclusively the beneficiary’s interests, and refrain from allowing any self-interest or rival interests to touch or affect his or her conduct’.⁷

However, fiduciary duties may contain different obligations in different jurisdictions. For example, ‘in the British Commonwealth, where, unlike the position in the United States, fiduciary accountability contemplates only the duty of loyalty’.⁸ As a matter of fact, in the strict sense, a range of duties, including the duty of care, are not regarded as fiduciary duties in English law.⁹

In other words, although there are a variety of duties ensuring the good performance of charity trustees, such as the duty of loyalty, the duty of care¹⁰ and other related duties,¹¹ not all those duties fall within the scope of

⁵ Regarding a comprehensive study of fiduciary duties, generally, see Tamar Frankel, *Fiduciary Law* (OUP 2011).

⁶ *Bristol & West Building Society v Mothew* [1998] Ch 1, 18.

⁷ Joshua Getzler, ‘Duty of Care’ in Peter B.H. Birks & Arianna Pretto (eds), *Breach of Trust* (Hart Publishing 2002) 41.

⁸ Robert Flannigan, ‘The Economics of Fiduciary Accountability’ (2007) 32 *Delaware Journal of Corporate Law* 393, 398; *Bristol & West Building Society* (n 6); *Breen v Williams* (1996) 186 CLR 71 (HC) (Australia); *K.L.B. v British Columbia* [2003] 2 SCR 403 (Canada).

⁹ *Bristol & West Building Society* (n 6) 17; *Permanent Building Society (in liquidation) v Wheeler* (1994) 14 ACSR 109, 157; Law Commission, *Fiduciary Duties of Investment Intermediaries (Law Com No 350)* (Law Commission 2014) 53.

¹⁰ With regard to the duty of care, it has been codified in some areas. For example, see CA 2011, s 221(2); Trustee Act 2000, ss 1-2 and sch1. From a comparative perspective, the duty of care is also widely recognised in other European countries. European Foundation Centre (n 1) 16.

¹¹ In the United States, the duty of obedience may be also recommended to become an essential

fiduciary duties in English law. In this context, to facilitate a comparative study in both jurisdictions, the scope of fiduciary duties discussed in this chapter is limited to the duty of loyalty.¹²

5.2.2.2 The Duty of Loyalty

Given that the recently enacted Charity Law 2016 (China) does not mention the term ‘duty of loyalty’ or ‘fiduciary duty’, here the thesis will discuss the rules in English law, and further explore whether similar rules are available in Chinese charity law.

In English law, there are comparatively detailed rules governing the duty of loyalty and some rules have been codified in some respects. As suggested by Hubert Picarda, this duty mainly includes two aspects, observing the objects¹³ and avoiding or remedying conflicts of interest.¹⁴ Both aspects of this duty require charity trustees to perform in the best interests of the charitable purpose/public benefit rather than in any other party’s private interests. For example, according to the Charities Act 2011, the charity trustee of a charitable incorporated organisation (CIO)¹⁵ ‘must exercise the powers and perform the functions that the charity trustee has in that capacity in the way that the charity trustee decides, in good faith, would be most likely to further the purposes of the CIO.’¹⁶

As regards the duty to observe the objects, English law requires that ‘all charity trustees are obliged to use charity funds for the specific purposes set

component of fiduciary duties in charity governance. Rob Atkinson, ‘Unsettled Standing: Who (Else) Should Enforce the Duties of Charitable Fiduciaries?’ (1998) 23 *Journal of Corporation Law* 655, 661.

¹² Regarding a more detailed discussion of fiduciary duties in English law, see Robert Pearce and Warren Barr, *Pearce & Stevens’ Trusts and Equitable Obligations* (6th edn, OUP 2015) 850-899.

¹³ *Baldry v Feintuck* [1972] 2 All ER 81.

¹⁴ Hubert Picarda QC, ‘Harmonising Nonprofit Law in the European Union: An English Perspective and Digest’ in Klaus J. Hopt and Thomas von Hippel (eds), *Comparative Corporate Governance of Non-Profit Organizations* (CUP 2010) 187.

¹⁵ A charitable incorporated organisation (CIO) is a new type of incorporated charity created by the Charities Act 2006 and is only regulated by the Charity Commission, compared to charitable companies. Generally, see Gareth G. Morgan, *Charitable Incorporated Organisations* (Directory of Social Change 2013).

¹⁶ CA 2011, s 221.

out in the charity's governing document and for no other purpose'.¹⁷ Similarly, Chinese law requires that 'the property of a charity should be exclusively used for its charitable purposes according to its governing document and donation agreement'.¹⁸

However, in contrast to Chinese law, in English law, a range of guidance and best practices are available to further clarify and facilitate the implementation of this requirement, such as '*The Hallmarks of an Effective Charity*'¹⁹ issued by the Charity Commission and '*Good Governance: A Code for the Voluntary and Community Sector*' (2nd edn)²⁰ issued by the Governance Code Steering Group. According to the '*Charity Governance Code for Larger Charities*' and the '*Charity Governance Code for Smaller Charities*', which recently replaced the above two documents, charity trustees are recommended to take a range of measures to clarify and ensure efficient realisation of the purposes pursued by their charity, among which one suggestion is that charity trustees should 'periodically [review] the organisation's charitable purposes, and the external environment in which it works, to make sure that the charity, and its purposes, stay relevant and valid'.²¹

In respect of the duty to avoid or remedy conflicts of interest, its core requirement can be concluded as the principle that 'no one who has a duty

¹⁷ Debra Morris and Karen Atkinton, 'Charities Biting the Hand that Feeds: Relationships with Their Funders' in Debra Morris and Jean Warburton (eds), *Charities, Governance and the Law: the Way Forward* (Key Haven 2003) 199; *Attorney General v Brandreth* (1842) 1 Y & C Cas 200. In addition, in some special situations, to protect the public benefit, it is necessary for charity trustees to apply to change the current purpose of their charity into a more updated one. In this context, the cy-près principle can help tackle this issue, which will be discussed in Chapter 6. See, for example, CA 2011, ss 61-68.

¹⁸ CL 2016 (China), s 52.

¹⁹ Charity Commission, *The Hallmarks of an Effective Charity* (Charity Commission 2008) 6. It is worth noting that, this document has been replaced by the 'Charity Governance Code' recently (<<https://www.gov.uk/government/publications/the-hallmarks-of-an-effective-charity-cc10>> accessed 20 September 2017).

²⁰ The Governance Code Steering Group, *Good Governance: A Code for the Voluntary and Community Sector* (2nd edn, The Governance Code Steering Group 2010) 14. This document has been replaced by a new edition recently.

²¹ Charity Governance Code Steering Group, *Charity Governance Code for Larger Charities* (Charity Governance Code Steering Group 2017) 8; also Charity Governance Code Steering Group, *Charity Governance Code for Smaller Charities* (Charity Governance Code Steering Group 2017) 8.

to perform shall place himself in a situation to have his interest conflicting with his duty'.²² This duty can play two roles in English law, i.e., to avoid entering into transactions involving private interests and to make charity trustees accountable for the benefits they obtained by using their fiduciary position.²³ Or, according to Hubert Picarda, this duty requires that charity trustees should act gratuitously and should not make any profit from their role as charity trustees.²⁴ In the following discussion, this requirement is referred to as the 'principle of voluntary trusteeship'.

Nevertheless, although those rules are still applicable, there are some exceptions and more detailed rules governing those exceptions in English law.²⁵ For example, the benefits of charity trustees, according to the guidance of the Charity Commission, can be further divided into payment of expenses to a trustee, paying trustees for services, paying for trusteeship, employing a trustee or connected person and compensating trustees for loss of earnings, which apply some specific rules respectively.²⁶

By contrast, the recently enacted Charity Law 2016 (China) only provides one rule directly tackling conflicts of interest, which is too simple to regulate the complex situations with which fiduciary duties have to deal in practice.²⁷

Managers of a charity must not damage the benefits of this charity, the beneficiaries or the general public for the benefits of their associates; if those managers transact with the charity, they must

²² *Movitex Ltd v Bulfield* [1988] BCLC 104, 117.

²³ Peter Luxton, 'Conflicts of Interest in Charity Law' in Alison Dunn (ed), *The Voluntary Sector, the State and the Law* (Hart Publishing 2000) 227.

²⁴ Hubert Picarda QC, *The Law and Practice Relating to Charities* (4th edn, Bloomsbury Professional 2010) 633.

²⁵ Generally, see Luxton (n 23) 227-240; Charity Commission, *Conflicts of Interest: A Guide for Charity Trustees (CC29)* (Charity Commission 2014); Charity Commission, *Case Study: Conflicts of Interest* (Charity Commission 2014); Charity Commission, *Legal Underpinning: Conflicts of Interest: A Guide for Charity Trustees (CC29)* (Charity Commission 2014).

²⁶ Charity Commission, *Trustee Expenses and Payments* (Charity Commission 2012); concerning an overview of the legal rules in this area, see Law Commission, *Technical Issues in Charity Law: A Consultation Paper (Consultation Paper No 220)* (Law Commission 2015) 147-161.

²⁷ Regarding trustees in a charitable trust, there are more detailed rules governing their duties. TL 2001 (China), ss 25-42. However, those rules do not regulate charity trustees in other types of charity.

not participate in the decision relating to this transaction and the matters concerning the related transaction must be disclosed to the public.²⁸

5.2.3 Evaluating the Rules Governing Fiduciary Duties in Both Jurisdictions

If the fiduciary duties imposed by law are very strict and the punishment for breaking them is quite severe, then charity trustees may be less motivated by intrinsic motivations such as altruism and fewer capable individuals (including many professionals) may choose to act as charity trustees (due to the ‘crowding out phenomenon’, as noted in Chapter 3).

However, without any fiduciary duty, there may be room for charity trustees to fall prey to moral hazard.²⁹ Hence, in designing fiduciary duties, the law should balance the costs of moral hazard after monitoring charity trustees and the monitoring costs. In this context, this thesis will look for a reasonable approach to reducing those agency costs in designing fiduciary duties, and then evaluate whether Chinese law or English law has taken or partly taken this approach.

5.2.3.1 Looking for a Reasonable Approach to Reducing Agency Costs

First, fiduciary duties should contain a mandatory aspect to help reduce the costs of the charity trustees’ moral hazard and the supervisory costs of key stakeholders. Traditionally, ‘there is a mandatory core to the fiduciary obligation that cannot be overridden by agreement. For example, the principal cannot authorize the fiduciary to act in bad faith’.³⁰

²⁸ CL 2016 (China), s 14.

²⁹ The thesis does not deny the altruism of a host of volunteers. However, in a legal system lacking basic rules governing the performance of volunteers, some individuals mainly pursuing self-interest under the cloak of being a volunteer may damage the benefits of charities and other supporters. That is an important reason why fiduciary duties exist.

³⁰ Robert H. Sitkoff, ‘The Economic Structure of Fiduciary Law’ (2011) 91 Boston University Law Review 1039, 1046.

The reason for the existence of those mandatory rules, from an economic perspective, is that they ‘serve an internal protective and cautionary function that protects the principal, and an external categorization function that protects third parties who deal with the fiduciary’.³¹ This economic argument can help justify the mandatory rules regarding the fiduciary duties of charity trustees in the context of charity governance.

As suggested in Chapter 3, in a charity, the position of the principal (from an economic perspective) should be replaced by the charitable purpose/public benefit it pursues. In this context, the charitable purpose/public benefit itself cannot even negotiate with the charity’s trustees directly and is further vulnerable if the duty of loyalty and other duties can be eliminated totally. Therefore, the mandatory rules of fiduciary duties can reduce the costs of the charity trustees’ moral hazard and internally protect the realisation of the charitable purpose/public benefit³² by constraining those trustees’ discretion.

On the other hand, the external categorisation function of these mandatory rules is to ‘minimize third-party information costs’.³³ In terms of charity governance, combined with the charitable purpose/public benefit, the non-distribution constraint and other principles and rules governing charities, the mandatory rules of fiduciary duties can inform donors, volunteers and the general public that the mandatory fiduciary duties governing charity trustees cannot be changed, and have to be complied with. This can help maintain the public trust and confidence, and thus reduce the supervisory costs of key stakeholders.

Second, the costs of enforcement and the costs of the negative effects of external intervention relating to fiduciary duties should be controlled. In

³¹ *ibid.*

³² In practice, this is also the focus of the charity regulators in regulating charity trustees. See, for example, Charity Commission, *Inquiry Report: Amy Marion Dwyer Will Trust* (Charity Commission 2014); Charity Commission, *Inquiry Report: Saint Stephen the Great Charitable Trust; Saint Stephen the Great* (Charity Commission 2016); Sam Burne James, ‘Regulator Orders Legacy Fund to Review Governance after “Poor Management” Cost It £66,000’ *Third Sector* (London, 28 July 2014) <<http://www.thirdsector.co.uk/regulator-orders-legacy-fund-review-governance-poor-management-cost-66000/governance/article/1305522>> accessed 20 September 2017.

³³ Sitkoff (n 30)1047.

terms of charity governance, ‘as the recipients of public trust, confidence and donations, charity trustees have a moral responsibility’³⁴ to efficiently realise their charity’s purpose. And, in practice, there is scope for internal motivations (such as voluntary spirit) and informal rules or norms (such as reputation and recommended practices) to adjust the conduct of charity trustees and to make them perform effectively and efficiently.³⁵ As noted in Chapter 3, in contrast to legal duties and liabilities, those internal motivations and informal rules and norms are usually self-enforced and cost-effective.

In this context, the contents and legal consequences for breach of fiduciary duties should be reasonably limited to allow the above internal motivations of voluntary charity trustees and informal norms to play a role. This can not only reduce the costs of the legal enforcement of fiduciary duties, but also help control the costs of the negative effects of external intervention, such as ‘undue restrictions or burdensome procedures that make it difficult to recruit [charity trustees].’³⁶ In this respect, even if there are concerns about the situation where ‘in the absence of inappropriate self-dealing, fiduciaries generally have little to fear from the regulators’,³⁷ it is worth noting that, the legal requirements on fiduciary duties should be reasonably and pragmatically limited.

Therefore, a well-designed legal mechanism governing fiduciary duties should help control the serious mismanagement and misconduct of charity trustees in order to reduce the costs of their moral hazard and the

³⁴ Lord Hodgson, *Trusted and Independent: Giving Charity back to Charities-Review of the Charities Act 2006* (The Stationery Office 2012) 22.

³⁵ James J. Fishman, ‘Improving Charitable Accountability’ (2003) 62 *Maryland Law Review* 218, 246.

³⁶ James J. Fishman, ‘The Development of Nonprofit Corporation Law and an Agenda for Reform’ (1985) 34 *Emory Law Journal* 617, 677. In this context, an insightful statement in corporate governance may also apply to charity governance: ‘the accountability rules, no matter to whom the accountability lies, must not be so restrictive as to stifle the entrepreneurial talents of the managers, which talents constitute the rationale of conferring the wide discretion upon them in the first place.’ Paul L. Davies and Sarah Worthington, *Principles of Modern Company Law* (9th edn, Sweet & Maxwell 2012) 379.

³⁷ Evelyn Brody, ‘Accountability and Public Trust’ in Lester M. Salamon (ed), *The State of Nonprofit America* (Aspen Institute & Brookings Institute Press 2002) 479.

supervisory costs of key stakeholders; but, in the meantime, the contents and legal consequences of fiduciary duties should be limited in a reasonable and pragmatic manner in order to reduce the enforcement costs and the costs of the negative effects of external intervention.

5.2.3.2 An Economic Analysis of Chinese Law and English Law

As noted above, in the recently enacted Charity Law 2016 (China), there are few rules dealing with conflicts of interest, which cannot sufficiently reduce the costs of the charity trustees' moral hazard in practice. By contrast, English law provides more detailed rules relating to fiduciary duties, which can perform better in controlling those costs.

On this basis, in England, the Charities Act 2006 (the main contents of which are further consolidated by the Charities Act 2011) and case law seem to strike a balance between controlling the charity trustees' moral hazard and reducing the related monitoring costs in developing their legal rules. For example, English law establishes fiduciary duties by statutory and case law to prevent the moral hazard of charity trustees and accordingly to reduce the supervisory costs of key stakeholders.³⁸

Meanwhile, to ensure the sound performance of charity trustees and to encourage more capable individuals to act as charity trustees, recently English law has adopted a series of measures to protect and support charity trustees by efficiently reducing their legal burdens and risks, such as indemnity insurance,³⁹ and relieving charity trustees acting honestly and reasonably from liability.⁴⁰ Those measures can help reduce the costs of the negative effects of external intervention (such as, inefficient use of charitable resources due to excessive legal limitations and burdens).

Therefore, in contrast to Chinese law, English law takes a range of more

³⁸ Susan R. Moody, 'Policing the Voluntary Sector: Legal Issues and Volunteer Vetting' in Alison Dunn (ed), *The Voluntary Sector, the State and the Law* (Hart Publishing 2000) 40.

³⁹ CA 2011, s 189.

⁴⁰ CA 2011, s 191.

effective measures in reducing the charity trustees' moral hazard and balancing different agency costs relating to fiduciary duties.

5.2.4 Improving the Rules Governing Fiduciary Duties in Chinese Law

Given that English law in this area works better in reducing agency costs, Chinese law can draw on English law to develop its specific legal rules of fiduciary duties governing charity trustees. Accordingly, the following discussion will assess how to improve the current rules governing fiduciary duties in Chinese law.

5.2.4.1 The Necessity of Codification

Currently, Chinese law does not stipulate detailed rules with regard to charity trustees and their fiduciary duties, except for the quite simple rules in the Trusts Law 2001 (China), the Regulation on the Administration of Foundations 2004 (China) and the recently enacted Charity Law 2016 (China). This problem may, to some extent, be redressed by the governing documents of charities. However, in order to efficiently reduce the moral hazard of charity trustees and protect charitable assets, it may be a better choice to enact the basic legal rules relating to fiduciary duties.⁴¹

As a matter of fact, in England, fiduciary duties have been codified in a range of legal areas. For example, in the context of charitable companies, the substantial content of those duties has been codified comprehensively: there have been more detailed statutory rules governing the duty to act within powers, the duty to promote the success of the company, the duty to exercise independent judgment, the duty to exercise reasonable care, skill and diligence, the duty to avoid conflicts of interest, the duty not to accept benefits from third parties and the duty to declare interest in proposed transactions or arrangements.⁴²

⁴¹ International Center for Civil Society Law, 'Comments on the Draft Charity Law for the People's Republic of China' (2007) 5(1) *International Journal of Civil Society Law* 22.

⁴² Companies Act 2006, ss 171-177.

In addition, although in England the view against codification of fiduciary duties is quite strong,⁴³ given that China has no case law, in order to govern fiduciary duties, there must be clear legal rules in its statutory laws. In this context, when considering introducing the related rules developed by English case law into Chinese law, the above codified and detailed rules concerning fiduciary duties should not be ignored. Of course, those codified rules should be transformed according to the principles, such as the charitable purposes and public benefit requirement, of charity law, and established in a manner that will help to reduce the related agency costs.

5.2.4.2 Incorporating the Principle of Voluntary Trusteeship into Charity Law

Traditionally, in English charity law, charity trustees should not receive any profit from their charity, which means charity trustees are usually volunteers.⁴⁴ This is the principle of voluntary trusteeship.

By comparison, in the current laws, regulations and policies in China, voluntary trusteeship has not been accepted as a principle and seems not to be paid sufficient attention. As far as this thesis is concerned, so far, few Chinese scholars even mention this issue, let alone carry out any further analysis of it. Currently, the laws and administrative regulations in this area are quite obscure and uncertain. According to the Public Benefit Undertakings Donations Law 1999 (China), a public benefit social organisation should practise strict economics and reduce its management costs; the salary of its staff and administrative expenses should be paid with the organisation's revenues according to the standard stipulated by the government.⁴⁵ Therefore, although this law require charities to control their management costs, it does not mention the voluntary nature of charity

⁴³ For example, the Law Commission argues that '[s]tatutory codification of the law in this area would be a lengthy process and there is a danger of unintended consequences'. Law Commission (n 9) 146; Law Commission, *Fiduciary Duties and Regulatory Rules (Law Com No 236)* (Law Commission 1995) 72.

⁴⁴ *Robinson v Pett* (1734) 3 P Wms 249, 251; *Brocksopp v Barnes* (1820) 5 Madd 90; *Barrett v Hartley* (1866) LR 2 Eq 789.

⁴⁵ PBUDL 1999 (China), s 23.

trustees.

In addition, according to the Regulation on the Administration of Foundations 2004 (China), directors who do not have a full-time job in a foundation and supervisors (‘监事’) on this foundation’s supervisory board cannot receive any remuneration.⁴⁶ In other words, persons only acting as directors of a charitable foundation along with its supervisory board cannot receive any remuneration and accordingly should be volunteers. Hence, at least in the context of charitable foundations, Chinese law accepts the principle of voluntary trusteeship. However, in terms of the laws and regulations governing associations, civil non-commercial units and charitable trusts,⁴⁷ there is no similar rule requiring voluntary charity trustees. Hence, it is still unclear to what extent the principle of voluntary trusteeship is implemented in practice.

From the perspective of reducing agency costs relating to charity governance, the principle of voluntary trusteeship should be incorporated into Chinese charity law to govern all types of charity. The main reasons are as follows.

First, this principle will help reduce the costs of the charity trustees’ moral hazard. Persons who act as voluntary charity trustees are usually motivated by a strong sense of altruism (possibly also combined with other intangible factors, such as reputation). The voluntary nature of trusteeship can help control the costs relating to their moral hazard.

Second, this principle can help reduce the supervisory costs of donors and

⁴⁶ RAF 2004 (China), s 23. By comparison, in the US, benefits can be given to charity trustees although ‘there are complex legal rules designed to prevent trustees benefiting from their trusteeship to the detriment of the charity’. The Joint Committee on the Draft Charities Bill, *The Draft Charities Bill: Vol. 1 Report, Formal Minutes and Evidence* (HL Paper 167-I; HC 660-I) (The Stationery Office 2004) 71. In addition, many European countries ‘set limitations on the extent to which board members may be remunerated, while remuneration is prohibited’ in several countries. European Foundation Centre (n 1) 16.

⁴⁷ According to the Trusts Law 2001 (China), the trustees of a trust can obtain remuneration from their trust when the trust document or any extra agreement between the parties to this trust allows it. TL 2001 (China), s 35.

the general public. It requires that unpaid charity trustees strictly abide by the non-distribution constraint, confirming to the public that charitable resources may only be used for the charitable purposes as far as possible. Accordingly, it can help reduce the supervisory costs of the financial supporters of a charity.

Third, it will control the costs of the negative effects of monetary payments. As noted in Chapter 3, a monetary payment to charity trustees may harm ('crowd out') their intrinsic motivations and further restrain the involvement of capable volunteers substantially motivated by these factors in charity governance. This principle can copy with this problem.

5.2.4.3 Improving the Rules Governing the Exceptions to the Principle of Voluntary Trusteeship

However, there should be some exceptions to the principle of voluntary trusteeship. For example, charity trustees are facing increasing legal risks and complexity in governing a charity, which is only a part-time job;⁴⁸ in practice, charity trustees are often volunteers⁴⁹ and 'may lack the corporate or legal expertise that their for-profit counterparts often possess';⁵⁰ or some transactions with the trustees of a charity can also benefit the realisation of this charity's purpose.

In those contexts, if the benefits given to charity trustees can contribute to realising the charitable purpose of a charity, in order to reduce the costs relating to inefficient use of charitable resources due to excessive legal limitations, it should be acceptable to provide reasonable benefits to them.

However, given the important role of voluntary trusteeship in reducing

⁴⁸ John Plummer, *How Are Charities Accountable?: A Study of the Approaches to Governance and Accountability Developed by Two Major Charities in Britain* (Demos 1997) 46.

⁴⁹ Karyn R. Vanderwarren, 'Financial Accountability in Charitable Organizations: Mandating an Audit Committee Function' (2002) 77(2) *Chicago-Kent Law Review* 963, 966; Thomas H. Boyd, 'A Call to Reform the Duties of Directors Under State Not-For-Profit Corporation Statutes' (1987) 72 *Iowa Law Review* 725, 728.

⁵⁰ Vanderwarren (n 49) 966; Fishman (n 36) 675.

several types of agency costs (such as the costs of the charity trustees' moral hazard, the supervisory costs of key stakeholders and the costs of the negative effects of monetary payments) as noted above, there should be a range of strict requirements, conditions and procedures to deal with conflicts of interests, to satisfy the information needs of key stakeholders, and to reduce the negative effects of a monetary incentive.

In this respect, the English approach can provide valuable experience. For example, in terms of payments to charity trustees for their services outside their role as charity trustees, the Charities Act 2011 requires a limitation on the amount of the remuneration, that the remuneration is in the best interests of the charity, that the paid charity trustees are a minority, and that there is no express prohibition provision in the government document.⁵¹

Those measures can help control conflicts of interests and reduce the negative effects of a monetary incentive (by limiting the amount of the remuneration). Meanwhile, English law also requires that the legal authority under which the payment was made, the name of the remunerated trustee, details of why the remuneration was paid, the amount of remuneration paid and other information should be provided in the charity accounts,⁵² which is beneficial to meeting the information needs and reducing the supervisory costs of key stakeholders. All those measures as a whole balance the different types of agency costs in charity governance and thus are worth considering in improving the legal rules in China.

Of course, there are some possible drawbacks relating to English law in this respect. For example, in English law, those rules are only applicable to a charity paying for services, which means that payment for the goods supplied by charity trustees is excluded from this rule. However, it is unreasonable to distinguish goods from services and only apply those rules

⁵¹ CA 2011, s 185.

⁵² Charity Commission and Office of the Scottish Charity Regulator, *Charities SORP (FRS 102)* (Charity Commission and Office of the Scottish Charity Regulator 2014) paras 9.6-9.7.

to services.⁵³ To make those rules function well in reducing the related agency costs, they should apply to both services and goods provided by charity trustees in the future charity law.

5.2.4.4 Providing Different Legal Consequences for Breach of Fiduciary Duties

In designing the legal rules governing legal consequences for breach of fiduciary duties, to balance the costs of the charity trustees' moral hazard with the monitoring costs, this thesis argues that a violation of fiduciary duties can be further divided into two parts, 'unintentional violation' ('过失违反') and 'intentional violation' ('故意违反'),⁵⁴ which lead to differing legal consequences. In this respect, although there is no counterpart to this distinction in English law, there is a similar approach distinguishing two different types of liability for breach of fiduciary duties in the Charities Act 2011.

For example, in terms of the purchase of indemnity insurance, in principle charity trustees can utilise their charity's funds to purchase insurance to indemnify them against liability for breach of trust or duty. However, this rule does not apply to the liability relating to conduct '(i) which [the charity trustees] knew (or must reasonably be assumed to have known) was not in the interests of the charity, or (ii) [which the trustees] did not care whether it was in the best interests of the charity or not'.⁵⁵ In addition, as the charity trustee of a charity, a person usually should be personally liable for a breach of duty. However, English law allows the Charity Commission to relieve the whole or part of this charity trustee's liability if the Commission considers that s/he 'has acted honestly and reasonably and ought fairly to be excused for the breach of trust or duty'.⁵⁶

⁵³ This problem is also pointed out by the Law Commission. Law Commission (n 26) 147-161.

⁵⁴ This is a typical classification of violations of duties in Chinese law. For example, see GPCL 2017 (China), ss 38 and 43; Criminal Law 1979 (China, revised in 2015) (CL 1979 (China, revised in 2015)), ss 14-15.

⁵⁵ CA 2011, s 189.

⁵⁶ CA 2011, s 191.

From an economic perspective, those rules can be regarded as English law aiming to strike a balance between controlling the charity trustees' serious moral hazard and reducing the costs of the negative effects of external intervention (in this context, the threat from legal liability). This arrangement can help reduce the related agency costs as a whole. Therefore, in designing the legal consequences of breach of fiduciary duties, it is necessary for Chinese law to distinguish two types of liability.

First, 'liability relating to unintentional violation'. In this situation, due to negligence, the charity trustee of a charity did not know that his/her performance would damage the charitable purpose/public benefit, or s/he would not have carried out this conduct.⁵⁷ Therefore, no severe moral hazard of the charity trustee exists in this situation.

Accordingly, the focus of the law should be on reducing the costs of the negative effects of external intervention. Given the voluntary nature of charity trustees, the difficulty in recruiting capable charity trustees and the various contributions that charity trustees make to a charity (such as fundraising, contacts with the local community, etc.), a less stringent liability seems to be more reasonable.⁵⁸ In this context, Chinese law can introduce indemnity insurance, and empower charity regulators to relieve charity trustees acting honestly and reasonably from liability to reduce the legal burdens and risks facing them.

Second, 'liability relating to intentional violation'. In this circumstance, a charity's trustees knew or should reasonably be assumed to have known that their performance would damage the charitable purposes/public benefit, but still carried out this conduct.⁵⁹ This usually means more serious moral hazard for those charity trustees.

⁵⁷ For example, see CL 1979 (China, revised in 2015), s 14.

⁵⁸ Vanderwarren (n 49) 968.

⁵⁹ CL 1979 (China, revised in 2015), s 15.

In this respect, the focus of the law should be on reducing those costs of moral hazard by clarifying and implementing the relevant civil or even criminal liabilities those charity trustees should bear. In particular for criminal liabilities, in China, although charity trustees may be punished by criminal law under some specific circumstances, such as ‘embezzlement’(‘职务侵占罪’), ‘misappropriation’(‘挪用资金罪’) and ‘non-state staff’s bribe-taking’(‘非国家工作人员受贿罪’),⁶⁰ there is no offence dealing with all the situations associated with a serious breach of fiduciary duties in charity governance. By contrast, any serious breach of duties or any abuse of power by the staff of a state-owned enterprise, company or public institution (as noted in Chapter 2, public institutions are usually government-controlled organisations) which leads to a serious loss to the state, is identified as an offence by Chinese criminal law.⁶¹

However, given the tax benefits⁶² conferred to, and the public nature of, charities, the future law in this respect should provide that a serious breach of fiduciary duties by charity trustees, resulting in a severe loss to their charity (and the public indirectly), also forms an offence. This will definitely facilitate the reduction of the charity trustees’ severe moral hazard in ensuring sound charity governance. Meanwhile, for the majority of charity trustees whose performance is honest and reasonable, they do not need to worry about this punishment.

5.3 Reassessing the Role of Internal Bodies in Charity Governance

5.3.1 Introduction

Internal bodies play an important role in charity governance. If an internal body in a charity is the governing body (made up of charity trustees), it will govern and be finally responsible for this charity. If not, then this internal body may play an essential role in monitoring or supporting the

⁶⁰ CL 1979 (China, revised in 2015), ss 163 and 271-272.

⁶¹ CL 1979 (China, revised in 2015), s 168.

⁶² For example, charities and their income can enjoy tax exemptions. CL 2016 (China), s 79.

performance of the governing body/charity trustees. Therefore, the law should distinguish the governing body from other internal bodies, and further provide reasonable rules to reduce the agency costs relating to other internal bodies supervising or supporting the governing body/charity trustees. However, the current legal rules in China cannot achieve this aim.

5.3.1.1 Which Internal Body Falls within the Scope of Charity Trustees?

Similar to the situation that the boards of for-profit companies are expected to ‘be free to drive their companies forward’,⁶³ charity trustees play a central role in governing a charity and ensuring the performance of all the staff is in the best interests of this charity. Meanwhile, in contrast to those governing a for-profit company, charity trustees usually play a more significant role in a charity, ‘as a mechanism to reduce information asymmetries and control costs for primary stakeholders’.⁶⁴

In this context, if it is not clear who are in charge of, and finally responsible for, a charity, the related governance mechanisms cannot be implemented in practice and there will be more disputes when deciding the internal affairs or other issues of this charity, increasing the related agency costs. Therefore, to avoid serious governance problems⁶⁵ and further protect the realisation of the charitable purposes pursued by a charity, it is vital to clarify ‘who the [charity] trustees of a charity are’.⁶⁶

However, there are two practical problems relating to the identity of charity trustees in China. First, due to the lack of a unified title referring to those persons in charge of a charity in Chinese law, it is not clear who are members of the governing body in some circumstances. As noted in Chapter 1, the recently enacted Charity Law 2016 (China) uses a number of terms,

⁶³ Sir Adrian Cadbury, *Report of the Committee on the Financial Aspects of Corporate Governance* (Gee and Co. Ltd. 1992) para 1.1.

⁶⁴ Gerhard Speckhacher, ‘Nonprofit Versus Corporate Governance: An Economic Approach’ (2008) 18(3) *Nonprofit Management & Leadership* 295, 316.

⁶⁵ For example, see Office of the Scottish Charity Regulator, *Who’s in Charge: Control and Independence in Scottish Charities* (Office of the Scottish Charity Regulator 2011).

⁶⁶ Con Alexander and Jos Moule, *Charity Governance* (Jordan Publishing Limited 2007) 7.

such as responsible persons,⁶⁷ decision-making bodies,⁶⁸ executive bodies⁶⁹ and managers,⁷⁰ but it does not clarify who are finally responsible for the conduct of their charity.⁷¹

Second, in China, different types of charity have different internal bodies. For example, in an incorporated association, its members and the board of directors are the essential internal bodies.⁷² By contrast, the board of directors and the supervisory board are the essential internal bodies in a ‘donated legal person’,⁷³ which is an incorporated non-membership public benefit organisation, such as a foundation, or a social service institute (‘社会服务机构’, the new name for a ‘civil non-commercial unit’).⁷⁴ This also increases the difficulty in identifying the charity trustees in a charity.

5.3.1.2 How to Design a Framework Governing Internal Bodies?

In terms of the legal framework governing internal bodies, there are some rules regulating different types of charities in the General Provisions of Civil Law 2017 (China), the Regulation on the Administration of Foundations 2004 (China) and the model governing documents issued by the Ministry of Civil Affairs.⁷⁵

However, currently, the legal rights, duties and liabilities relating to those internal bodies are not well-designed or unavailable (in terms of internal audit). For example, as noted in Chapter 1, formally, members are the

⁶⁷ CL 2016 (China), ss 9, 16, 54 and 95.

⁶⁸ CL 2016 (China), ss 11, 18 and 54.

⁶⁹ CL 2016 (China), s 11.

⁷⁰ CL 2016 (China), ss 14 and 58.

⁷¹ Similarly, due to some special terms or rules provided in the governing document of a charity, sometimes there are also problems in identifying its charity trustees in England. A recent example is the Greenfinch Charitable Trust. Charity Commission, *Inquiry Report: Greenfinch Charitable Trust* (Charity Commission 2016).

⁷² Model Governing Document of Associations, ss 14 and 17; GPCL 2017 (China), s 91.

⁷³ GPCL 2017 (China), s 93.

⁷⁴ GPCL 2017 (China), ss 87, 92 and 93.

⁷⁵ See, for example, GPCL 2017 (China), ss 89, 91 and 93; RAF 2004 (China), ss 20-24; Model Governing Document of Associations, ss 7-29; Model Governing Document of Foundations, ss 8-28; Model Governing Document of Civil Non-commercial Units (Legal Persons), ss 10-23; Model Governing Document of Civil Non-commercial Units (Partnerships), ss 10-16.

authority body of an association, but they are not required to be finally responsible for this association, whilst most governance functions (such as leading the activities of all internal bodies and enacting internal management rules) are performed by the board of directors, but the board is only regarded as the executive body.⁷⁶

The recently enacted Charity Law 2016 (China) only requires that charities should establish and improve their internal governance structures and clarify the rights and duties of their decision-making, executive and supervisory bodies,⁷⁷ which does not change the rules in those regulations and model governing documents. Similarly, although there are several rules regarding the internal bodies of non-profit organisations in the General Provisions of Civil Law 2017 (China), they do not fundamentally change the previous rules in this respect.⁷⁸

To solve those two problems, in this section, two internal bodies of vital importance in Chinese law, i.e., charity members and supervisory boards/trust supervisors, along with internal auditors/audit committees, which are totally ignored by the current Chinese law, will be explored from economic and comparative perspectives.

5.3.2 Reshaping the Rules concerning Charity Members as a Governance Mechanism

For the purposes of the thesis, charity members are restricted to members having the right to participate in charity governance. In England, charity members in charitable companies, charitable incorporated organisations (when members are not exactly the same as charity trustees) and charitable unincorporated associations can usually supervise charity trustees. In China, in a charitable association, its members can also supervise the board of directors.

⁷⁶ Model Governing Document of Associations, ss 17-18.

⁷⁷ CL 2016 (China), s 12.

⁷⁸ An exception may be the requirement for the establishment of a supervisory board as an essential internal body of all donated legal persons, which will be discussed below.

Members can bring a host of benefits to a charity, such as strengthening the accountability of its charity trustees, informing the trustees of the beneficiaries' demands and diverse opinions, extending the social influence of the charity, helping discover and attract volunteers and potential trustees, and obtaining more financial support. However, members may also bring some problems, such as more complexity of governance mechanisms and accordingly more (potential) conflicts and disputes.⁷⁹

So far, there is little, if any, legal or economic analysis of the role of charity members as a governance mechanism.⁸⁰ One of the reasons may be that '[m]ost charities and social welfare organizations, by contrast, have no members, or have members only in the ceremonial sense, offering affinity but not authority'.⁸¹ Based on the revised agency theory in this thesis, unless they donate assets to or act as volunteers of a membership charity, those members are not key stakeholders of this charity. Therefore, the use of charity members as a governance mechanism can be regarded as a special legal arrangement to strengthen the accountability of charity trustees⁸² in a membership charity.

Despite this, from an economic perspective, the monitoring costs relating to members as a governance mechanism should be reduced. Except for the costs of the negative effects of external intervention (such as less capable persons wanting to act as charity trustees) and the costs of supervision, as noted in Chapter 3, there may be two principal disadvantages for members to actively supervise charity trustees: one is the costs of the members' moral hazard (who may pursue their private benefits instead of the best interests of their charity) and the other is the costs relating to the members' collective decision-making process.

⁷⁹ Charity Commission, *Membership Charities (RS7)* (Charity Commission 2004) 9-11.

⁸⁰ Exceptions include Jean Warburton, 'Charities, Members, Accountability and Control' (1997) *Conveyancer and Property Lawyer* 106; Jean Warburton, 'Charity Members: Duties and Responsibilities' (2006) *Conveyancer and Property Lawyer* 330; Henry Hansmann, *The Ownership of Enterprise* (Harvard University Press 1996).

⁸¹ Evelyn Brody, 'The Board of Nonprofit Organizations: Puzzling through the Gaps between Law and Practice--A View from the United States' in Klaus J. Hopt and Thomas von Hippel (eds), *Comparative Corporate Governance of Non-Profit Organizations* (CUP 2010) 519.

⁸² Alexander and Moule (n 66) 52.

Accordingly, Chinese law should reduce those costs in designing its own legal rules governing charity members. Here the thesis will compare the role of charity members in both jurisdictions and discuss how to further reform the rules governing the decision-making rights, the supervision rights and the duties and liabilities of members, in order to reduce the related agency costs.

5.3.2.1 Comparing the Roles of Charity Members in China and England

Before discussing how to reduce the agency costs concerning charity members as an internal governance mechanism supervising charity trustees, it is necessary to compare the roles of charity members in those two jurisdictions to assess whether charity members in Chinese law are charity trustees.

As a matter of fact, in for-profit companies, no one will ask the question about whether members (principals) are directors (agents), because members are the company owners and thus the principals to whom directors owe fiduciary duties.

However, unlike shareholders in a for-profit company, charity members are not the owners of their charity,⁸³ and accordingly are not the principals of the charity's trustees. In this context, on the one hand, charity members are not the owners of a charity; but, on the other hand, they have the right to make decisions on some of this charity's major affairs.⁸⁴ This special position may affect their capacity and motivation in charity governance.⁸⁵ It is therefore necessary to discuss whether members are charity trustees in Chinese law.⁸⁶

⁸³ In this respect, charity members are also different from beneficiaries in a private trust.

⁸⁴ Mark Mullen and Josh Lewison, *Companies Limited by Guarantee* (3rd edn, Jordan Publishing Limited 2011) 93.

⁸⁵ For example, see Hansmann (n 4) 68.

⁸⁶ Here, the situation that a member is selected to act as a charity trustee will not be discussed, because even in Chinese law, there is no dispute about the fact that in a membership charity, its charity members can be selected to have a position on the board of directors.

With regard to this question, in England, it is charity trustees rather than members who are generally responsible for the strategic decision-making issues of their charity. For example, '[t]he CIO's charity trustees are to manage the affairs of the CIO and may for that purpose exercise all the powers of the CIO'.⁸⁷ However, sometimes members may be regarded as charity trustees in English law. '[I]f there is deadlock on the board of directors, or the directors are unable or unwilling to exercise their powers, such powers are by default exercisable by the general meeting'.⁸⁸ And '[i]f the general meeting were to continue to exercise these powers for any length of time, the members themselves become' charity trustees.⁸⁹

By contrast, in Chinese law, following the civil law tradition, members in an association are usually regarded as its supreme body (authority body; decision-making body) and the board of directors (the management board; executive body) is responsible for implementing their decisions.⁹⁰ And 'members often retain for themselves the power over the most important decisions affecting the organization',⁹¹ such as the right to select directors or the right to make decisions for their organisation. In this context, there may be disputes about whether members in Chinese law are also charity trustees. So far, there is no clear answer in China.

Nevertheless, charity members are not the owners of their charity. Meanwhile, even if they have the right to make decisions on some major affairs relating to their charity, especially in Chinese law, most of the decision-making rights (or, say, the general control and management rights) are, as a matter of fact, still empowered to the board of directors. For example, according to the Model Governing Document of Associations (issued by the Ministry of Civil Affairs), formally, members are the authority body of a charitable association, but they are not required to be finally responsible for this charity. In the meantime, most governance

⁸⁷ CA 2011, s 216(2).

⁸⁸ Peter Luxton, *The Law of Charities* (OUP 2001) 316; *Barron v Potter* [1914] 1 Ch 895.

⁸⁹ *ibid.*

⁹⁰ For example, see the Model Governing Document of Associations.

⁹¹ Lester M. Salamon, *The International Guide to Nonprofit Law* (John Wiley & Sons 1997) 21.

functions, including directing the activities of all internal bodies and making internal management rules, are performed by the board of directors.⁹²

To reduce the agency costs due to this unclear relationship between the members and the board of directors in a membership charity (i.e., a charitable association in Chinese law), the thesis argues that, in this membership charity, it is the board of directors rather than the members that should fall within the scope of charity trustees (the governing body). On this basis, the board of directors has the right to govern and should be finally responsible for the charity. Meanwhile, in this membership charity, its charity members should be identified as a special internal body supervising the board of directors. In this context, if the charity members can efficiently reduce the moral hazard of the board of directors, the monitoring costs of the charity's key stakeholders, such as the government, donors and the general public, will be reduced accordingly.

However, choosing members as an internal body supervising charity trustees also has its own costs. For example, charity members may be exposed to moral hazard if they can avoid the related legal duties and liabilities when making decisions on issues relating to their charity. To reduce the costs of moral hazard similar to those of charity trustees and other monitoring costs, the legal rules governing the participation of members in charity governance should be carefully designed. This question will be discussed in a more detailed manner below.

5.3.2.2 Distributing the Rights to Make Decisions Reasonably

As noted above, it is unclear whether charity members in Chinese law fall within the scope of charity trustees in English law. Although the thesis argues that they do not, sometimes charity members do have the rights to make decisions on some major issues, such as merger and dissolution. Nevertheless, as a governance mechanism, the excessive decision-making

⁹² Model Governing Document of Associations, s 18.

rights of members in a charity may increase a range of agency costs in practice.

First, it may increase the costs of the members' moral hazard, because 'members may be motivated by "personal" beliefs or aims rather than concern for the charity's purposes'.⁹³ That may be a very important reason for the Charity Commission to require that 'members cannot bind trustees to do something which is not permitted by the charity's governing document or which would be a breach of their duty'.⁹⁴

Second, it will increase the costs relating to the members' collective decision-making process. It is quite understandable that, when there is a huge number of members in a charity, even if they are totally altruistic and concerned about the charity, a decision made by them may still be very costly because of their diverse preferences and views in realising the charitable purposes, in particular 'when memberships split into factions'.⁹⁵ And, due to inefficient decisions and costly decision-making processes,⁹⁶ members in larger membership charities may elect 'a board that lacks the balance of skills and experience for the good governance of the charity or the degree of competence necessary to direct highly professional members of staff'.⁹⁷

Third, it will increase the supervisory costs and the costs of the negative effects of external intervention. Having a range of decision-making rights may cost charity members a great deal of time, energy and money to participate in the decision-making processes, increasing the supervisory costs. Meanwhile, 'members may not appreciate or understand operational

⁹³ Con Alexander and the Charities Team at Veale Wasbrough Vizards, *Charity Governance* (2nd edn, Jordan Publishing Limited 2014) 70.

⁹⁴ Charity Commission, *It's Your Decision: Charity Trustees and Decision Making (CC27)* (Charity Commission 2013) 12.

⁹⁵ Debra Morris, *Disputes in the Charitable Sector* (Charity Law Unit of University of Liverpool 2003) 20.

⁹⁶ Hansmann (n 80) 41-42.

⁹⁷ Kate Kirkland, 'The Governance of Membership Charities' (2004) 3 *Private Client Business* 171, 172.

circumstances to which the charity trustees are responding'.⁹⁸ And, 'because decisions are shared between the trustees and the members',⁹⁹ there may be more conflicts relating to decisions. Accordingly, charity trustees have to deal with those matters that are not related to the efficient use of charitable resources. This will negatively impede their performance in realising the charitable purposes and public benefit pursued by their charity.

All the above situations may not only disturb the effective performance of charity trustees, but also may increase the whole monitoring costs. To deal with those problems, English law has several methods to limit the decision-making rights of charity members. For example, in terms of a CIO, English law limits the scope of the members' decision-making rights by clarifying that the charity trustees can 'exercise all the powers of the CIO'¹⁰⁰ and by requiring that this CIO cannot amend its constitution in a way 'which would result in the CIO's ceasing to be a charity'.¹⁰¹ In addition, it provides that alterations relating to the CIO's purposes, the application of its property on dissolution, and the authorisation for benefits to its charity members, charity trustees or persons connected with them are regarded as 'regulated alterations' and accordingly need prior written consent from the Charity Commission.¹⁰² Those measures can help reduce the costs relating to the members' moral hazard and other related agency costs.

By contrast, in terms of the amendment to the constitution, the requirement in Chinese law seems even much stricter. According to the Model Governing Document of Associations, an amendment to the governing document of an association cannot be valid unless it obtains consent from its professional administrative unit and the approval of its registration and administration regulator.¹⁰³ Although it is unclear how Chinese regulators exercise this power in practice, it is apparent that allowing those regulators

⁹⁸ Alexander and the Charities Team at Veale Wasbrough Vizards (n 93) 70.

⁹⁹ Charity Commission (n 79) 10.

¹⁰⁰ CA 2011, s 216.

¹⁰¹ CA 2011, s 225.

¹⁰² CA 2011, s 226.

¹⁰³ Model Governing Document of Associations, s 40.

to have this unlimited discretion may result in another problem, excessive involvement of the government in internal governance, along with high costs of governmental regulation (such as high costs of moral hazard, high supervisory costs and high costs of the negative effects of external intervention), as discussed in Chapter 4.

In order to deal with those specific problems in Chinese charitable associations, Chinese law can draw on the experience of English law to improve its rules. For example, although members are the supreme body in a Chinese membership charity, Chinese law should confirm that the board of directors should be empowered with all the decision-making rights, unless specific requirements exist in the governing document of this charity. And, in terms of the specific requirements, the governing document should further clarify the members' remaining decision-making rights and the procedures for exercising those rights.

On this basis, for some major affairs which are directly associated with charity governance, such as the change of the purpose of a charity and the benefit provided to its charity trustees which fall with the 'regulated alterations' in English law, Chinese law should clarify the regulators' power to approve. However, to control the costs regarding governmental regulation, other alterations do not need the approval of the government.

5.3.2.3 Limiting the Forms of the Supervisory Rights of Charity Members

To reduce the related monitoring costs, this thesis argues that the law should limit the forms of charity members' supervisory rights. In this context, it is of value to assess whether Chinese law should recognise the right of members to take a derivative action against charity trustees.¹⁰⁴ In respect of this problem, several types of costs need to be taken into consideration.

¹⁰⁴ Currently in Chinese law, members in a charity do not have the right to take a derivative action against its charity trustees.

First, the costs of the members' moral hazard should be controlled. Given that, generally, 'members have no proprietary interest in the organization',¹⁰⁵ derivative action may provide members with the opportunity to pursue their own personal gain rather than the best interests of their charity, especially when a decision by the charity's trustees damages the personal interests of certain members (such as those members who are also the potential beneficiaries).

As a matter of fact, a derivative action in the commercial sector is a commonly recognised legal device to directly protect the interests of a firm, and indirectly the interests of the shareholders themselves. However, in charity governance, charity members do not have the ownership¹⁰⁶ on which a derivative action is based, and 'giving them standing to sue derivatively is giving them an element of control over something they do not own'.¹⁰⁷ It may increase the members' moral hazard if this right is authorised.

Second, unpredicted supervisory costs should be avoided. Derivative action may bring a similar result to giving the general public the right to enforce the fiduciary duties of charity trustees: a host of unnecessary litigation. In addition, in contrast to some other stakeholders, charity members have already acquired more legal protection in terms of internal governance: 'members generally have the opportunity of exercising some control over the organization's management through the exercise of voting power'.¹⁰⁸ Thus, obtaining a new supervisory right will lead to extra supervisory costs.

¹⁰⁵ Fishman (n 36) 664.

¹⁰⁶ Here, it is still necessary to distinguish charities from mutual benefits organisations: '[t]he relationship of the members to [a mutual benefit organization] is not unlike that of shareholders to a corporation: both receive a direct benefit from the organization in exchange for a financial stake.' Geoffrey A. Manne, 'Agency Costs and the Oversight of Charitable Organizations' (1999) *Wisconsin Law Review* 227, 242.

¹⁰⁷ Rob Atkinson, 'Unsettled Standing: Who (Else) Should Enforce the Duties of Charitable Fiduciaries?' (1998) 23 *Journal of Corporation Law* 655, 671. However, someone may argue that '[a] member does not expect the same return on his money as an investor in shares of stock, but he expects that his money will be used in the manner represented to him when he became a member'. Brenda Boykin, 'Note: the Nonprofit Corporation in North Carolina: Recognizing a Right to Member Derivative Suits' (1985) 63 *North Carolina Law Review* 999, 1012.

¹⁰⁸ Henry Hansmann, 'Reforming Nonprofit Corporation Law' (1981) 129 *University of Pennsylvania Law Review* 497, 613.

Third, the costs of the negative effects of external intervention should be reduced. In this context, the extra costs arising from bringing a legal suit should be taken into account. Bringing a legal suit may lead to effects which may be much more serious ‘than those typically resulting for a business corporation or an individual. Publicity generated by the mere filing of the suit may dry up sources of funds. The reputation of the organization may never recover.’¹⁰⁹

Hence, it may not be a good idea to introduce derivative action into charity governance in Chinese law. From a comparative perspective, in England, the legal rules relating to derivative action are stipulated by the Companies Act 2006.¹¹⁰ Therefore, theoretically, a charitable company’s members can use this rule to supervise its charity trustees.

However, in respect of charitable companies, the rules in company law have to be adopted jointly with charity law. According to the Charities Act 2011, ‘no charity proceedings relating to a charity are to be entertained or proceeded within any court unless the taking of the proceedings is authorised by order of the Commission’;¹¹¹ and, if the Commission can tackle this issue on its own, it will not authorise the proceedings.¹¹² Hence, even the right of members to bring a derivative action in the context of charitable companies is also quite limited.¹¹³

Therefore, in China, a more reasonable option may be to protect the current voting rights of members (such as the right to select or remove directors) and other supervisory rights commonly shared by other stakeholders. For example, members who know that charity trustees have committed severe

¹⁰⁹ Fishman (n 36) 671.

¹¹⁰ Companies Act 2006, ss 260-264.

¹¹¹ CA 2011, s 115.

¹¹² *ibid.*

¹¹³ In the United States, some state laws and some scholars support the idea of recognising the right of members to bring a derivative suit. Boykin (n 107); Thomas Lee Hazen and Lisa Love Hazen, ‘Punctilious and Nonprofit Corporate Governance--A Comprehensive Look at Nonprofit Directors’ Fiduciary Duties’ (2012) 14(2) University of Pennsylvania Journal of Business Law 347. However, even in this context, the rights of members to bring derivative suits are, or are recommended to be, limited.

misconduct or mismanagement can report their complaints to governmental regulators,¹¹⁴ which have the duty and capacity to investigate, and, if the wrongdoing is confirmed, to enforce the fiduciary duties of, remove or punish, charity trustees. Meanwhile, charities can build an internal dispute resolution mechanism to reduce conflicts and disputes within the membership or between their members and charity trustees to further reduce the related monitoring costs.

5.3.2.4 Clarifying the Duties and Liabilities of Charity Members

In the commercial sector, shareholders are deemed and encouraged to pursue their own private benefits. By contrast, in the charitable sector, members are not the owners of their charity, and sometimes may perform for their own private benefits instead of the best interests of the charity.

Accordingly, members having the rights to vote and to make decisions on the major issues regarding a charity may damage the best interests of the charity. In particular, in the case of members also acting as (potential) beneficiaries, the risk of conflicts of interest may be very high. Therefore, to reduce the costs of the charity members' moral hazard, they should be subject to the relevant duties and liabilities similar to those held by charity trustees.

In terms of the duties of charity members, in China the Model Governing Document of Association requires members to protect the legal rights of their association.¹¹⁵ By contrast, in England, due to lack of case law, it is still uncertain 'except in relation to a CIO or where there is an express duty incorporated into the constitution'.¹¹⁶

In respect of CIOs, the law requires any member to 'exercise the powers that the member has in that capacity in the way that the member decides, in

¹¹⁴ Boykin (n 107) 1009; CL 2016 (China), s 97.

¹¹⁵ Model Governing Document of Associations, s 11.

¹¹⁶ Alexander and Moule (n 66) 69.

good faith, would be most likely to further the purposes of the CIO'.¹¹⁷ This duty is indeed important, especially when members have the potential power to control their charity and further limit the charitable resources for their own use, which may make this charity become a mutual benefit association in all but name. Meanwhile, in contrast to the rule in China, this rule makes it much clearer that charity members have a duty to perform in the best interests of their charity whether their private interests conflict with the best interests of this charity or not. Therefore, Chinese law should introduce this rule into its future charity law.

Regarding the liabilities of charity members, according to the Model Governing Document of Associations, if a Chinese member seriously violates the rules provided in the governing document of his or her association, the board of directors or the standing board of directors has the right to remove his/her membership.¹¹⁸ But there is no further rule governing members' liability. Similarly, English law does not make clear the legal consequences of violating the above duty. However, English law does empower the Charity Commission to suspend or remove an individual's membership.¹¹⁹

From the perspective of reducing the members' moral hazard in exercising their decision-making and supervisory rights, apart from removal from membership, Chinese law should stipulate that, if they violate their duties, the relevant members of a charity should pay for the loss or part of it, or be removed by the charity regulators or the charity, depending on the seriousness of their action.¹²⁰

Nevertheless, given that charity members are not charity trustees who govern and are finally responsible for their charity, when designing Chinese law in this respect, the duties and liabilities of those members should be

¹¹⁷ CA 2011, s 220.

¹¹⁸ Model Governing Document of Associations, s 13.

¹¹⁹ CA 2011, s 83.

¹²⁰ Concerning the legal consequences for breach of duties, see the discussion in section 5.2.4.4 of this chapter.

limited to the situations where they exercise their decision-making and supervision rights, and thus be separated from the other duties (such as the duty to submit charity accounts) exclusively belonging to charity trustees.

5.3.3 Improving the Rules Relating to Supervisory Boards/Trust Supervisors

Here, supervisors include supervisors (‘监事’)/supervisory boards (‘监事会’) and trust supervisors (‘信托监察人’). According to the model governing documents regarding foundations and civil non-commercial units (issued by the Ministry of Civil Affairs) in China, supervisors (‘监事’) are an essential internal body in the context of foundations and civil non-commercial units which are legal persons.¹²¹ However, foundations with more than three supervisors can, and larger civil non-commercial units who are legal persons must, establish a supervisory board as their essential internal body.¹²²

By contrast, a ‘donated legal person’, which is created as a new type of incorporated non-membership organisation in accordance with the recently enacted General Provisions of Civil Law 2017 (China),¹²³ is required by law to establish a supervisory board as its internal supervisory body.¹²⁴ Accordingly, a supervisory board will automatically become the essential internal body of all those incorporated foundations and social service institutes (civil non-commercial units) in the future.

One reason for Chinese law to require the establishment of a supervisory board in donated legal persons may be that, in an association, at least its members as an internal body can make the board of directors accountable whilst, in an organisation without membership, it is also necessary to

¹²¹ Model Government Document of Foundations, s 16; Model Government Document of Civil Non-commercial units (Legal Persons), s 20.

¹²² *ibid.*

¹²³ Donated legal persons include but are not limited to incorporated foundations and social service institutes (the new name for ‘civil non-commercial units’). GPCL 2017 (China), s 92.

¹²⁴ GPCL 2017 (China), s 93.

establish an internal body to supervise the board of directors.¹²⁵ This arrangement complies with the general idea of agency theory: ‘[o]ne method of reducing shirking is for someone to specialize as a monitor to check the input performance of team members’.¹²⁶

In respect of charitable trusts (which are unincorporated), trust supervisors are created as a special legal device in Chinese law to supervise trustees.¹²⁷ In this context, they are quite similar to trust protectors in a private trust, who ‘[play] a role somewhat like the board of directors of a corporation, overseeing the performance of the management on behalf of the shareholders, or in this case, the trust beneficiaries’.¹²⁸ In the context of charity governance, it is necessary to discuss the relationship between those supervisors and charity trustees and how to reduce the related agency costs relating to those supervisors monitoring charity trustees.

5.3.3.1 Comparing the Role of Supervisory Boards/Trust Supervisors in Chinese Law with that of English Charity Trustees

Before discussing how to reduce the agency costs relating to supervisory boards in Chinese charitable donated legal persons and trust supervisors in Chinese charitable trusts, it is necessary to clarify whether they can be regarded as part of English charity trustees.

First, we need to consider whether supervisory boards in China can be identified as charity trustees. To answer this question, it is of value to have a brief assessment of the board structures of organisations in both jurisdictions, as indicated in Table 2 below. In terms of corporate governance, there are two prominent board structures: one-tier structure and two-tier structure.

¹²⁵ Similarly, in many continental European countries, there is a legally required supervisory board in a public benefit foundation. European Foundation Centre (n 1) 15.

¹²⁶ Armen A. Alchian and Harold Demsetz, ‘Production, Information Costs, and Economic Organization’ (1972) 62(5) *The American Economic Review* 772, 781.

¹²⁷ TL 2001 (China), s 64; CL 2016 (China), s 49.

¹²⁸ Jeffrey Evans Stake, ‘A Brief Comment on Trust Protectors’ (2006) 27 *Cardozo Law Review* 2813, 2814.

Both for-profit companies and charities in England usually take the one-tier board structure. In a for-profit company, the board of directors is the only board and the independent directors (non-executive directors)¹²⁹ are responsible for overseeing the executive directors. By comparison, in an English charity, the board of directors (whatever its name) is an unpaid governing body which is made up of non-executive directors/trustees responsible for making strategic policies and overseeing their implementation.

Nevertheless, in both for-profit companies and charities, independent/non-executive directors¹³⁰ are ‘required to play a dual role in [England], i.e., they should both participate in the formulation of business strategy and take sufficient distance from the executives in order to monitor their behaviour’.¹³¹

By contrast, for-profit companies and some charities in China usually take a two-tier board structure, which means that there are two separated boards in an organisation: the board of directors (the management board, in charge of management) and the supervisory board (in charge of supervising the board of directors).¹³² In this context, it is clear that the functions of the board of directors in an English charity are further divided into two aspects: strategic decision-making and supervision of executives. The former function is

¹²⁹ Regarding independent directors or non-executive directors in the UK, see John Parkinson, ‘Evolution and Policy in Company Law: The Non-executive Director’ in John Parkinson, Andrew Gamble and Gavin Kelly (eds), *The Political Economy of the Company* (Hart Publishing 2000) 233-263.

¹³⁰ Concerning a detailed analysis of independent directors in charity governance, generally, see Dana Brakman Reiser, ‘Director Independence in the Independent Sector’ (2007) 76(2) *Fordham Law Review* 795.

¹³¹ S.H. Goo and Fidy Xiangxing Hong, ‘The Curious Model of Internal Monitoring Mechanisms of Listed Corporations in China: the Sinonisation Process’ (2011) 12(3) *European Business Organization Law Review* 469, 491; generally, see Rita Esen, ‘Managing and Monitoring: the Dual Role of Non-executive Directors on U.K. and U.S. Boards’ (2000) 11(6) *International Company and Commercial Law Review* 202, 202-209.

¹³² Although quite different in structure, ‘there is no stringent theoretical—let alone empirical—proof that one of the two systems is better than the other’. Klaus J. Hopt, ‘Comparative Corporate Governance: the State of the Art and International Regulation’ (2011) ECGI Working Paper No. 170/2011 <<http://ssrn.com/abstract=1713750>> accessed 20 September 2017; generally, see Carsten Jungmann, ‘The Effectiveness of Corporate Governance in One-Tier and Two-Tier Board Systems’ (2006) *European Company and Financial Law Review* 426.

delivered to the board of directors and the latter is shared by the supervisory board.

However, in China, there is a more complex board structure in terms of listed companies. In this area, China also transplants the independent director system widely used in England into its laws and accordingly forms an unusual ‘dual monitoring system’ (i.e., the co-existence of independent/non-executive directors and a supervisory board) in corporate governance. A similar situation may also happen in a charitable donated legal person when some of its directors have a full-time job in this charity, which will be discussed below.

Table 2 Main Types of Board Structures of For-profit and Charitable Organisations in England and China		
Types	Examples	Board(s)
One-tier (co-existence of executive and non-executive directors)	Some for-profits in England	The board of directors
One-tier (only including non-executive directors)	Some charities in England	The board of directors
Two-tier (co-existence of executive directors and non-executive supervisors)	Some for-profits in China	The board of directors
		The supervisory board
Two-tier (including executive directors, non-executive directors and non-executive supervisors)	Chinese listed companies and some donated legal persons	The board of directors
		The supervisory board

After the above analysis, it may be much easier to identify the nature of supervisory boards in Chinese law. Given that the board of directors is the essential internal body responsible for the general control and management of the administration of a charity, it is, of course, part of the governing body. Meanwhile, as regards the charity’s supervisory board, although it does not

make decisions for this charity, it shares one function of supervising the management affairs with English charity trustees. Therefore, the thesis argues that the supervisory board in a charity should be regarded as part of the governing body and should have similar fiduciary duties to the board of directors. Accordingly, the supervisory board of a charity acts as a self-regulatory mechanism of the governing body.

This argument can also be justified by the current Chinese company law, which enacts that supervisors on the supervisory board share similar fiduciary duties to those on the board of directors (the management board).¹³³ Therefore, in Chinese law, it can be reasonably argued that, if a charity has a supervisory board, both the board of directors and the supervisory board should be regarded as the governing body of this charity.

Second, we need to consider whether trust supervisors in a Chinese charitable trust fall within the scope of charity trustees as defined in English law. This question can be further divided into two sub-questions. Firstly, are charitable trusts organisations? Secondly, what is the relationship between trust supervisors in charitable trusts and supervisory boards in charitable donated legal persons?

As a matter of fact, whether trust supervisors of a charitable trust are an internal or external governance mechanism depends on the nature of the charitable trust itself, i.e., whether it is a (special) contract, property or an organisation. Only when the charitable trust is an organisation, may its trust supervisors be regarded as an internal governance mechanism. As noted in Chapter 2, here, the function of organisations (legal entities) is defined as ‘the shielding of the assets of the entity from claims of the creditors of the entity’s owners or managers.’¹³⁴

However, concerning the nature of trusts, there are absolutely different

¹³³ Company Law 1993 (China, revised in 2013), Chapter 6.

¹³⁴ Henry Hansmann and Reinier Kraakman, ‘The Essential Role of Organizational Law’ (2000) 110 Yale Law Journal 387, 390.

views both in common law countries and civil law countries transplanting trusts law.¹³⁵ In terms of private trusts, currently there are three basic approaches (contract, property and legal entity).¹³⁶ Despite this, in terms of Chinese charitable trusts, the thesis argues that, from an economic perspective, charitable trusts can be identified as organisations.

Firstly, the general arguments in economics on the nature of trusts as property or contracts are usually limited to private trusts (such as family trusts, commercial trusts or pension trusts) and can never be easily adapted to an explanation of charitable trusts, in which beneficiaries are uncertain and have no right (whether the right *in personam* or the right *in rem*) to directly enforce the fiduciary duties of trustees.¹³⁷ Secondly, in Chinese law, trusts law complies with the principle of independence of trust property (‘信托财产独立原则’), which means that a trust’s property is separated from its settlors’ and trustees’ own property.¹³⁸ This complies with the definition of organisation from an economic perspective. Therefore, a Chinese charitable trust can be regarded as an organisation,¹³⁹ rather than a property or contract established exclusively for charitable purposes.

On this basis, trust supervisors can be understood and designed as an internal governance mechanism. Meanwhile, similar to the distinction

¹³⁵ Generally, see Ming Wai Lau, *The Economic Structure of Trusts* (OUP 2011).

¹³⁶ Regarding the contract approach, generally, see John H. Langbein, ‘The Contractarian Basis of the Law of Trusts’ (1995) 105 *Yale Law Journal* 625. In respect of the property approach, generally see *ibid*; Ming Wai Lau, ‘The Nature of the Beneficial Interest: Historical and Economic Perspectives’ (2013) <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2213055> accessed 20 September 2017. Concerning the legal entity approach, generally, see Henry Hansmann and Ugo Mattei, ‘Trust Law in the United States: A Basic Study of Its Special Contributions’ (1998) 46 *American Journal of Comparative Law* 133; Henry Hansmann and Ugo Mattei, ‘The Functions of Trust Law: A Comparative Legal and Economic Analysis’ (1998) 73 *New York University Law Review* 434; Henry Hansmann and Reinier Kraakman, ‘The Essential Role of Organizational Law’ (2000) 110 *Yale Law Journal* 387. Regarding a civil law perspective, generally, see Pierre Lepaulle, ‘An Outsider’s View Point of the Nature of Trusts’ (1928) 14 *Cornell Law Quarterly* 52; Lionel Smith, ‘Trust and Patrimony’ (2009) 28 *Estates, Trusts and Pensions Journal* 332.

¹³⁷ Regarding the role of beneficiaries in charity governance, see the discussion in Chapter 6.

¹³⁸ TL 2001 (China), s 16.

¹³⁹ In addition, recently, some scholars have begun to harmonise the above three arguments by suggesting that organisational law is a mix of fiduciary governance and asset partitioning. Robert H. Sitkoff, ‘Trust Law as Fiduciary Governance plus Asset Partitioning’ in Lionel Smith (ed) *The World of the Trust* (CUP 2013) 428-453.

between the board of directors and the supervisory board in a Chinese charitable donated legal person, the governance function in a charitable trust is further divided into the decision-making function and the monitoring function, which are performed by its trustees and trust supervisors respectively. Therefore, both trust supervisors and trustees form the governing body of a charitable trust.

In summary, supervisory boards/trust supervisors in Chinese law can be regarded as a self-regulatory mechanism of charity trustees. On the one hand, this mechanism is different from charity members, because both supervisory boards and trust supervisors are part of charity trustees. On the other hand, this mechanism plays a similar function to members, reducing the costs of the charity trustees' moral hazard and accordingly reducing the monitoring costs of key stakeholders.

5.3.3.2 Designing Supervisory Boards as Voluntary Internal Bodies

Non-executive directors and a supervisory board can co-exist in a donated legal person in China. For example, according to the Regulation on the Administration of Foundations 2004 (China), in a foundation, paid directors should not exceed one third of the whole directors,¹⁴⁰ and directors who do not have a full-time job in the foundation and supervisors cannot receive any remuneration.¹⁴¹ In this context, in terms of foundations, Chinese law builds a two-tier board structure similar to that of Chinese listed companies: there may be paid executive directors and unpaid non-executive directors on the board of directors and unpaid non-executive supervisors on the supervisory board. However, in contrast to Chinese listed companies, sometimes there may be a more extreme situation in a donated legal person; that is, both directors and supervisors are non-executive.

In this context, the problems of the dual monitoring system in relation to Chinese listed companies may also occur in Chinese foundation governance,

¹⁴⁰ RAF (China) 2004, s 20.

¹⁴¹ RAF (China) 2004, s 23.

the biggest being that non-executive directors and supervisors share similar functions. Accordingly, this governance mechanism may result in conflicts and disputes¹⁴² and unnecessary monitoring costs. Thus, to reduce the unnecessary monitoring costs due to the co-existence of independent directors and a supervisory board which share similar functions, the thesis argues that a supervisory board should be an alternative rather than an essential internal body in a charitable foundation or any other donated legal person.

5.3.3.3 Recognising the Rights of Supervisory Boards to Enforce Fiduciary Duties

In terms of trust supervisors, they are mainly ‘established to represent the indefinite beneficiary, so whether [they] supposedly enjoys all the rights of the beneficiary except the distribution-receiving right needs clarification.’¹⁴³ Nevertheless, the trust supervisors of a charitable trust not only have the right to approve the trustees’ report concerning trust affairs¹⁴⁴ and the trustees’ liquidation report,¹⁴⁵ but also can directly bring a legal suit to protect the beneficiaries’ interest in their own name.¹⁴⁶ In other words, in Chinese law, trust supervisors of charitable trusts have the rights to enforce the fiduciary duties of trustees. By contrast, currently, the supervisory board in a charity does not have this right in monitoring the board of directors.

Here, the problem is whether it is cost-effective to confer this right upon trust supervisors or supervisory boards. Based on the revised agency theory, this thesis supports allowing supervisory boards (along with trust supervisors) to enjoy this supervisory rights. The main reason can be concluded as follows.

First, the costs relating to those supervisors’ moral hazard are low.

¹⁴² Goo and Hong (n 131) 503.

¹⁴³ Yinglu Li, ‘Charitable Trusts in China’ (2014) 20(4) *Trusts and Trustees* 345, 349.

¹⁴⁴ TL 2001 (China), s 67.

¹⁴⁵ TL 2001 (China), s 71.

¹⁴⁶ TL 2001 (China), s 65.

Supervisors on a supervisory board do not obtain any remuneration. Thus, as a self-regulatory mechanism of charity trustees, those supervisors are more able to efficiently supervise directors and accordingly reduce the supervisory costs of key stakeholders. Second, in contrast to charity members, the number of those supervisors is comparatively small, which may not lead to collective decisions having high costs.

Third, the current legal rules contribute to reducing the supervisory costs of supervisory boards in monitoring directors. In terms of the supervisory board in a charitable donated legal person, there is no detailed rule setting out their rights in the recently enacted General Provisions of Civil Law 2017 (China). However, according to the Model Governing Document of Foundations, the supervisory board of a foundation has the rights to check the financial affairs of this foundation, to attend the meeting of the board of directors, and to raise questions or suggestions on the matters to be decided by the board of directors.¹⁴⁷ Therefore, by exercising those rights, the supervisory board may already have been familiar with the governance issues relating to the board of directors, making it easy for this supervisory board to find any mismanagement and misconduct by the directors.

Therefore, similar to the right of trust supervisors to enforce the fiduciary duties of trustees, the right of supervisory boards to bring a legal suit requiring directors to perform their fiduciary duties should be recognised by law.

5.3.3.4 Distributing Governance Mechanisms Supervising those Supervisors

After clarifying the role of those supervisors as part of the governing body (charity trustees), supervisory boards and trust supervisors should also be regulated by the internal and external governance mechanisms regulating directors and trustees (such as fiduciary duties, supervision by members,

¹⁴⁷ Model Governing Document of Foundations, s 19.

governmental regulation and public accountability), in order to reduce the costs of those supervisors' moral hazard.

First, with respect to fiduciary duties and liability, given that Chinese law enacts no rule regulating trust supervisors, the future law can provide that trust supervisors should have similar fiduciary duties and liabilities to supervisory boards. For example, it is of value to introduce the principle of voluntary trusteeship into the rules governing trust supervisors. Currently, supervisors in a Chinese charitable foundation cannot receive any remuneration.¹⁴⁸ So the remaining problem is whether trust supervisors should have the right to receive remunerations. So far the law does not provide a clear answer.

Supervisors on a commercial company's supervisory board can, of course, receive remunerations from the company. However, given the role of supervisory boards/trust supervisors as charity trustees, the rule governing those supervisors should also comply with the principle of voluntary trusteeship. The only exception in the future should be the situations mentioned above when discussing the fiduciary duties of charity trustees and the related accountability and transparency mechanisms should be put in place accordingly.

In addition, given that there is no detailed legal rule¹⁴⁹ governing the liabilities of trust supervisors and supervisory boards,¹⁵⁰ the thesis argues that, as part of charity trustees, those supervisors should be liable for breach of their fiduciary duties, which is similar to the liability imposed on directors and trustees.

Second, the methods selecting or removing supervisors should be clarified

¹⁴⁸ RAF 2004 (China), s 23.

¹⁴⁹ One exception may be the rule in the Regulation on the Administration of Foundations 2004 (China): if supervisors on the supervisory board encroach upon, pocket or embezzle the property of the foundation, they should return their illegally occupied property; and, if their above activity constitutes an offence, they will be punished by criminal law. RAF 2004 (China), s 43.

¹⁵⁰ By contrast, Chinese company law requires that the supervisors on the supervisory board should pay for the loss arising from the conflicts of interest. CL 1993 (China, revised in 2013), s 21.

in practice. In terms of supervisory boards, the Regulation on the Administration of Foundations 2004 (China) does not enact the related rules. However, according to the Model Governing Document of Foundations, supervisors of a foundation can be selected and removed by its major donors and professional administrative unit separately, or by the registration and administration regulator if necessary.¹⁵¹

In terms of charitable trusts, the Charity Law 2016 (China) provides that a charitable trust's settlors have the right to select its trust supervisors. In addition, according to the Trusts Law 2001 (China), trust supervisors shall be prescribed in the trust document. If there is no provision in the trust document, the regulator of public benefit undertakings shall appoint trust supervisors.¹⁵² However, there is no rule relating to removing trust supervisors. In this context, the future law should make it clear that, if the trust supervisors of a charitable trust do not perform their duties, they may be removed according to the governing document, or by the governmental regulator (whether it is the department of civil affairs or the court).

Third, given that in a charity, the board of directors (or the trustee) is responsible for decision-making and the supervisory board (or the trust supervisor) is in charge of supervision, the law should require that the supervisory board and the trust supervisor cannot participate in the decision-making affairs of its charity in case of a potential risk: '[i]f every decision of A is to be reviewed by B, then all we have really is a shift in the locus of authority from A to B and hence no solution to the original problem.'¹⁵³

5.3.4 Promoting the Development of Internal Audit in a Charity

Audit can be further divided into internal audit and external audit. External audit is mainly responsible for supervising charity trustees, which will be discussed in Chapter 7, whilst internal audit can contribute to the

¹⁵¹ Model Governing Document of Foundations, s 18.

¹⁵² TL 2001 (China), s 64.

¹⁵³ Kenneth J. Arrow, *The Limit of Organization* (W. W. Norton & Company 1974) 78.

strengthened governance capacity of charity trustees in efficiently controlling and ruling their charity.

As a matter of fact, '[i]nternal auditing is a young, modern profession.'¹⁵⁴ For charity trustees, receiving complete information without verification may not help them to sufficiently improve their performance.¹⁵⁵ To support charity trustees in reducing the residual loss arising from inefficient use of charitable resources due to insufficient information, it is of value to establish an internal audit function in a charity to strengthening the completeness, accuracy and objectiveness of information that the charity trustees receive relating to charity governance, management and operation.

5.3.4.1 Developing Rules Governing Internal Audit Relating to Charities

Establishing an internal audit function in a charity is not a legal requirement in either jurisdiction. However, as 'part of the internal control management',¹⁵⁶ internal auditors will facilitate this charity's trustees to efficiently perform their duties in order to reduce the residual loss due to a range of risks.

Therefore, for the government, professional organisations or charity umbrella organisations, it is helpful to issue guidance or recommended practices relating to the internal audit of charities in support of the establishment and development of internal audit mechanisms in the charitable sector. In this respect, the '*Internal Financial Controls for Charities*'¹⁵⁷ published by the Charity Commission and the '*International Standards for the Professional Practice of Internal Auditing*' issued by The Institute of Internal Auditors (which is an international professional

¹⁵⁴ Jeffrey Ridley and Andrew Chambers, *Leading Edge Internal Auditing* (ICSA Publishing Limited 1998) xxxviii.

¹⁵⁵ Paul Palmer and Adrian Randall, *Financial Management in the Volunteer Sector* (Routledge 2002) 36.

¹⁵⁶ Charity Commission, *Internal Financial Controls for Charities* (Charity Commission 2012) 3.

¹⁵⁷ *ibid.*

organisation specialising in providing best practices regarding internal auditing)¹⁵⁸ are good examples for China to draw on.

5.3.4.2 Encouraging the Establishment of an Audit Committee in a Larger Charity

The role of an audit committee ‘is to help the trustees meet their responsibilities for risk management, having effective internal controls and the efficient and effective use of funds’.¹⁵⁹ For smaller charities, as noted by the Charity Commission, ‘[i]t is unlikely that [those] charities will have the resources to support a separate audit committee’.¹⁶⁰

By contrast, for a larger charity¹⁶¹ which is facing more complicated governance structures, operational risks or other significant challenges, one good measure to support the governance function of its charity trustees is the establishment of an audit committee within the charity, which can facilitate those charity trustees to strengthen control over the charity’s financial operations.¹⁶²

In addition, to assist this mechanism in helping charity trustees perform their duties in order to reduce the residual loss, it is necessary to establish the related rules governing audit committees. However, there is no specific legal rule available in either jurisdiction. To tackle this problem, the government, charity umbrella organisations or professional bodies can design model rules regulating audit committees.¹⁶³

In addition, a charity with an audit committee can stipulate the basic rules

¹⁵⁸ The Institute of Internal Auditors, *International Standards for the Professional Practice of Internal Auditing* (The Institute of Internal Auditors 2016).

¹⁵⁹ Charity Commission (n 156) 7.

¹⁶⁰ *ibid* 6; Dana Brakman Reiser, ‘Director Independence in the Independent Sector’ (2007) 76(2) *Fordham Law Review* 795, 804-805.

¹⁶¹ Regarding the definition of larger charities, see the discussion in Chapter 7.

¹⁶² Karyn R. Vanderwarren, ‘Financial Accountability in Charitable Organizations: Mandating an Audit Committee Function’ (2002) 77(2) *Chicago-Kent Law Review* 963, 963.

¹⁶³ Regarding a typical example of provisions governing the audit committee in a charity, see Alexander and the Charities Team at Veale Wasbrough Vizards (n 93)161-163.

associated with the functions, capacity, nomination and other matters regarding the audit committee. In this respect, the ‘*Guidance on Audit Committee*’¹⁶⁴ issued by the Financial Reporting Council can provide many insightful rules and ideas to assist charities in drafting the rules relating to the audit committee in their governing documents, although some terms (such as ‘shareholders’) and rules should be revised in order to comply with charity law and the features of charities.

5.4 Conclusion

This chapter has carried out a comprehensive study of Chinese law relating to the internal governance mechanisms of charities from economic and comparative perspectives. The basic conclusions relating to fiduciary duties and internal bodies were reached respectively.

First, in terms of the fiduciary duties of charity trustees, there are few rules governing fiduciary duties in Chinese new charity law, and this is insufficient to reduce the costs of the charity trustees’ moral hazard. By contrast, there are more detailed rules governing fiduciary duties in English law, which can contribute to the reduction of those costs.

Meanwhile, the design of English law in this respect takes agency costs into account in practice and strikes a balance between the costs of the charity trustees’ moral hazard and the monitoring costs. For example, in England, on the one hand, fiduciary duties are developed by case law and statutes to prevent the moral hazard of charity trustees. On the other hand, recently, English law has adopted a series of measures to protect and support charity trustees, such as indemnity insurance, and relieving charity trustees acting honestly and reasonably from liability.

In this context, on the one hand, China should reduce the costs of moral hazard and balance those costs with the monitoring costs (such as the costs

¹⁶⁴ Financial Reporting Council, *Guidance on Audit Committee* (The Financial Reporting Council Limited 2016).

of the negative effects of external intervention) in improving its legal rules governing fiduciary duties. On the other hand, as a civil law country, China should codify the substantial contents of the fiduciary duties of charity trustees.

For example, Chinese law should incorporate the principle of voluntary trusteeship into its future rules. Meanwhile, to reduce the costs relating to inefficient use of charitable resources and other monitoring costs, it is necessary for the law to draw on the experience of English law, clarifying the exceptions to this principle and detailing the related conditions and procedures ensuring accountability and transparency.

In addition, Chinese law should further provide different legal consequences for breach of fiduciary duties. In terms of ‘unintentional violation’, to avoid unnecessary costs of the negative effects of external intervention, the legal consequence of violating fiduciary duties can be relaxed by introducing indemnity insurance, empowering regulators to relieve charity trustees from liability and other methods. By contrast, for intentional violation, to control the costs relating to the charity trustees’ severe moral hazard, the law cannot relax the liability of those charity trustees, and should further clarify its civil and criminal consequences.

Secondly, with respect to internal bodies supervising charity trustees, the discussion is further divided into three parts, charity members, supervisory boards/trust supervisors, and internal auditors/audit committees.

In respect of charity members, in England, it is comparatively clear that it is charity trustees (such as the board of directors in a charitable company) rather than members who govern a membership charity. By contrast, in Chinese law, formally, members are regarded as the decision-making body/authority body in a membership charity (a charitable association). However, in practice, it is the board of directors that governs and is finally responsible for this charity.

From the perspective of reducing the agency costs due to this unclear relationship between charity members and charity trustees, it is necessary to clarify that members in Chinese law should not be regarded as part of charity trustees. Instead, they are designed by law as a special internal governance mechanism supervising charity trustees of membership charities, to reduce the charity trustees' moral hazard and the monitoring costs of key stakeholders, such as donors and the general public.

On this basis, in contrast to Chinese law, the current legal rules in England are more cost-effective. For example, English law empowers a CIO's charity trustees to exercise all the powers to manage its affairs, limits its members' rights to amend its governing document (such as making this CIO cease to be a charity) and requires that alterations regarding the purposes, the application of property on dissolution, and the benefits transferred to the members, charity trustees and connected persons should obtain the Charity Commission's approval. Those legal limitations on the scope and procedure regarding the members' decision-making rights in a CIO reduce the costs of those members' moral hazard and other monitoring costs, such as the costs relating to their collective decision-making process. By contrast, Chinese law gives the government unlimited discretion to decide whether to approve this amendment, which may reduce the costs regarding the exercise by members of decision-making rights, but in the meantime may lead to excessive participation by the government in internal governance, increasing the unnecessary costs associated with governmental regulation.

Nevertheless, there exists a similarity in both jurisdictions: neither Chinese law nor English law directly empowers members to bring a derivative action, which helps reduce the costs of the members' moral hazard, supervisory costs and costs of the negative effects of external intervention. For example, in England, although theoretically, a charitable company's members have the right to bring a derivative action in accordance with the Companies Act 2006, this right is quite limited because of the restrictive requirements by the Charities Act 2011 on 'charity proceedings'.

In addition, in terms of members' duties, English law clarifies the duty of a CIO's members as being to perform in the best interests of this charity in exercising their powers, contributing to the reduction of the costs of the members' moral hazard. In contrast to Chinese law, which requires members to protect the rights of their association, the rule in English law is much clearer, specifying that those members' duty is to perform in the best interests of their charity, whether there are conflicts of interest or not. However, regarding the liabilities of members when breaching their duties, there are few rules in either jurisdiction.

Therefore, to reduce the agency costs relating to charity members as a mechanism supervising charity trustees, Chinese law should empower charity trustees/directors to exercise the whole decision-making rights in principle. Meanwhile, when members have the decision-making rights, the law and the governing document of their charity should further clarify the scope of those rights and the related procedures. However, the government's power to approve an amendment to the governing document of a membership charity should be limited to those closely associated with charity governance, such as the 'regulated alterations' in English law, to control the costs arising from excessive participation by the government in internal governance issues.

In addition, Chinese law should sustain its current legal arrangement which does not recognise the rights of members to bring a derivative action. Finally, Chinese law should further clarify the duties and liabilities of members in exercising any decision-making and supervisory rights.

In terms of supervisory boards/trust supervisors, it is found that, in contrast to the dual roles (i.e., the decision-making function and the supervisory function) that charity trustees play in English law, the decision-making function is separated from the supervisory function in China. For example, in a Chinese charitable donated legal person (which is incorporated), the board of directors is responsible for decision-making while the supervisory board exercises supervisory rights. In a Chinese charitable trust (which is

unincorporated), its trustees have the rights to make decisions for this trust whilst the trust supervisors are responsible for supervising those trustees.

By contrast, in English law, charity trustees play those dual roles in practice, making decisions for their charity on the one hand and supervising the performance of the management team on the other. Therefore, supervisory boards/trust supervisors in Chinese law should be regarded as part of charity trustees. On this basis, supervisory boards and trust supervisors can be identified as a self-regulatory mechanism of charity trustees.

To control monitoring costs regarding accountability to supervisory boards/trust supervisors, Chinese law should be reformed as follows. First, given that the co-existence of unpaid non-executive directors and an unpaid supervisory board in a charitable donated legal person leads to unnecessary monitoring costs, Chinese law should design the supervisory board of a charity as a voluntary internal body rather than an essential internal body. Second, given the low costs of moral hazard, collective decisions and supervision regarding supervisory boards in monitoring directors, the law should recognise their right to enforce the fiduciary duties of directors, which has already been enjoyed by trust supervisors in a charitable trust. In addition, to reduce the costs of the supervisory boards/trust supervisors' moral hazard, Chinese law should distribute governance mechanisms regulating charity trustees to monitor those supervisors, such as imposing the fiduciary duties (including the principle of voluntary trusteeship) and liabilities of directors and trustees on them, and clarifying the methods for selecting or removing those supervisors.

In respect of internal auditors and audit committees, neither Chinese law nor English law provides any specific rule governing internal audit. However, in England, the Charity Commission at least issues some guidance on how to ensure sound internal audit, such as '*Internal Financial Controls for Charities*'.

To facilitate charity trustees to deal with different types of risks in order to

reduce the residual loss, the government, professional bodies and charity umbrella organisations can issue the relevant guidance in support of charity trustees to effectively make use of some effective internal auditing mechanisms. A larger charity can be encouraged to establish an audit committee to strengthen its trustees' ability to govern it.

In the next chapter, this thesis will examine another important aspect of charity governance, i.e., accountability to third parties.

Chapter 6 Improving Accountability to Third Parties

6.1 Introduction

This chapter will make an economic and comparative study of the legal rules governing accountability to third parties, mainly including donors and beneficiaries. In terms of ensuring sound charity governance, governmental regulators usually play a vital role.¹ However, the role of the government in ensuring sound charity governance may be limited in practice, due to restrictive budgets and not enough staff. Accordingly, as a supplement to governmental regulation, third parties, along with internal governance and public accountability, can also play a role in supervising and supporting charity trustees in some circumstances.

Accordingly, this chapter will examine the problems relating to accountability to donors and beneficiaries respectively in China and England. Based on the revised agency theory, this chapter argues that, in terms of donors, although they are ‘key stakeholders’ (who provide charitable resources voluntarily) defined in Chapter 3 and should act as supervisors to make charity trustees accountable for the charitable purpose/public benefit pursued by their charity, their supervisory rights should be reasonably limited to avoid unnecessary monitoring costs. By contrast, although their views and experience are quite useful for the improvement of the quality of services or goods provided by a charity, beneficiaries are neither key stakeholders nor capable candidates to act as ‘other selected stakeholders’. Instead, it is more suitable for beneficiaries to play a supportive role in charity governance.

The following discussion will provide a detailed analysis of the roles of and legal rules governing donors and beneficiaries from economic and comparative perspectives to develop the above arguments and further offer a range of reform suggestions to improve Chinese law in this area.

¹ See the discussion in Chapter 4.

6.2 Reducing the Agency Costs relating to Accountability to Donors

6.2.1 Introduction

6.2.1.1 Clarifying the Scope of the Term ‘Donors’

In this chapter, donors are defined as financial supporters of the charitable purpose of a charity on a voluntary basis (excluding the government providing tax benefits to charities, which has been discussed in Chapter 4). Accordingly, a party to any commercial contract, such as a sales contractor (including any government department funding charities through contracts for sales of goods or services,² or any purchaser of goods or services of charities in their ‘primary purpose trading’³), with a charity does not fall within this definition and thus will not be discussed any more.

6.2.1.2 A Comparison of the Legal Nature of Donations in England and China

In England, because of the doctrine of consideration, donations themselves are usually not contracts,⁴ and accordingly donors do not have any contractual rights to supervise charity trustees. However, this does not mean that donors cannot have any other supervisory rights in English law, which will be further examined below. Here, it is only worth noting that, donors at least have rights to impose conditions and terms on their donations, and they, as members of the general public, have rights to access information about charities.

By contrast, except for bequests⁵ and initial donations by the founders⁶ of a

² In China, these contracts are usually named as public service purchase contracts (‘公共服务购买合同’).

³ As regards a recent analysis of the primary purpose trading, see Charity Commission, *Trustees, Trading and Tax: How Charities May Lawfully Trade* (Charity Commission 2016) 9.

⁴ Edwin Peel, *The Law of Contract* (13th edn, Sweet & Maxwell 2011) 71.

⁵ In accordance with Chinese legal theory, a bequest is not a contract but a unilateral action (‘单方行为’). Thus, it can be taken into effect without the consent of the donee. And the donee will have the right to acquire the title of the donated property without the need to give any promise. Of course, the

‘donated legal person’,⁷ *inter vivos* donations are contracts (‘donation contracts’)⁸ in China, which are directly regulated by the Contract Law 1999 (China) and other relevant laws.⁹

In accordance with Chinese law, a donation contract is ‘a contract whereby the donor transfers his property to the donee without reward and the donee manifests his acceptance of the donation’.¹⁰ In this context, on the one hand, the term ‘donation contract’ seems to be very strange to English law scholars; on the other hand, the so-called ‘contract culture’¹¹ is also difficult for Chinese law scholars to understand because both grants¹² and contracts in English law can be regarded as contracts from the perspective of Chinese law.

However, in terms of the specific legal rules, the gap may not be so huge. Although donations are usually regarded as contracts in Chinese law, according to the Contract Law 1999 (China), except for donation contracts aimed at realising the public benefit, such as the relief of disasters or poverty, performing moral duties or being notarised, donors have the right to revoke

donee can give up this right. Zejian Wang, *An Introduction to Civil Law* (China University of Political Science and Law Press 2003) 83-84 (王泽鉴: 《民法概要》, 中国政法大学出版社 2003 年版).

⁶According to Chinese civil law theory, an initial donation of the founder (‘捐助行为’) is also a unilateral action. *ibid* 66.

⁷ In Chinese law, donated legal persons include but are not limited to charitable foundations and social service institutes (the new title for civil non-commercial units). GPCL 2017 (China), s 92.

⁸ For example, see CL 1999 (China), Chapter 11 (donation contracts); PBUDL 1999 (China). It is necessary to point out that Chinese law complies with a general principle that ‘the special law should be adopted before the general law’. Thus, in terms of donation contracts, the Public Benefit Undertakings Donations Law 1999 (China) is the special law that should be used to regulate donation contracts before the Contract Law 1999 (China). And, only if there is no rule governing a legal issue in this special law, the Contract Law 1999 (China), as a general law, can be deployed to regulate the relevant legal relationship.

⁹ An absolute gift in English law can also be regarded as a donation contract according to Chinese law.

¹⁰ CL 1999 (China), s 185.

¹¹ The phenomenon can be concluded as that ‘[c]ontracts or service agreements have increasingly replaced existing grant aid and voluntary organisations have become exposed to the tighter service specifications, increased accountability and managerialism’. Lynne Russell and Duncan Scott, *The Impact of the Contract Culture on Volunteers* (Joseph Rowntree Foundation 1997); Debra Morris, *Charities and the Contract Culture: Partners or Contractors? Law and Practice in Conflict* (Charity Law Unit of University of Liverpool 1999).

¹² In England, ‘[t]here is no legal difference between a grant and a donation, it is simply that grants are often awarded by institutions and are more likely to be for specific purposes’. Sayer Vincent LLP, *Grants and Contracts* (Sayer Vincent LLP 2015) 5.

the donation before transferring the title of their property to donees.¹³ In a recent case, Cheng Ji, the son of Xianxin Ji (a well-known Chinese scholar who died in 2009) brought a legal suit against Peking University, requiring the university to return his father's donation. However, he lost his case because the court identified that this was a donation aimed at realising the public benefit, and thus could not be revoked.¹⁴

However, for any other donation which does not fall within the above exceptions, its donees do not have the right to enforce the donation contract. Accordingly, this situation is quite similar to that in English law, where gratuitous promises usually cannot be enforced except for those in the form of deed.¹⁵

6.2.1.3 The Necessity to Limit Donors' Rights in Charity Governance

As noted in Chapter 3, because of contract failure, donors may prefer to trust and donate assets to a charity rather than a for-profit firm. In this context, donation contracts may not be an efficient way to supervise charities: the ineffective contract supervision itself (due to serious information asymmetry) is the main reason why donors choose to donate property to a charity rather than a commercial firm to benefit the community: in contrast to a for-profit company, a charity 'gives [donors] greater assurance that the services they desire will in fact be performed as they wish'.¹⁶

¹³ CL 1999 (China), s 186.

¹⁴ Suya Liu, 'The Appeal relating to Xianlin Ji Legacy Case Has Begun, but Cheng Ji is Still willing to be reconciled with Peking University' *Beijing Evening News* (Beijing, 27 March 2017) <http://news.xinhuanet.com/legal/2017-03/27/c_1120703112.htm> accessed 20 September 2017.

¹⁵ Peel (n 4) 169. In addition, although donations are usually not regarded as contracts in English law, if a donation takes the form of a third party beneficiary contract which is regulated by the Contracts (Rights of Third Parties) Act 1999, it can become a valid contract. For example, see *Charity Commission for England and Wales v Framjee and others* [2014] EWHC 2507. As a matter of fact, in common law countries, there are still other side doors allowing a binding gift promise, such as reliance and moral obligation plus subsequent promise. George S. Geis, 'Gift Promises and the Edge of Contract Law' (2014) 3 *University of Illinois Law Review* 663.

¹⁶ Henry Hansmann, 'Reforming Nonprofit Corporation Law' (1981) 129 *University of Pennsylvania Law Review* 497, 504; Rob Atkinson, 'Unsettled Standing: Who (Else) Should Enforce the Duties of Charitable Fiduciaries?' (1998) 23 *Journal of Corporation Law* 655, 666.

In this context, in contrast to ending donations, it is too costly for ordinary donors to take any further action (such as designing complex contract terms and conditions) to supervise charity trustees.¹⁷ Therefore, unless there are specific charity scandals, the general public and smaller donors usually choose to trust charities and donate unrestricted gifts to them directly without any detailed requirements on the use methods, necessary outcomes, quality standards or evaluation approaches, etc.

However, this may not be suitable for or satisfy some major donors¹⁸ or donors with some specific requirements (restricted gifts¹⁹) on controlling the use of their donated property.²⁰ These donors may have the motivation, and many of them may also have the professional capacity (such as some large grant-making foundations or corporate donors), to further supervise the performance of a charity through detailed contract terms and conditions.²¹

In terms of the motivation, donors are usually committed to benefiting the community and ‘most would prefer that the goal is accomplished at the lowest possible cost’.²² In the meantime, many donors ‘bargain over the best way to use the invested resources for the organization’s mission—and even over the interpretation of the mission itself’.²³ In reality, donors are

¹⁷ Martin Ricketts, *The Economics of Business Enterprise: An Introduction to Economic Organisation and the Theory of the Firm* (Edward Elgar Publishing Limited 2002) 38.

¹⁸ In the Code of Fundraising Practice, a ‘major donor’ means ‘an individual or family with the potential to make or procure a gift which would have a significant impact on the work of the organisation’. Fundraising Regulator, *Code of Fundraising Practice* (Fundraising Regulator 2016) para 11.2 <<https://www.fundraisingregulator.org.uk/wp-content/uploads/2016/06/Code-of-Fundraising-Practice-v1-3.pdf>> accessed 20 September 2017.

¹⁹ In English law, a restricted gift can be regarded as a ‘special trust’, i.e., ‘property which— (a) is held and administered by or on behalf of a charity for any special purposes of the charity, and (b) is so held and administered on separate trusts relating only to that property’. CA 2011, s 287.

²⁰ Similarly, in the United States, a donor may choose to establish a donor-advised fund in which the donor reserves the right to advise the charity in respect of distribution of this fund. Panel on the Nonprofit Sector, *Strengthening Transparency, Governance, Accountability of Charitable Organizations: A Final Report to Congress and the Nonprofit Sector* (Independent Sector 2005) 39.

²¹ Ciaran Connolly, Noel Hyndman and Danielle McConville, ‘Conversion Ratios, Efficiency and Obfuscation: A Study of the Impact of Changed UK Charity Accounting Requirements on External Stakeholders’ (2013) 24 *Voluntas* 785, 788; Noel Hyndman and Paul McDonnell, ‘Governance and Charities: An Exploration of Key Themes and the Development of a Research Agenda’ (2009) 25(1) *Financial Accountability & Management* 5, 12.

²² Geoffrey A. Manne, ‘Agency Costs and the Oversight of Charitable Organizations’ (1999) *Wisconsin Law Review* 227, 234.

²³ Gerhard Speckhacher, ‘Nonprofit Versus Corporate Governance: An Economic Approach’ (2008)

motivated by quite different reasons, such as religious beliefs, tax incentives, altruism and warm-glow giving, economic reasons and personal connection.²⁴ Accordingly, donors motivated by different reasons may have different views about whether or how to supervise charity trustees.

In this context, supervision through donation contracts is a double-edged sword. It may promote efficient governance in a charity (by monitoring the performance of the charity directly, and that of its charity trustees indirectly), but may also have some negative effects on the charity's normal operation, due to the donors' motivation of pursuing private benefits, the excessive supervisory costs, or the costs of the negative effects of external intervention.

In this respect, as noted above, in contrast to English law, *inter vivos* donations (excluding initial donations of the founders of a donated legal person) in China are regarded as contracts. This arrangement may allow donors to play a more active role in charity governance. However, when a donation contract provides a range of decision-making and supervisory rights to the donors without imposing any legal duty or liability, the donors may pursue their own private benefits (as if they were the owners), greatly increasing the total monitoring costs of the key stakeholders of the related charity.

However, so far there has been little academic exploration concerning the limitation of donors' rights relating to charities in China. For example, in terms of charitable trusts, '[t]he need of clarifying the rights of settlor[s] has not drawn lots of attention'.²⁵ Nevertheless, to reduce the agency costs regarding accountability to donors, it is necessary to reasonably restrict the rights of donors in charity governance. Here, the thesis will focus on an examination of three pertinent problems: the condition of accepting a donation, the limitations on the rights of donors participating in charity

18(3) Nonprofit Management & Leadership 295, 313.

²⁴ Ciaran Connolly, Alpa Dhanani and Noel Hyndman, *The Accountability Mechanisms and Needs of External Charity Stakeholders* (Certified Accountants Educational Trust 2013) 13-14.

²⁵ Yinglu Li, 'Charitable Trusts in China' (2014) 20(4) *Trusts and Trustees* 345, 348.

governance, and the cy-près principle. The first one is related to any donation before its establishment. By contrast, the focus of the analysis of the other two is on any donation that has been legally established.

6.2.2 Denying Donations that May Bring Legal or Moral Risks

6.2.2.1 Reducing the Moral Hazard of Donors

Generally, a charity will accept any form of donation from any individual or organisation. However, sometimes receiving donations may bring legal or moral risks to this charity. In this context, to reduce the donors' moral hazard (especially when donors use a charity as a tool to carry out money laundering or other illegal activities) and maintain the public confidence and trust, charity trustees should take proper measures to prevent or manage those issues through the relevant legal procedures.²⁶

According to the Charity Law 2016 (China), charities cannot accept any donation violating laws, regulations and social mores.²⁷ So far, there is no definition of 'social mores' in Chinese law. However, this term is quite similar to 'public policy' in English law, which 'is a variable notion, depending on changing manners, morals and economic conditions'.²⁸ From the perspective of reducing the moral hazard of donors, this requirement is good but insufficient. It should be complemented by some further conditions. One is associated with fiduciary duties.

²⁶ In this respect, the Fundraising Regulator provides the relevant guidance on this problem. See Fundraising Regulator (n 18) para 1.3.2.

²⁷ CL 2016 (China), s 15.

²⁸ Ashwinie Kumar Bansal, *Arbitration & ADR* (2nd edn, Universal Law Publishing 2009) 91. A typical example in this respect is a donation of land by a married man to a woman (who is not his wife) if she continues to have a sexual relationship with him. Huixing Liang, *The Hermeneutics of Civil Law* (China University of Political Science and Law Press 1995) 299 (梁慧星: 《民法解释学》, 中国政法大学出版社 1995 年版); concerning a similar case in English law, see *Benyon v Nettlefold* (1850) 3 Mac & G 94.

6.2.2.2 Emphasising the Role of Fiduciary Duties in Refusing Illegal or Immoral Donations

In England, ‘the fiduciary nature of charitable trusteeship and directorship [...] demands that all decisions taken at trustee level are made solely in the interests of the charity itself’.²⁹ Accordingly, fiduciary duties³⁰ themselves require, and can also be used by, charity trustees to act independently to avoid any undue intervention by donors and other stakeholders.

Regarding donations bringing legal or moral risks to charities, in contrast to Chinese law, fiduciary duties in English law can further control the costs of the donors’ moral hazard: if the terms or conditions of a donation do not violate laws, regulations or social mores, but may conflict with the charity trustees’ fiduciary duties, they should utilise their fiduciary duties to refuse this kind of donation.

For example, in a CIO, a charity trustee has a duty to ‘exercise the powers and perform the functions that the charity trustee has in that capacity in the way that the charity trustee decides, in good faith, would be most likely to further the purposes of the CIO’.³¹ In this context, for a charity aimed at environmental protection, accepting a donation from heavy industry (which causes much of the pollution) may violate its aims and seriously damage the public trust and confidence in this charity, even though the donation itself complies with the laws, regulations and social mores. Therefore, the charity trustees in this charity should perform their fiduciary duty and not accept this kind of donation.

In this context, Chinese law should draw on the experience of English law and attach great importance to the role of fiduciary duties in this area: if receiving a donation would lead to the trustees of a charity violating their fiduciary duties, it is the duty of those charity trustees to refuse it. In

²⁹ Jonathan Garton, *The Regulation of Organised Civil Society* (Hart Publishing 2009) 145.

³⁰ Concerning the evaluation of the fiduciary duties of charity trustees, see the discussion in Chapter 5.

³¹ CA 2011, s 221.

addition, it is helpful for charity trustees to further set up the internal rules and procedures or model donation contracts to deal with those issues.

6.2.3 Limiting the Decision-Making and Supervisory Rights of Donors in Charity Governance

6.2.3.1 Comparing the Legal Rights of Donors in Charity Governance in the Two Jurisdictions

Here, ‘legal rights’ is defined as rights which are directly conferred by law, compared to those given by the contract between a donor and a charity/charity trustee or created in the governing document of a charity.

In this respect, English law does not allow donors to play an important role in charity governance. With respect to unrestricted gifts, except for public access to information, which will be discussed in Chapter 7, donors have no further legal rights to supervise donees. As regards any donation in the form of a trust, after the formation of the trust, the settlor also has no right to supervise the recipient, except for the special rights stipulated in the trust document.³² Even for a charitable trust, its settlor also does not ‘have [the] standing to enforce its terms’.³³

Nevertheless, donors or settlors may utilise ‘charity proceedings’³⁴ to supervise charity trustees: case law in this area seems to be ‘not prepared to rule out the possibility that a donor or settlor would or could be a “person interested”’³⁵ to bring charity proceedings. However, this is only a possible option rather than a statutory right of donors or settlors in English law.³⁶

³² Marion R. Fremont-Smith, ‘The Search for Great Accountability of Nonprofit Organizations: Recent Legal Developments and Proposals for Change’ (2007) 76(2) *Fordham Law Review* 609, 618.

³³ G E Dal Pont, *Law of Charity* (LexisNexis 2010) 553.

³⁴ The ‘charity proceedings’ will be further assessed when discussing beneficiaries in this chapter.

³⁵ Hubert Picarda QC, *The Law and Practice Relating to Charities* (4th edn, Bloomsbury Professional 2010) 917.

³⁶ Concerning whether a donor or settlor can be regarded as a ‘person interested’, English case law seems to be ‘the subject of controversy’. *ibid*; *Haslemere Estates Ltd. v Baker* [1982] 1 WLR 1109, 1122; *Bradshaw v University College of Wales, Aberystwyth* [1988] 1 WLR 190; *Re Hampton Fuel Allotment Charity* [1989] Ch 484, 493; Charity Commission, *Charities and Litigation: the Legal*

By contrast, in terms of charitable corporations which are regarded as ‘the creatures of the founder’,³⁷ English law does confer supervisory rights upon their founders. One traditional mechanism is a ‘visitor’,³⁸ who can be authorised by the founder of a charitable corporation to have almost unlimited power³⁹ to interpret the governing document and ‘those internal powers and discretions that derive from [it]’.⁴⁰ Meanwhile, the founder and his/her heirs may act as the visitors on their own.⁴¹ However, the exclusive jurisdiction of this traditional governance mechanism has been greatly reduced due to the recent legal reform,⁴² and to some extent, ‘lies in legal desuetude and academic disfavor’.⁴³

Nevertheless, for charitable donations, the general approach of English law is to protect the concerns and information needs of donors through supervision by the Attorney General and the Charity Commission or public access to information, rather than to empower those donors to implement the terms and conditions attaching to their donations directly.

In contrast to English law, Chinese law allows donors to play a much more important role in charity governance. First, donors have the legal rights to supervise charity trustees indirectly. For example, in a charitable donation, the donor has the legal right to inquire of the donee (charity) about the use and management of the donated property and put forward views and suggestions. With respect to this inquiry, the donee (charity) should reply truthfully.⁴⁴ In this respect, although it is the related charity that is accountable to its donor, its charity trustees are finally responsible for performing those duties.

Underpinnings (Charity Commission 2016) 13-14.

³⁷ *St John's, Cambridge v Toddington* (1757) 97 ER 245, 269.

³⁸ Regarding the discussion of ‘visitors’, see Picarda (n 35) 735-761; Kathryn Chan, *The Public-Private Nature of Charity Law* (Hart Publishing 2016) 34-38.

³⁹ *Thomas v University of Bradford* [1987] AC 795 (HL).

⁴⁰ *ibid* 820.

⁴¹ *Philips v Bury* (1694) 90 ER 1294, 1299.

⁴² Picarda (n 35) 735.

⁴³ Atkinson (n 16) 694; regarding the problems associated with this mechanism, see Atkinson (n 16) 695.

⁴⁴ PBUDL 1999 (China), s 21.

Second, Chinese donors have a range of supervisory rights directly monitoring the performance of charity trustees. For example, in terms of a donated legal person, Chinese law provides that, if the decision-making procedure of the decision-making body, executive body or legal representative of this organisation violates the laws, administrative regulations or its governing document, or the contents of the decision do not comply with the governing document, the founders (‘捐助入’) can request the court to revoke the decision.⁴⁵

Meanwhile, in a charitable foundation, the initiators or major donors⁴⁶ of this foundation are allowed by the Model Governing Document of Foundations (issued by the Ministry of Civil Affairs) to supervise its governing body. For example, the major donors and initiators have the legal right to nominate the candidates for directorship; and, when the board of directors needs to be re-elected, the major donors have the legal right to nominate the candidates and elect the new board of directors.⁴⁷ In addition, the major donors of a foundation also have the legal right to determine its supervisors (‘监事’).⁴⁸

In terms of Chinese charitable trusts, similar to the legal right of major donors in a charitable foundation, settlors have the legal right to appoint and change trustees, to appoint trust supervisors, and to receive the report from trustees and trust supervisors.⁴⁹ In addition, in contrast to settlors in English law and other donors in Chinese law, Chinese settlors have more legal rights relating to charitable trust governance.⁵⁰ For example, apart from some

⁴⁵ GPCL 2017 (China), s 94. Regarding ‘donated legal persons’, see the discussion in Chapter 5.

⁴⁶ In contrast to England and civil law jurisdictions, Chinese law governing foundations does not even mention the term ‘founder’ (‘the person who establishes a foundation and transfers a portion of his assets to the foundation’). Thomas von Hippel and Knut B. Pißler, ‘Nonprofit Organizations in the People’s Republic of China’ in Klaus J. Hopt and Thomas von Hippel (eds), *Comparative Corporate Governance of Non-Profit Organizations* (CUP 2010) 462.

⁴⁷ Model Governing Document of Foundations, s 10.

⁴⁸ Model Governing Document of Foundations, s 18.

⁴⁹ CL 2016 (China), ss 46-49.

⁵⁰ Generally, see Atsoko Sese, ‘Comparative Studies on the Trust Law of the PRC: Taking into Consideration of the Enactment of the PRC Property Law and Amendment to Japanese Trust Law, English and the U.S. Trust Law’ (2009) 1 Kyoto Prefectural University Academic Report (Public Policy) 63.

rights relating to access to information,⁵¹ the settlors of a trust have the right to require its trustees to adjust the management methods of the trust property,⁵² the right to require the trustees to make compensation for loss due to breach of their fiduciary duties,⁵³ and the right to make decisions for the trust's affairs if the conflicts between the trustees cannot be resolved according to the trust document.⁵⁴

6.2.3.2 Contract Freedom in Relation to Charitable Donations in Chinese Law

Apart from the legal rights which are directly conferred upon donors by law, settlors in a charitable trust and founders in an English charitable corporation/a Chinese donated legal person (including but not limited to a Chinese charitable foundation) can also design the rules in the governing document of this trust/corporation/donated legal person in order to enjoy some supervisory rights. In Chinese private law theory, this arrangement is reflective of the principle of 'self-governance of private law' ('私法自治'), which means that, within the scope of private law, individuals are allowed to create legal relations freely as long as they do not violate the spirit of the law.⁵⁵

Meanwhile, in China, another legal area reflecting the principle of self-governance of private law is contract law, which protects contract freedom. In this respect, as noted above, in contrast to English law, Chinese law recognises *inter vivos* donations (not including initial donations of the founders of any donated legal person) as donation contracts. Accordingly, apart from legal rights given to Chinese donors and rights provided in the governing documents of charities, donors can also design the related

⁵¹ TL 2001 (China), s 20.

⁵² TL 2001 (China), s 21.

⁵³ TL 2001 (China), s 22.

⁵⁴ TL 2001 (China), s 31. Here, it is worth noting that, in accordance with the Charity Law 2016 (China), charitable trusts are regulated by the Trusts Law 2001 (China) if there are no specific rules in the Charity Law 2016 (China). CL 2016 (China), s 50.

⁵⁵ Huixing Liang, *General Theories of Civil Law* (3rd edn, Law Press) 158 (梁慧星: 《民法总论(第三版)》, 法律出版社 2007 年版).

contractual rights to supervise charity trustees.

In this respect, one typical problem is associated with the methods for donors to exercise their contractual rights. According to the principle of contract freedom in Chinese law (which is also a basic principle both in common law and civil law jurisdictions), contractors can agree that, if one party does not perform the contractual duties, the other party will have the right to revoke the contract and get his/her property back.

However, from the perspective of reducing agency costs in relation to charity governance, the problem relating to this principle lies in the fact that, if donors have the right to recover their charitable donations from supervising a charity, it may facilitate them or their heirs to recover the donated property in the name of correcting the charity's wrongdoing.

In this context, even if a charity's trustees do something wrong and their mismanagement or misconduct is corrected, the charitable purpose and public benefit that the charity pursues will still suffer the loss: there will be less property available to benefit the public (i.e., the costs of the negative effects of external intervention).⁵⁶ This is particularly true for the heirs of a donor who 'may not have the donor's charitable inclinations at heart. They may, indeed, prefer to see the gift fail than to see it re-tailored in a way that the donor would have preferred.'⁵⁷

Currently, Chinese law seems to take two contradictory approaches to tackling this problem. The first approach is to empower donors to supervise donees without clarifying whether the donors can recover their donations if the donees do something wrong. For example, according to the Public Benefit Undertakings Donations Law 1999 (China), a donee who changes the nature and purpose of the donated property without the consent of the donor will be ordered to make corrections and be given a warning by the relevant governmental department. If the donee refuses to make corrections,

⁵⁶ Atkinson (n 16) 693.

⁵⁷ *ibid.*

upon the consent of the donor, the government will deliver this donated property to another public benefit social organisation or public institution with the same or similar purposes.⁵⁸ In this context, the law at least provides an opportunity to ensure that the donated property continues to be used for charitable purposes, but it does not make the legal consequence clear if the donor refuses to consent.

Similarly, the recently enacted Charity Law 2016 (China) only stipulates that a charity's donor has the right to request correction if the charity violates the terms of the donation agreement on the charitable purposes or abuses the charity's property. However, it is unclear whether the donor can recover his/her donated property if the charity does not correct its abuse.⁵⁹

The second approach is to allow donors to recover their donations in supervising charities. For example, according to the Contract Law 1999 (China), where a donation is subject to obligations, the donee should perform his/her obligations according to the donation contract.⁶⁰ The donor has the right to withdraw the donation when the donee does not perform his/her obligations under the donation contract,⁶¹ and to recover the donated property from the donee.⁶² Similarly, the Regulation on the Administration of Foundations 2004 (China) provides that, if the use of the donated property by a foundation violates the donation agreement, the donor has the right to require the foundation to abide by the donation agreement or to apply to the court to withdraw the donation and revoke the donation agreement.⁶³

A well-known Chinese case relating to the second approach is *Lijiang Moms Charity Association v United Moms Charity Association* (‘丽江妈妈联谊会

⁵⁸ PBUDL 1999 (China), s 28.

⁵⁹ CL 2016 (China), s 42.

⁶⁰ CL 1999 (China), s 190.

⁶¹ CL 1999 (China), s 192(3).

⁶² CL 1999 (China), s 194.

⁶³ RAF 2004 (China), s 39.

诉美国妈妈联谊会公益事业捐赠纠纷案’),⁶⁴ where United Moms Charity Association required to recover the donated property because Lijiang Moms Charity Association used the donated property--which should have exclusively provided orphans with clothes, food and health care--for another purpose (purchasing a building to establish a school for orphans). United Moms Charity Association finally won this case, and thus recovered its donated property. However, in this case, it is not necessary to worry about the loss of property benefiting the public: given its charitable status, this organisation will continue to use the property for other charity projects.

However, for donors that are not charities, this may not be the case. In this respect, a recent case is directly related to Chinese Red Cross Foundation. A donor called Shuai Wang donated 12 yuan to this charity, which carried out an online fundraising activity (selling virtual drinks called ‘Bai Xue Cola’) to assist a patient called Bai Xue. Then, Wang found that the charity had used part of the raised money to help other patients without informing him in advance, so he brought a legal suit against the charity to revoke the donation contract and recover his money. Wang finally lost the case due to a lack of sufficient proof (he could not prove that his 12 yuan donation was among the money used to help other patients).⁶⁵

Strictly speaking, in this case, Wang’s donation cannot even be identified as charitable, because it does not satisfy the public benefit requirement. Nevertheless, even if it was a charitable donation and the plaintiff won this case, it would reduce the money used to benefit the public because of the return of the donation to the donor and the relevant costs relating to the legal suit.

⁶⁴ *Lijiang Moms Charity Association v United Moms Charity Association* (2002) The Third Civil Tribunal of Yunnan Higher People’s Court, Final Judgment, No. 26 (丽江妈妈联谊会诉美国妈妈联谊会公益事业捐赠纠纷案(2002)云高民三终字第 26 号).

⁶⁵ Ji Hong, ‘Chinese Red Cross Foundation Won the Legal Suits relating to “Bao Xue Cola”’ *China Red Cross News* (Beijing, 1 January 2016) <<http://news.redcrossol.com/miropaper/article.aspx?aid=4066>> accessed 20 September 2017.

6.2.3.3 Reasonably Limiting Donors' Rights in Supervising Charity Trustees

Given that donors do not play an important role in English law, there are few costs relating to their moral hazard or other monitoring costs regarding accountability to them. By contrast, the current legal rules giving a range of legal and contractual rights to donors in China may increase the costs of their moral hazard and other monitoring costs by allowing them to make decisions, supervise charity trustees or recover their donations.

For example, in respect of legal rules governing Chinese charitable trusts, the rights of settlors are suitable for regulating private trusts rather than charitable trusts. In a charitable trust, when the settlors exercise the supervisory rights as noted above, if they are motivated by their private benefits, those supervisory rights may finally damage the best interests of the charitable trust, resulting in high costs of the settlors' moral hazard and other monitoring costs (such as the supervisory costs relating to bringing legal suits).

To reduce the agency costs relating to donors in supervising charity trustees, the thesis argues that the legal and contractual rights of donors should be limited. First, donors should have similar fiduciary duties to charity trustees in making decisions on, or supervising the management of, the internal issues of a charity.

As a matter of fact, Chinese legislators have begun to realise that the possibility of the donors' moral hazard exists. A typical example is a rule provided by the recently enacted Charity Law 2016 (China): a charity's major donors cannot damage the interests of this charity, its beneficiaries or the general public for the benefits of their associates.⁶⁶ However, this rule only applies to 'major donors', which is not defined in this new law. From the perspective of reducing the costs of the donors' moral hazard and other

⁶⁶ CL 2016 (China), s 14.

monitoring costs, all donors, whether they are ‘major donors’ or not, should have fiduciary duties in exercising their decision-making or supervisory rights.

Second, Chinese law should replace the return of charity property with alternative supervisory methods. Donors and their heirs⁶⁷ may make use of contractual rights to recover the donated property in the name of accountability and accordingly reduce the property available to benefit the public, leading to high costs in relation to their moral hazard and the related monitoring costs. Hence, the thesis argues that, the right of donors to supervise the performance of a charity should be evaluated in the context of charity governance.

The justification for donors to supervise a charity should be to make its performance comply with its charitable purposes and public benefit, but not to pursue their own private benefits (by recovering the previously donated property). If donors are given the right to recover their property when a charity does something wrong, this method will not greatly help correct the charity’s wrongdoing, but may mainly benefit the donors or their heirs through giving the donation back to them and may lead to excessive conflicts and legal suits in the name of correcting the wrongdoing of the charity’s trustees.

Hence, it is necessary to restrict donors’ right to recover charitable donations (as a supervisory right) in tackling the wrongdoing of charity trustees and to find more reasonable options to replace this supervisory right. Among them, a good strategy is to limit donors’ remedy to ‘specific performance by the donee or diversion to another charitable organization’.⁶⁸ In other words, donors should not be given the right to recover the donated property if the

⁶⁷ ‘Not all heirs will have the donor’s charitable incentive to enforce the terms of the gift, given the fact that the gift may have been carved out of their inheritance or that they may hold a reversionary interest in the gift’. Hansmann (n 16) 611; Marion Fremont-Smith, *Foundations and Government: State and Federal Law and Supervision* (Russell Sage Foundation 1965) 206-207.

⁶⁸ Iris J. Goodwin, ‘Donor Standing to Enforce Charitable Gifts: Civil Society vs. Donor Empowerment’ (2005) 58 *Vanderbilt Law Review* 1093, 1162.

relevant charity does something wrong, but can be empowered to transfer the donated property to another charity with the same or similar purposes.

This legal arrangement can reduce the costs relating to both charity trustees and donors' moral hazard, help avoid unnecessary legal suits motivated by the self-interest of donors or their heirs, and, finally, reduce the relevant agency costs in supervising the performance of charity trustees.

6.2.4 Enhancing the Legal Rules Governing the Cy-près Principle in Chinese Law

6.2.4.1 Clarifying the Role of the Cy-près Principle in Reducing the Agency Costs Relating to Charity Governance

In contrast to the board of directors in a for-profit company, due to a lack of owners and effective market control mechanisms, charity trustees may be supervised in a looser manner. To limit their discretion and accordingly reduce the costs of the charity trustees' moral hazard, it is necessary for them to obey the conditions and terms provided by donors.⁶⁹

In this respect, charity laws in both England and China usually respect the special requirements of donors as long as these requirements do not violate the legal rules (such as the rules respecting conflicts of interest) or public policy.⁷⁰ For example, according to the Public Benefit Undertakings Donations Law 1999 (China), the use of donated property should respect the will of the donor and comply with the public benefit purposes and no one can divert donated property to other purposes. In addition, both the donated property received by public benefit social organisations (‘社会团体’) and any value added to it are social public properties (‘社会公共财产’) and protected by law. Neither organisations nor individuals are allowed to

⁶⁹ In addition, the conditions and terms required by donors are also a useful way to stimulate charitable donations. To encourage donors, it is ‘eminently desirable that no doubt should be cast on the security and permanency of their bequests’. *Re Weir Hospital* [1910] 2 Ch 124, 138.

⁷⁰ See, for example, Matthew Harding, *Charity Law and the Liberal State* (CUP 2014) 31-33.

misappropriate, divert for other purposes or damage these properties.⁷¹

However, as time goes by, the original donors' requirements on charitable donations may be impossible or impractical or lead to inefficient use of charitable resources. In this context, strictly complying with these requirements⁷² may often result in the remaining property being returned to the donors or their heirs, or negatively affect the performance of the charity trustees.

From an economic perspective, this approach leads to high costs relating to both the donors' moral hazard (donors and their heirs may seek to return their donated property) and the negative effects of external intervention (fewer donations available to benefit the public, or inefficient use of charitable resources).

In this respect, the *cy-près* principle in England can help reduce those two types of costs by relaxing or eliminating the relevant requirements of donors in some circumstances. This principle allows charity property to be used for a charitable purpose which is 'as near as possible to the one originally specified'⁷³ when the original purpose of this property becomes impossible or impracticable or any other special reason exists.⁷⁴ In this context:

[d]onor-imposed restrictions were binding only to the extent that [the charity regulator] chose to enforce them. By vesting enforcement powers in [the charity regulator] rather than the donor, the law ensured that the public had a voice in deciding whether donor-imposed restrictions produced the best social use for

⁷¹ PBUDL 1999 (China), ss 5 and 7.

⁷² This is called the 'dead hand' problem by many law scholars. For example, see Richard Posner, Posner RA, *Economic Analysis of Law* (3rd edn, Little, Brown and Company 1986) 481-483; Evelyn Brody, 'From the Dead Hand to the Living Dead: The Conundrum of Charitable Donor Standing (symposium)' (2007) 41 *Georgia Law Review* 1183.

⁷³ Picarda (n 35) 437.

⁷⁴ *ibid* 437-473; Rachael Mulberon, *The Modern Cy-près Doctrine: Applications and Implications* (UCL Press 2006).

subsidized charitable assets.⁷⁵

Accordingly, it will keep ‘in existence a gift to charity so that it may continue as a public benefit from generation to generation’⁷⁶ and ensure the efficient use of charitable resources for the public benefit.

6.2.4.2 Identifying the Rules Relating to the Cy-près Principle in China

There is no rule called ‘the cy-près principle’ in Chinese charity law. However, similar rules do exist to the cy-près principle of English charity law. For brevity, these rules in Chinese law are also called ‘the cy-près principle’.⁷⁷

For example, according to the Trust Law 2011 (China), if there is no person who has the right to own the trust property or the trust property belongs to the uncertain public when the charitable trust terminates, the trustee should utilise the trust property for a purpose similar to the original charitable purpose, or transfer it to a charity or another charitable trust with a similar purpose with the approval of the public benefit undertakings regulator.⁷⁸ Similarly, in accordance with the Regulation on the Administration of Foundations 2004 (China), the remaining property after deregistration should be used for the public benefit purposes stipulated in the government document; properties which cannot be dealt with according to the governing document will be donated by the registration and administration regulator to another public benefit organisation which has the same nature and purpose, and be made public.⁷⁹

⁷⁵ Reid Kress Weisbord and Peter DeScioli, ‘The Effects of Donor Standing on Philanthropy: Insights from the Psychology of Gift-Giving’ (2009/10) 45 *Gonzaga Law Review* 225, 237.

⁷⁶ Lord Nathan, *Report of the Committee on the Law and Practice relating to Charitable Trusts* (The Stationery Office 1952), para 71; Jonathan Garton, ‘Justifying the Cy-près Doctrine’ (2007) 21(3) *Trust Law International* 134, 134-149.

⁷⁷ As a matter of fact, many continental European countries also have similar rules. European Foundation Centre, *Exploring Transparency and Accountability: Regulation of Public-Benefit Foundations in Europe* (European Foundation Centre 2011) 14.

⁷⁸ TL 2001 (China), s 72.

⁷⁹ RAF 2004 (China), s 33; also RRAA 1998 (China, revised in 2016), s 26; Model Governing Document of Associations, s 45; PRRACNU 1998 (China), s 25.

In the recently enacted Charity Law 2016 (China), there are several sections concerning the cy-près principle.⁸⁰ For example, after liquidation, a charity's remaining property should be transferred to another charity having the same or similar purpose in accordance with the governing document of the former charity; where the governing document does not make any requirement, this property should be transferred to another charity having the same or similar purpose under the leadership of the department of civil affairs, and this transfer should be disclosed to the public.⁸¹

In addition, after a charity project is terminated, the remaining donated property should be disposed of according to the fund-raising scheme or donation agreement; if there is no requirement in the fund-raising scheme or donation agreement, the charity should use the remaining property for other charity projects having the same or similar purposes, and disclose it to the public.⁸²

6.2.4.3 How to Further Improve the Cy-près Principle in Chinese Law

In English law, the cy-près principle mainly applies to charitable trusts.⁸³ By contrast, the above rules stipulated in the Charity Law 2016 (China) apply to charities which are not charitable trusts.⁸⁴ Another feature of Chinese law in this respect is that all situations applying the cy-près rules are 'supervening' rather than 'initial', and that the 'paramount/general charitable intent' does not play any role in deciding whether to apply those rules or not.⁸⁵ However, although it may be a disadvantage for Chinese law to ignore the adoption of

⁸⁰ However, given that this law has only been implemented recently, there are no practical examples of implementing the cy-près principle in real life.

⁸¹ CL 2016 (China), s 18; also GPCL 2017 (China), s 95.

⁸² CL 2016 (China), s 57.

⁸³ However, the courts also apply this principle to other incorporated charities in some situations. For example, see *Liverpool and District Hospital for Diseases of the Heart v Attorney General* [1981] 1 Ch 193. For most incorporated charities, changing purposes is very straightforward. They just need the consent of the Charity Commission. Charity Commission, *How to Make Changes to Your Charity's Governing Document* (Charity Commission 2014).

⁸⁴ As noted above, the cy-près principle applying to charitable trusts is provided by the Trusts Law 2001 (China). TL 2001 (China), s 72.

⁸⁵ As to terms such as 'initial', 'supervening' and 'paramount/general charitable intent' and a comprehensive analysis, generally, see Picarda (n 35) 445-470.

the cy-près rules at the initial stage, it falls outside the focus of the thesis, which is on making charity trustees perform well for the charitable purposes and public benefit; thus, it will not be discussed any more.

As noted above, the existence of the cy-près principle can reduce the agency costs, mainly including the costs of the donors' and their heirs' moral hazard, and the costs of the negative effects of external intervention. In this context, by drawing on the experience of English law, it is necessary to improve the current legal rules governing the cy-près principle in Chinese law, in particular the Charity Law 2016 (China), in order to further reduce the related agency costs.

First, the situations in which the cy-près principle is applied should be extended. As noted above, the cy-près principle can reduce both the high costs of the donors' and their heirs' moral hazard and the high costs of the negative effects of external intervention. Thus, if the situations to apply this principle are very limited, the cy-près principle cannot effectively reduce those costs.

In Chinese law, only when charities are liquidated or charity projects are terminated is it possible to adopt the above legal rules. This legal arrangement strictly limits the scope of applying this principle, such as the circumstance where the effective use of charitable resources becomes urgent. Therefore, the scope of utilising the cy-près scheme in Chinese law is very restrictive.

By contrast, recently, English law has relaxed its traditionally strict requirement on the adoption of the cy-près principle (limited to impossibility or impracticability),⁸⁶ and provides for many occasions in order to satisfy the changing social demand more effectively and efficiently.⁸⁷ Those extended situations can assist the cy-près principle in reducing the related agency costs, and thus should be taken into account in

⁸⁶ *ibid* 446-454.

⁸⁷ CA 2011, s 62 (occasions for applying property cy-près).

revising Chinese law in future.

Second, Chinese law should detail the factors regulators need to consider. Currently, Chinese law does not clarify what factors regulators must take into account, resulting in the costs of the regulators' moral hazard due to their unlimited discretion in applying the *cy-près* principle. By contrast, English law stipulates several matters that the court and the Charity Commission should consider in making a *cy-près* scheme, which can be integrated into Chinese law to reduce the charity regulators' moral hazard:

- (a) the spirit of the original gift,
- (b) the desirability of securing that the property is applied for charitable purposes which are close to the original purposes, and
- (c) the need for the relevant charity to have purposes which are suitable and effective in the light of current social and economic circumstances.⁸⁸

Third, Chinese law should not give donors the right to approve a change to the purpose of their donated property. As noted above, in terms of charity projects in Chinese law, only when they are terminated can the *cy-près* principle be applied. However, in circumstances which do not relate to the termination of charity projects, what is the procedure if it is necessary to change the purpose of the donated property?

According to the Charity Law 2016 (China), if it is necessary to change the purpose stipulated in the donation agreement, the charity should obtain the donor's consent.⁸⁹ In other words, the law directly empowers donors to decide whether to change the purpose of the property that they have donated. However, this legal arrangement may increase their moral hazard. In dealing

⁸⁸ CA 2011, s 67(3); also *Re Lepton's Charity* [1972] Ch 276; *Peggs v Lamb* [1994] Ch 172. Similarly, in the United States, '[I]beralization started to appear at the start of the twentieth century as some judges looked at the broad purposes of a gift and expressed more concern for the needs of society than the narrow wishes of donors'. Marion R. Fremont-Smith (n 32) 622.

⁸⁹ CL 2016 (China), s 55. There are similar legal rules in the Public Benefit Undertakings Donations Law 1999 (China). PBUDL 1999 (China), s 18.

with this problem, Chinese law should not give donors the right to decide on a change in purpose of the donated property after it has already been delivered to a charity. In the meantime, the law should further clarify, and apply the *cy-près* principle to, those ‘necessary’ situations.

6.3 Rethinking the Role of Beneficiaries in Charity Governance

6.3.1 Introduction

Beneficiaries usually cannot influence the performance of a charity by any contract enforcement mechanism, unless they have to pay for the products or services provided by the charity.⁹⁰ In that case, they can usually be protected by the relevant consumer protection laws and regulations. In addition, beneficiaries can also supervise charity trustees by acting as members of a charity, or even performing as charity trustees. However, in those circumstances, the beneficiaries’ rights to supervise charity trustees are derived from their other roles. In the meantime, in these situations, to reduce the costs of the beneficiaries’ moral hazard, it is important for Chinese law to efficiently control and manage conflicts of interest,⁹¹ which has been explored in Chapter 5.

As to the supervisory mechanisms exclusively relating to beneficiaries, it is necessary to point out that beneficiaries are not the owners of their charity. From an economic perspective, this fact makes charity governance different from both corporate governance (where shareholders are the owners) and private trust governance (in which beneficiaries are the owners).

Meanwhile, as noted in Chapter 3, beneficiaries are not key stakeholders

⁹⁰ In England, an exception may be a third-party beneficiary contract created according to the Contracts (Rights of Third Parties) Act 1999. For example, if a donor signs a third-party beneficiary contract with a charity to benefit another charity, the latter as beneficiary will have the enforceable contractual rights to supervise the former charity. *Charity Commission for England and Wales* (n 15). In China, in some limited circumstances, such as insurance contracts, the law may also empower beneficiaries, who are not a party to a contract, to directly enforce the contractual rights. Insurance Law 2009 (China).

⁹¹ Charity Commission, *Users on Board: Beneficiaries who Become Trustees* (Charity Commission 2012).

who provide charitable resources voluntarily to a charity. Despite this, beneficiaries may fall within the scope of ‘other selected stakeholders’ defined in Chapter 3 and thus play a similar role to charity members in supervising charity trustees and reducing the monitoring costs of key stakeholders. However, whether beneficiaries can play such a role should be carefully assessed in the context of reducing agency costs.

As a matter of fact, in both jurisdictions, beneficiaries of charities usually cannot protect themselves directly by enforcing the fiduciary duties of charity trustees, but can be protected by other governance mechanisms, such as accountability to governmental regulators (the Charity Commission or the department of civil affairs).⁹²

In this section, the thesis seeks to justify the legal arrangement denying or limiting beneficiaries’ rights to enforce the fiduciary duties of charity trustees on the one hand and to argue that beneficiaries should play a more supportive rather than supervisory role in charity governance on the other.

6.3.2 Denying or Limiting Beneficiaries’ Rights to Enforce Fiduciary Duties

As noted in Chapter 3, a charity’s beneficiaries are neither this charity’s key stakeholders who voluntarily provide charitable resources, nor its owners. Accordingly, if a governance mechanism exists that confers the rights to enforce the fiduciary duties of charity trustees upon beneficiaries, it must be created directly by operation of law, which falls within the scope of ‘other selected stakeholders’ defined in this thesis, in order to reduce the charity trustees’ moral hazard and the monitoring costs of key stakeholders. In this respect, it is necessary to assess whether it is cost-effective to select beneficiaries to play this supervisory role.

⁹² In addition, with regard to charitable trusts, Chinese law also establishes a mechanism called ‘trust supervisors’, who can represent beneficiaries to directly enforce the fiduciary duties of trustees in their own name. In respect of those trust supervisors, see the analysis in Chapter 5.

6.3.2.1 The ‘Other Interested Persons’ Rule in Chinese Law vs ‘Charity Proceedings’ and the ‘Persons Affected’ Rule in English Law

In both jurisdictions, there is no rule directly allowing all beneficiaries to enforce the fiduciary duties of charity trustees. However, some other governance mechanisms exist that may be available for beneficiaries to enforce the fiduciary duties of charity trustees in some situations.

In China, in terms of ‘donated legal persons’,⁹³ the law provides that, if the decision-making procedure of the decision-making body, executive body or legal representative of a donated legal person violates the laws, administrative regulations or its governing document, or the contents of the decision do not comply with the governing document, its founders and other interested persons can request the court to revoke the decision (For brevity, this rule is called the ‘other interested persons’ rule in the following discussion).⁹⁴ However, there is no further explanation of the meaning of ‘other interested persons’, so it is unclear whether beneficiaries can automatically make use of this rule to enforce the fiduciary duties of charity trustees.

In England, there are two main governance mechanisms that may be available for beneficiaries to supervise charity trustees. First, if a beneficiary falls within the scope of ‘any person interested in the charity’ (which is similar to the ‘other interested persons’ rule in China), s/he may bring charity proceedings.⁹⁵ In this context, although beneficiaries cannot become a separate governance mechanism supervising charity trustees, they may utilise this mechanism to enforce the fiduciary duties of charity trustees. However, English law takes a very restrictive approach in allowing persons to bring charity proceedings.

⁹³ See the discussion in Chapter 5.

⁹⁴ GPCL 2017 (China), s 94.

⁹⁵ As to the definition of and the procedure relating to charity proceedings, see Picarda (n 35) 913-946.

According to the Charities Act 2011, ‘any person interested in the charity’⁹⁶ may bring charity proceedings. However, the rights of those persons to bring charity proceedings are generally limited by the order of the Charity Commission and if under charity law the Charity Commission can deal with the case, then the claim will be denied.⁹⁷ In accordance with the guidance of the Charity Commission, charity proceedings can only be authorised by the Commission ‘where matters are contentious, intractable, and difficult and cannot be resolved in any other way whether by the commission or anybody else’.⁹⁸

In addition, in terms of ‘any person interested’ in the charity, there is only one further explanation from English case law. In *Re Hampton Fuel Allotment Charity*, the ‘interested persons’ was referred to as those having ‘an interest materially greater than or different from that possessed by ordinary members of the public’.⁹⁹ However, it is still very difficult to judge whether a person is an interested person.¹⁰⁰ In *RSPCA v Attorney General*, Lightman J pointed out that this test was ‘not a technical rule of law, but a practical rule of justice affording a degree of flexibility responding to the facts of each particular case’.¹⁰¹

In this context, whether someone belongs to the ‘interested person’, to a great extent, depends on the specific circumstances and facts of a case.¹⁰² In *Re Hampton Fuel Allotment Charity*, it was held that a potential beneficiary would not always qualify as an interested person.¹⁰³ Therefore, it is clear that English law takes a very restrictive approach to allowing private parties (including beneficiaries) to bring charity proceedings to directly enforce the fiduciary duties of charity trustees.

⁹⁶ CA 2011, s 115.

⁹⁷ *ibid.*

⁹⁸ Charity Commission, *Charities and Litigation: A Guidance for Trustees* (Charity Commission 2016) 11.

⁹⁹ *Re Hampton Fuel Allotment Charity* (n 36) 494.

¹⁰⁰ Peter Luxton, *The Law of Charities* (OUP 2001) 521.

¹⁰¹ *Royal Society for the Prevention of Cruelty to Animals v Attorney General* [2001] EWHC 474 (Ch) [21].

¹⁰² *Re Hampton Fuel Allotment Charity* (n 36) 496.

¹⁰³ *ibid* 493.

Second, in English law, there is a ‘persons affected’ rule¹⁰⁴ which may be used by beneficiaries to indirectly enforce the fiduciary duties of charity trustees. As noted in Chapter 4, to strengthen the accountability of the Charity Commission, the Charities Act 2006 established the Charity Tribunal (the functions of which are now performed by the First-tier Tribunal and the Upper Tribunal) to deal with an appeal against the Commission. It is worth noting that, appeals to the Tribunal do not belong to the above ‘charity proceedings’, ‘because (i) the Tribunal is not a court and (ii) it does not exercise the court’s inherent jurisdiction with respect to trusts for charitable purposes’.¹⁰⁵ In this respect, English law provides that persons specified in column 2 of schedule 6 to the Charities Act 2011 may bring an appeal against the decisions, directions and orders made by the Charity Commission and listed in column 1 of schedule 6 to the Charities Act 2011.¹⁰⁶

In some situations, those persons include ‘any other person who is or may be affected by’ the decision/direction/order.¹⁰⁷ As noted by Alison McKenna, the Principal Judge of the First-tier Tribunal (Charity), although the Tribunal is established to enhance the accountability of the Charity Commission,¹⁰⁸ it ‘may in fact also be used as a mechanism by which charities are held to account by members of the public’.¹⁰⁹ From her perspective, this rule seems to ‘cast the net wider than the need to show an interest in it, whether a “sufficient” one or not’.¹¹⁰

In this context, although in a recent case, the appeal of one beneficiary (the second appellant) failed to require the Charity Commission to ‘allow the trustees very little room to manoeuvre in the discharge of their

¹⁰⁴ Alison McKenna, ‘Applications to the First-Tier Tribunal (Charity) by “Persons Affected” by the Charity Commission’s Decision’ (2013-14) 16 *The Charity Law & Practice Review* 147, 147-162.

¹⁰⁵ *ibid* 153-154.

¹⁰⁶ CA 2011, s 319.

¹⁰⁷ CA 2011, sch 6.

¹⁰⁸ Before the creation of this Tribunal, legal suits against the Charity Commission had to be brought to the High Court, which was both expensive and time-consuming.

¹⁰⁹ McKenna (n 104) 162.

¹¹⁰ *ibid* 155.

responsibilities as trustees' in its scheme,¹¹¹ it does open a door for beneficiaries to take advantage of this rule to supervise charity trustees indirectly.

However, it remains to be seen whether all beneficiaries can automatically fall within 'any other person who is or may be affected'. In addition, even if all beneficiaries are identified as those persons who are or may be affected, their rights to supervise charity trustees will still be limited because the scope of the decisions, directions and orders against which they can bring an appeal is restricted by English law.¹¹²

In summary, neither Chinese law nor English law directly gives all beneficiaries the right to enforce the fiduciary duties of charity trustees, although they may make use of other governance mechanisms to supervise charity trustees under restrictive circumstances.

6.3.2.2 The Reasons and Measures to Limit Beneficiaries' Rights in Chinese Law

From an economic perspective, choosing beneficiaries as a governance mechanism enforcing the fiduciary duties of the governing body of a charity may be too costly to implement. First, it is extremely necessary to control the costs of the beneficiaries' moral hazard. On the one hand, in contrast to shareholders in a for-profit company or beneficiaries in a private trust, beneficiaries in a charity are not the owners of this charity. On the other hand, beneficiaries do not fall within the scope of key stakeholders who provide charitable resources to a charity and form the economic basis for its existence (according to Hansmann's enterprise ownership theory). Instead, beneficiaries are only the channel for a charity to realise its charitable purpose and public benefit.¹¹³

¹¹¹ *Sparrow, Carne and Websper v Charity Commission for England & Wales* (CA/2013/0006; CA/2013/0007 and CA/2013/0008) [29].

¹¹² CA 2011, sch 6.

¹¹³ James J. Fishman, 'The Development of Nonprofit Corporation Law and an Agenda for Reform' (1985) 34 *Emory Law Journal* 617, 670; George Gleason Bogert, 'Proposed Legislation Regarding

In this context, in contrast to key stakeholders, beneficiaries are more likely to pursue their personal gain rather than the charitable purpose/public benefit pursued by the relevant charity. And, if the current beneficiaries of a charity have the right to enforce the fiduciary duties of its charity trustees and finally succeed, ‘charitable assets [may be] locked into uses that may not produce the greatest good to either the greatest number or to the most needy’.¹¹⁴ Accordingly, this governance mechanism may increase rather than reduce the monitoring costs of key stakeholders:

beneficiaries may be able to exercise rights their benefactor never intended, against the very wishes of the benefactors themselves (and [...] against both the charitable fiduciaries’ ideas of the particular charity’s best interests and the [regulator]’ conception of the best interests of charity in general).¹¹⁵

Second, different from other selected stakeholders defined in Chapter 3, such as charity members and supervisory boards/trust supervisors (discussed in Chapter 5) and external auditors (who will be examined in Chapter 7), a charity’s beneficiaries are usually uncertain or sometimes may be the general public if this charity is aimed at benefiting the society as a whole. Accordingly, allowing beneficiaries to enforce the fiduciary duties of charity trustees may lead to a similar result of empowering all members of the public to enforce those duties: high monitoring costs, such as the costs relating to the beneficiaries’ moral hazard mentioned above, the supervisory costs relating to the exercise by them of those rights, and the costs of the negative effects of external intervention relating to charity trustees’ accountability to beneficiaries.

That may be why, in terms of charity proceedings, English law limits the rights of private parties (including beneficiaries) through the pre-

State Supervision of Charities’ (1954) 52 Michigan Law Review 633, 633.

¹¹⁴ Atkinson (n 16) 693.

¹¹⁵ *ibid* 674-675.

authorisation of bringing the charity proceedings.¹¹⁶ This approach may be reasonably explained as a method to protect charities and charity trustees from ‘being harassed by a multiplicity of hopeless challenges’,¹¹⁷ especially unnecessary litigation by ‘busybodies’.¹¹⁸ It will help reduce the costs due to the negative effects of external intervention by preventing ‘charities from frittering away money subject to charitable trusts in pursuing litigation relating to internal disputes’;¹¹⁹ otherwise, some of charities’ charitable resources will have to be used to deal with legal disputes rather than to realise their charitable purposes.

Third, in Chinese law, there are already a range of governance mechanisms to control the charity trustees’ moral hazard. For example, in terms of governmental regulation, the recently enacted Charity Law 2016 (China) allows any organisation or individual finding that there is any illegal activity relating to charities or charitable trusts to complain or report to the department of civil affairs, other related regulators or charity industry organisations. And the latter should carry out a timely investigation.¹²⁰ In addition, the existing supervisory mechanisms, such as accountability to supervisory boards/trust supervisors,¹²¹ contract supervision by donors,¹²² and consumer protection mechanisms (if beneficiaries are also consumers), also help monitor the performance of charity trustees.

Meanwhile, the Charity Law 2016 (China) also requires that a charity or a charitable trust’ trustee should inform its beneficiaries of the funding standards (e.g., the specific amount of payment to any beneficiary), work procedures (i.e., what steps the charity or the trustee takes to assist beneficiaries), work regulations (i.e., the rules with which the charity or the trustee should comply in carrying out the relevant charitable activities) and

¹¹⁶ CA 2011, s 115.

¹¹⁷ *Scott v National Trust for Places of Historic Interest or Natural Beauty* [1998] 2 All ER 705 (HC).

¹¹⁸ *Ibid.*

¹¹⁹ *Muman v Nagasena* [2000] 1 WLR 299, 305.

¹²⁰ CL 2016 (China), s 97.

¹²¹ See the analysis in Chapter 5.

¹²² See the discussion in this chapter.

other related information.¹²³ In this context, empowering beneficiaries (member of the general public if a charity is aimed at benefiting the whole community) to enforce fiduciary duties, as a matter of fact, increases the whole monitoring costs of key stakeholders in ensuring compliance by charity trustees.

Accordingly, to control the costs of the beneficiaries' moral hazard, the supervisory costs, the costs of the negative effects of external intervention and the whole monitoring costs relating to the existing governance mechanisms, the current approach to restricting the rights of a charity's beneficiaries to enforce the fiduciary duties of its trustees in Chinese law should be preserved.

Following this logic, the 'other interested persons' rule recently enacted in Chinese law should not be regarded as empowering all beneficiaries of a Chinese donated legal person to enforce the fiduciary duties of its charity trustees. Instead, it depends on the discretion of the courts to strengthen the accountability of charity trustees by considering the specific facts of a case.

6.3.3 Involving Beneficiaries in the Promotion of Charity Governance

6.3.3.1 The Value of the Supportive Role of Beneficiaries in Charity Governance

In practice, beneficiaries can play a positive role in supporting rather than supervising charity trustees. For instance, a charity can establish the related mechanisms ensuring that the needs, comments or even complaints of its beneficiaries are delivered to the trustees in a timely manner.¹²⁴ This can

¹²³ CL 2016 (China), s 75. However, although the law stipulates that charities and trustees have a duty to disclose their information to the public and further clarifies the legal consequence of breaching this duty (CL 2016 (China), ss 71 and 99), there remains uncertainty about whether the duty to inform beneficiaries of the funding standards, work procedures and work regulations is part of the duty to disclose information to the public. If it is not, then it will become a legal rule without any legal consequence and thus the effect of this rule remains to be seen in practice.

¹²⁴ In the guidance of the Charity Commission, a range of methods relating to 'user involvement' are available. Charity Commission (n 91) 2-3.

reduce the residual loss by enhancing the efficiency of the charity trustees' performance without increasing the costs of the beneficiaries' moral hazard, the supervisory costs or the costs of the negative effects of external intervention.

6.3.3.2 Encouraging Beneficiaries to Participate in Charity Governance as Advisors or Non-voting Members

In this respect, there are many useful methods that can be used to improve this mechanism. One good way is to encourage beneficiaries to act as non-voting advisors of a charity. 'This enables [those beneficiaries] to put forward their views but avoids the obstacles associated with trusteeship such as conflicts of interest and remuneration'.¹²⁵

In addition, for a membership charity, it may be helpful to attract some beneficiaries to become its non-voting members¹²⁶ (because voting members will play a more supervisory rather than supportive role in charity governance).¹²⁷ A discussion of their interests and views can inspire the charity's trustees when making decisions on realising the public benefit and help enhance the quality of services and goods delivered by this charity.

6.3.3.3 Building a Complaints Procedure Facilitating the Understanding of the Needs of Service Users

Nevertheless, 'complaints can help improve the charity's performance'.¹²⁸ For charity trustees of any charity, complaints may assist them in supervising the performance of the charity's volunteers and employees and understanding the demands and expectations of its service users, which

¹²⁵ Robert Meakin, 'The Legal Aspects of User Trusteeship' in Debra Morris and Jean Warburton (eds), *Charities, Governance and the Law: the Way Forward* (Key Haven 2003) 93.

¹²⁶ In contrast to voting members, those members usually 'have no role in determining the constitution and direction of the charity'. Charity Commission, *Membership Charities* (Charity Commission 2004) 5.

¹²⁷ Concerning the voting members as a governance mechanism, see the discussion in Chapter 5.

¹²⁸ Charity Commission, *Cause for Complaints? How Charities Manage Complaints about Their Services* (Charity Commission 2006) 7.

‘could be key determinants of long-term success’.¹²⁹

Therefore, it is of great value for charities to build a formal complaints procedure to deal with those specific complaints. Of course, in this respect, it is necessary to recognise that ‘[t]here is no “one size fits all” procedure’.¹³⁰ Charities should take account of their own features (such as the size, activity area, etc.) in establishing the specific complaints procedure.

6.4 Conclusion

This chapter has assessed the legal rules regarding accountability to third parties, especially to donors and beneficiaries, from economic and comparative perspectives and further provided a range of reform strategies.

First, in terms of accountability to donors, in contrast to English law, Chinese law not only identifies *inter vivos* donations (excluding initial donations of the founders of any donated legal person) as ‘donation contracts’, but also allows Chinese donors to enjoy a range of legal and contractual rights to supervise charity trustees, leading to higher agency costs.

Firstly, regarding donations bringing legal or moral risks to charities, in contrast to the rule in China, fiduciary duties in English law can better reduce the costs of the donors’ moral hazard. For example, if some terms of a donation do not violate laws, regulations or social mores, but conflict with the fiduciary duties of charity trustees, the charity trustees can directly refuse this kind of donation.

Secondly, given that donors do not play an important role in English law, there are few costs relating to their moral hazard. By contrast, in China, the current legal rules giving donors a great deal of decision-making and

¹²⁹ Ciaran Connolly and Noel Hyndman, *Performance Reporting by UK Charities: Approaches, Difficulties and Current Practice* (The Institute of Chartered Accountants of Scotland 2003) 18.

¹³⁰ Charity Commission (n 128) 38.

supervisory rights may increase the costs of their moral hazard and other monitoring costs that may arise from them in making decisions, supervising charity trustees or recovering their donations.

Thirdly, in terms of the *cy-près* principle, in contrast to English law, the limited situations in which this principle can be applied, the high discretion enjoyed by regulators and the rights of donors to approve the change of purpose of a donation in Chinese law may increase the costs of the negative effects of external intervention (excessive limitations on the application of this principle may result in inefficient use of charitable resources), and costs relating to both the charity regulators' and the donors' moral hazard.

Therefore, to deal with those problems and accordingly reduce the related agency costs, Chinese law should strengthen the role of the fiduciary duties of charity trustees in refusing illegal or immoral donations. In addition, all donors should have fiduciary duties in exercising their decision-making and supervisory rights. Meanwhile, Chinese law should reasonably limit the contract freedom relating to charitable donations by replacing the return of charitable donation (as a method of supervising charity trustees) with alternative methods, such as the right to transfer the donated property to another charity with similar purposes.

Furthermore, Chinese law should draw on the English experience, extending the situations in which the *cy-près* principle can be applied and limiting the discretion of charity regulators by clarifying the factors they need to consider in applying this principle. In the meantime, donors' rights to consent to the change of purpose of their donated property should be revoked in the future reform.

Second, in respect of accountability to beneficiaries, neither Chinese law nor English law allows all beneficiaries to directly enforce the fiduciary duties of charity trustees. However, in England, beneficiaries may make use of the 'charity proceedings' or the 'persons affected' rule to supervise charity trustees indirectly. Despite this, currently, English law takes a

restrictive approach in allowing private parties to bring charity proceedings. Meanwhile, the ‘persons affected’ rule is mainly used to supervise the Charity Commission rather than charity trustees, and the scope of the decisions, directions and orders against which they can bring an appeal is also limited. By contrast, in Chinese law, it is still uncertain whether beneficiaries can make use of the recently created legal rules governing the ‘other interested persons’ of a donated legal person to enforce the fiduciary duties of charity trustees.

Nevertheless, from an economic perspective, beneficiaries are neither owners nor key stakeholders (providing charitable resources) of a charity. In this context, given the strong self-interest motivations of beneficiaries (pursuing private benefits from, rather than the best interests of, the relevant charity), the large number of beneficiaries and the existence of other governance mechanisms, to reduce the related agency costs, the current legal arrangement in both jurisdictions, which limits the role of beneficiaries in directly enforcing the fiduciary duties of charity trustees, should be preserved.

However, to promote sound charity governance and reduce the residual loss due to a lack of related information, beneficiaries can be encouraged to participate in charity governance as non-voting members or advisors in support of the decision-making of charity trustees, and charity trustees should build a complaints procedure facilitating the understanding of the needs of service users.

In respect of the rights of the general public, including donors and beneficiaries, to access information, the thesis will integrate them into the next chapter, which focuses on public accountability.

Chapter 7 Enhancing Public Accountability

7.1 Introduction

This chapter will explore the public accountability mechanisms based on an economic and comparative analysis¹ of the law and practice in China and England, and identify the possible reform suggestions to improve the governance mechanisms relating to the charity accounting, reporting, auditing and public access to information in China.

Falling within the scope of ‘key stakeholders’ defined in Chapter 3, the general public not only provides charitable resources to charities indirectly (by recognising the tax benefits enjoyed by those charities), but are also donors or potential donors to any charity. Hence, their concerns and information needs should be protected.

As a matter of fact, in practice, ‘[i]t is the belief that charities operate in the best interest of the public that allows them to continue to operate’.² In this context, if the public totally trusts charities and their charity trustees, and those charities and charity trustees really perform well for their respective charitable purposes, there will be few, if any, agency costs left: the public would not need any further supervisory measures to monitor the charity trustees whilst those trustees would not need to justify their performance through a range of activities enhancing transparency and accountability. However, this can never be a reality.

The reality is that insufficient accounting, reporting, auditing and information disclosure mechanisms may seriously damage the public’s trust

¹ Regarding a previous comparative study of the financial accounting of Chinese charities, see Guanzhong Zuo, ‘The Transparency of Chinese Affiliated International Charities: A Comparative Analysis’ (Master’s thesis, Auckland University of Technology 2012) <<http://aut.researchgateway.ac.nz/bitstream/handle/10292/5228/ZuoG.pdf?sequence=3>> accessed 20 September 2017.

² Lord Hodgson, *Trusted and Independent: Giving Charity back to Charities-Review of the Charities Act 2006* (The Stationery Office 2012) 14; Jeremy Kendall and Martin Knapp, *The Voluntary Sector in the UK* (Manchester University Press 1996) 257.

‘and reduce both charitable giving and charitable activity’.³ Especially in China, a lack of accountability and transparency may be the most important reason why charities cannot currently enjoy the public’s trust and confidence.⁴ As noted by Xijin Jia (a senior researcher at the NGO Research Centre in Tsinghua University), the main issue lies in ‘public trust or accountability of charities’.⁵

Hence, to improve charity trustees’ performance, reduce the difficulty for the public to supervise them, and maintain public confidence and trust, the general public should also have some kind of supervisory rights to make charity trustees accountable for the charitable purpose/public benefit.⁶ However, accountability to the general public has its own costs, which may be a vital reason why, in respect of charity governance, the law neither gives the general public the right to enforce the fiduciary duties of charity trustees,⁷ nor forces charity regulators to make a comprehensive investigation of each charity every day. Instead, given the vast size of the public, to control the monitoring costs relating to public accountability,⁸ different from other key stakeholders, such as the government and donors discussed in the previous chapters, the rights that the general public can exercise directly are usually limited to their access to information.

³ Noel Hyndman and Danielle McMahon, ‘The Evolution of the UK Charity Statement of Recommended Practice: the Influence of Key Stakeholders’ (2010) 28 *European Management Journal* 455, 465; Debra Morris, ‘New Charity Regulation Proposals for England and Wales: Overdue or Overdone’ (2005) 80 *Chicago-Kent Law Review* 779, 785; Evelyn Brody, ‘Agents without Principals: the Economic Convergence of the Nonprofit and For-profit Organizational Forms’ (1996) 40 *New York Law School Law Review* 457, 466.

⁴ Rachel Wang, ‘Why No One Trusts Government Charities in China Anymore’ *The Atlantic* (Washington, 13 May 2013) <<http://www.theatlantic.com/china/archive/2013/03/why-no-one-trusts-government-charities-in-china-anymore/273989/>> accessed 20 September 2017.

⁵ Edward Wong, ‘Online Scandal Underscores Chinese Distrust of State Charities’ *The New York Times* (New York, 3 July 2011) <<http://www.nytimes.com/2011/07/04/world/asia/04china.html?src=un&feedurl=http%3A%2F%2Fjsn8.nytimes.com%2Fpages%2Fworld%2Fasia%2Findex.jsonp>> accessed 20 September 2017.

⁶ ‘The [charities] are agencies of society as a whole, and everyone has a right to participate in their governance.’ John E. Chubb and Terry M. Moe, *Politics, Markets and America’s Schools* (The Brookings Institution 1990) 32.

⁷ In this respect, there is an interesting discussion of the standing rules in charity law from the perspective of the public law-private law divide. See Kathryn Chan, *The Public-Private Nature of Charity Law* (Hart Publishing 2016) 81-101.

⁸ Karyn R. Vanderwarren, ‘Financial Accountability in Charitable Organizations: Mandating an Audit Committee Function’ (2002) 77(2) *Chicago-Kent Law Review* 963, 964; Lord Hodgson (n 2) 65.

In order to exercise this right to access information, charity accounts and reports should be put in place and sometimes there should be an external audit to strengthen the accuracy, objectivity and reliability of the information contained in charity accounts. Accordingly, the term ‘public accountability’ used in this chapter mainly refers to any mechanism governing accounting, reporting, auditing and public access to information, although those mechanisms are, to some degree, related to governmental regulation,⁹ internal governance¹⁰ and accountability to third parties¹¹ explored in the previous chapters. On this basis, this chapter will examine three areas of public accountability respectively, i.e., charity accounting and reporting, auditing, and public access to information.

Based on the revised agency theory, this chapter argues that, in designing the rules governing charity accounts and reports, charity audits, and public access to information, the law should help reduce the supervisory costs of the general public and other key stakeholders and strike a balance between the supervisory costs of key stakeholders and other agency costs, such as the negative effects of external intervention, when there are conflicts in reducing those costs.

A detailed economic and comparative assessment will be carried out to enrich those arguments in the areas of charity accounting and reporting, auditing, and public disclosure, and to look for those well-designed rules or insightful ideas in support of further reform in China.

⁹ For example, the Charity Commission has the power to make charities have their accounts audited or examined. CA 2011, s 146.

¹⁰ For example, charity trustees have the duty to prepare and submit the relevant accounts and reports and make them public. CA 2011, ss 130-143 and 162-173.

¹¹ For example, donors can make use of this right to monitor the performance of charity trustees.

7.2 Improving the Charity Accounting and Reporting System

7.2.1 Introduction: Satisfying the Information Needs of Key Stakeholders

From an economic perspective, the existence of charity accounts and reports is aimed at satisfying the information needs of the general public and other key stakeholders¹² in order to reduce their supervisory costs. However, in this regard, Chinese law does not effectively take account of the information needs of key stakeholders in developing its charity accounting and reporting system.

For example, there are few, if any, rules relating to the disclosure of remuneration of charity trustees and other staff and the transactions with related parties in either the Private Non-profit Organisations Accounting System 2005 (China) (‘民间非营利组织会计制度’), which constitutes the basic accounting system governing charities and other non-profit organisations in China, or the recently enacted Charity Law 2016 (China).¹³ In addition, there is no requirement on trustees of a charity to explain how they realise the charity’s purpose and public benefit through their activities.

By contrast, to reduce the supervisory costs of key stakeholders in supervising charity trustees, the law and practice in England considers the information needs of stakeholders, including ‘funders, donors, financial supporters, service users and other beneficiaries’,¹⁴ in particular the ‘past, current and potential funders, donors and financial supporters’,¹⁵ in

¹² For example, among all the stakeholders, according to a survey by two specialists in this area, ‘the perception amongst charity managers and auditors of charity financial statements [is] that the annual report of a charity should primarily be directed towards meeting contributors’ information needs’. Ciaran Connolly and Noel Hyndman, *Performance Reporting by UK Charities: Approaches, Difficulties and Current Practice* (The Institute of Chartered Accountants of Scotland 2003) 11.

¹³ One exception may be the rules in the CL 2016 (China) governing transactions with related parties. CL 2016 (China), s 14.

¹⁴ Charity Commission and Office of the Scottish Charity Regulator, *Charities SORP (FRS 102)* (Charity Commission and Office of the Scottish Charity Regulator 2014) (*Charities SORP (FRS 102)*), para 1.1.

¹⁵ *Charities SORP (FRS 102)*, ‘Introduction’, para 12.

designing the contents of charity accounts and reports. For example, the *Charities SORP (FRS 102)* details rules governing the benefits of charity trustees and other staff,¹⁶ and incorporates a public benefit report into the annual reports of charities, which is ‘important for transparency and building public trust and confidence’.¹⁷

Despite this, it is worth noting that, in England, the practice does not always perform as well as expected. For example, it was recently found that there were a range of problems associated with charity fundraising in England, such as targeting vulnerable people and selling data.¹⁸ As a response to those scandals, the Charities (Protection and Social Investment) Act 2016 added the requirement that further information be provided about fundraising in a charity’s annual report.¹⁹

Therefore, China should take account of both the experience and lessons of English law in this area to improve its rules. On the one hand, to reduce the supervisory costs of the general public and other key stakeholders, it is still necessary for China to draw on the experience of English law, considering the information needs of key stakeholders and accordingly designing the related rules governing charity accounts and reports.

On the other hand, drawing on the lessons of English law, in reforming its current rules governing charity accounts and reports, it is also critical for Chinese law and charity regulators to actively respond to the changing information needs of key stakeholders (especially when the current information required by law cannot effectively tackle the charity trustees’ moral hazard in practice) in order to further control the related supervisory costs of those key stakeholders.

¹⁶ *Charities SORP (FRS 102)* paras 9.1-9.32.

¹⁷ Lord Hodgson (n 2) 27.

¹⁸ For example, see Public Administration and Constitutional Affairs Committee, *The 2015 Charity Fundraising Controversy: Lessons for Trustees, the Charity Commission, and Regulators* (Third Report of Session 2015-16, HC431) (The Stationery Office 2016).

¹⁹ CPSIA 2016, s 13.

Of course, given the initial stage of the development of a charity accounting and reporting system in China, the first step is to draw on English law's experience, ensuring the information can satisfy the basic need of the general public. In this regard, this section will evaluate three types of problems, i.e., problems regarding 'comparability', 'relevance' and 'understandability',²⁰ and further discuss how to 'enhance the relevance, comparability and understandability of the information presented in charity accounts'²¹ and reports in China.

7.2.2 Ensuring the Comparability of Information Contained in Charity Accounts and Reports

To facilitate the general public to carry out a comparative assessment of the performance of charity trustees through the information contained in charity accounts and reports in order to reduce their supervisory costs, it is of value to reduce any unnecessary limitations on the application of unified rules.

7.2.2.1 Basic Components of Charity Accounts and Reports in Both Jurisdictions

Before discussing how to improve Chinese law to ensure the comparability of information contained in charity accounts and reports, it is necessary to provide a brief introduction to the basic components of charity accounts and reports in both jurisdictions. In England, according to the *Charities SORP (FRS 102)*, charity accounts (financial statements) may include a statement of financial activities, a balance sheet, a statement of cash flows, an income and expenditure account, and notes,²² while the contents of an annual report²³ mainly contain 'objectives and activities; achievements and

²⁰ The definitions of those three terms can be found in the standard issued by the Financial Reporting Council. Financial Reporting Council, *The Financial Reporting Standard Applicable in the UK and Republic of Ireland* (The Financial Reporting Council Limited 2015) paras 2.4-2.5 and 2.11.

²¹ This is also one of the objectives of the *Charities SORP (FRS 102)*. *Charities SORP (FRS 102)*, 'Objective of the SORP', para 10.

²² *Charities SORP (FRS 102)*, 'How to use the modular SORP', para 26.

²³ Concerning a comprehensive study of annual reports, generally, see Edmund Douglas Hayward Flack, 'The Role of Annual Reports in A System of Accountability for Public Fundraising Charities' (DPhil thesis, Queensland University of Technology 2007) <<http://eprints.qut.edu.au/16362/1/-Edmund-FlackThesis.pdf>> accessed 20 September 2017.

performance; financial review; structure, governance and management; reference and administrative details; exemptions from disclosure; and funds held as custodian trustee on behalf of others'.²⁴

In Chinese law, a counterpart to the relationship between charity accounts and annual reports is the relationship between financial reports ('财务会计报告') and annual work reports ('年度工作报告'). In accordance with the Private Non-profit Organisations Accounting System 2005 (China), financial reports mainly include accounts ('财务报表', i.e., financial statements, including at least a balance sheet, a statement of financial activities and a statement of cash flows), notes and a financial situation statement ('财务情况说明书'). In this context, accounts and notes are, as a whole, similar to charity accounts in England.

Furthermore, a financial situation statement is a special document focusing on explanations concerning the purpose, organisational structure and staff, etc. of the organisation; explanations regarding financial activities, completion of the annual plan and budget, analysis of the differences arisen, and the plan and budget of the next financial period, etc.; and explanations in relation to other matters having a major influence on the operation of the organisation.²⁵ In this respect, the financial situation statement is similar to the strategic report (the former 'operating and financial review'),²⁶ which forms part of a company's annual report in English company law.

7.2.2.2 The Current Problems in Chinese Law

Currently, there are several problems affecting the application of unified rules in Chinese law. First, the current law governing financial reports does not apply to charitable trusts. In terms of the financial reports of charities, except for charitable trusts, the contents are clear and unified.

²⁴ *Charities SORP (FRS 102)* para 1.14; also *Charities SORP (FRS 102)* paras 1.1-1.53.

²⁵ Private Non-profit Organisations Accounting System 2005 (China), s 72.

²⁶ Accounting Standards Board, *Reporting Statement: Operating and Financial Statements* (The Accounting Standards Board Limited 2006); Financial Reporting Council, *Guidance on the Strategic Report* (The Financial Reporting Council Limited 2014).

However, in contrast to associations, civil non-commercial units and foundations, charitable trusts are not regarded as organisations in Chinese law. Therefore, this system does not regulate the contents of financial reports relating to charitable trusts. This arrangement makes it difficult for key stakeholders to compare the performance of charity trustees in a charitable trust with the achievement of those in other types of charity. By contrast, in England, the *Charities SORP (FRS 102)* also regulates charitable trusts, and thus reduces the unnecessary barrier to comparing the achievement of charity trustees in different charities.²⁷

Second, the relationship between financial reports and annual work reports varies by type of charity. In English law, there is a clear relationship between charity accounts and annual reports: a charity's accounts mainly deal with the financial position and financial performance of this charity, and its annual report 'provides a context within which to interpret the accounts and links the activities and achievements reported with the sources of income used to finance them and the expenditure incurred on those activities'.²⁸

By contrast, in China, there is no such clear relationship, and the relationship between financial reports and annual work reports may differ by type of charity. This phenomenon continues to exist after the enactment of the Charity Law 2016 (China), because this new law does not distinguish the contents of an annual work report from those of a financial report at all, although it requires that they should contain the matters relating to annual fund-raising activities and donations received; the matters relating to the management and use of charity property; the matters relating to the implementation of charitable projects; and the wages and benefits of the

²⁷ Nevertheless, in England, the type of charities does play a role in deciding the basis on which charity accounts should be prepared. For example, for non-company charities, only when their annual income exceeds £250,000, do they need to prepare their charity accounts on the accruals basis required by the *Charities SORP (FRS 102)* whilst other non-company charities only need to prepare their accounts on the receipts and payments basis, which is much simpler than the former. However, all charitable companies have to prepare their charity accounts on the accruals basis. Charity Commission, *Charity Reporting and Accounting: the Essentials* (Charity Commission 2015).

²⁸ *Charities SORP (FRS 102)* para 1.12.

staff.²⁹

Firstly, as to associations and civil non-commercial units, the contents of their annual work report are the matters about whether the association/unit complies with laws, regulations and national policies; the matters relating to the completion of the registration procedure according to the regulations; the matters relating to the activities carried out according to the governing document; the matters relating to the changing staff and internal bodies; and the matters relating to financial management.³⁰ Therefore, it seems that financial reports, as part of the matters relating to financial management, are contained in those organisations' annual work reports.

Secondly, with respect to foundations, the contents in their annual work report include a financial report; an auditor's report; the matters relating to fundraising, receiving donations and providing funding, etc.; the matters relating to the changing staff and internal bodies; and other matters.³¹ Here, it is very clear that annual work reports in Chinese foundations include financial reports.

Thirdly, the relationship between financial reports and annual work reports in a Chinese charitable trust is not clear. As a matter of fact, even the term 'financial reports' or 'annual work reports' is not mentioned by the law governing charitable trusts. In this regard, neither the Trusts Law 2001 (China) nor the Charity Law 2016 (China) requires the trustees of a charitable trust to provide an annual work report. Instead, the Trusts Law 2001 (China) imposes a duty on the trustees of a trust to give a report on the management of the trust's affairs and the financial position.³² In addition, in accordance with the Charity Law 2016 (China), the trustees must make a report on the management of the trust's affairs and property to the settlors and file the matters relating to the management of the trust's affairs and financial situation with the filing authority (i.e., the department of civil

²⁹ CL 2016 (China), s 13.

³⁰ RRAA 1998 (China, revised in 2016), s 28; PRRACNU 1998 (China), s 23.

³¹ RAF 2004 (China), s 36.

³² TL 2001 (China), s 67.

affairs), and disclose those matters to the general public.³³

The different types of relationship between financial reports and annual work reports may not facilitate the general public and other key stakeholders to have a comparative evaluation of the achievement of charity trustees working in different types of charity, thus increasing the supervisory costs of those key stakeholders.

7.2.2.3 Applying the Same Regulatory Framework to Charitable Trusts and Unifying the Relationship between Financial Reports and Annual Work Reports

The above arrangement in Chinese law may negatively influence members of the general public to compare the performance of charity trustees in different charities, thus increasing their supervisory costs. Therefore, the thesis argues that the same regulatory framework governing non-profit organisations should also be applied to evaluate the performance of trustees in charitable trusts and that Chinese law should further clarify and unify the relationship between financial reports and annual work reports in all charities, including charitable trusts.

In terms of the second suggestion, one good option is to draw on the English approach that separates financial reports from annual work reports. On this basis, an annual work report can be developed into a supportive and explanatory document assisting users in understanding and evaluating how charity trustees perform their fiduciary duties in achieving their charity's purposes, which will be discussed below. In addition, in China, charity trustees, whether they are trustees of a charitable trust or members of the governing body of any other charity, should be required to carry out the same duty to make financial reports and annual work reports.³⁴

³³ CL 2016 (China), s 48.

³⁴ According to the Charity Law 2016 (China), charities now have the duty to disclose their annual work reports and financial reports to the general public. CL 2016 (China), s 72.

7.2.3 Enhancing the Relevance of the Information Contained in Charity Accounts and Reports

According to *'The Financial Reporting Standard Applicable in the UK and Republic of Ireland'* issued by the Financial Reporting Council, 'relevance' in this context means that the 'information is capable of influencing the economic decisions of users by helping them evaluate past, present or future events and confirming, or correcting, their past evaluations'.³⁵

In terms of charity governance, relevance is directly associated with the information concerning the performance of charity trustees in realising the charitable purpose and public benefit pursued by their charity. For key stakeholders, one common goal may be that: '[t]he greatest possible portion of the wealth donated to private charity must be conserved and used to further the charitable, public purpose; waste must be minimized and diversion of funds for private gain is intolerable.'³⁶

In this respect, to satisfy the information needs of key stakeholders,³⁷ it is necessary to improve the current rules governing the contents of charity accounts and reports in China. Here, two specific recommendations are made with a comparative analysis of English law.

7.2.3.1 Detailing the Rules Governing Remuneration of Charity Trustees

First, it is of value to detail the rules governing remuneration of charity trustees. In making decisions about whether to support and fund a charity, the general public does want to know its charity trustees' remuneration. As a matter of fact, only by knowing this information, can donors and the general public have a basic understanding that 'the charity is operating for the public benefit and that its trustees are acting in the interests of their charity

³⁵ Financial Reporting Council (n 20) para 2.5.

³⁶ Kenneth L. Karst, 'The Efficiency of the Charitable Dollar: An Unfulfilled State Responsibility' (1960) 73(3) Harvard Law Review 433, 434.

³⁷ Hyndman and McMahon (n 3) 463-464.

and not for private benefit'.³⁸

However, in contrast to the detailed rules stipulated in the *Charities SORP (FRS 102)*,³⁹ a major drawback in Chinese law relating to charity accounts lies in its insufficient rules relating to the disclosure of the remuneration of charity trustees and other staff and the transactions with related parties. For example, there is no definition or interpretation of 'related parties' in the Charity Law 2016 (China), compared to a full definition in the *Charities SORP (FRS 102)*.⁴⁰

Moreover, alongside a lack of detailed rules, there are several problems relating to the relevant rule of the Charity Law 2016 (China), which provides that annual work reports and financial reports should include information relating to the wages and benefits ('福利') of the staff.⁴¹ One problem is that it is not clear whether charity trustees (members of the governing body) fall within the scope of the term 'staff'. Another one is the scope of benefits ('福利'). It is worth noting that, in China, benefits ('福利') are usually confined to the employee benefits provided by an organisation. Other advantages, such as those arising from transactions with related parties, are not viewed as benefits ('福利') in this context. Accordingly, this vague expression may not facilitate some charity trustees to add this information to their charity accounts.

Therefore, the contents of charity accounts in China should be provided in a more detailed way to ensure that the information directly relating to the implementation of the fiduciary duties of charity trustees is clearly defined and disclosed. For example, China can draw on the experience of the *Charities SORP (FRS 102)*, providing detailed rules governing disclosure of charity trustees' remuneration, benefits, expenses and transactions with

³⁸ *Charities SORP (FRS 102)* para 9.2.

³⁹ *Charities SORP (FRS 102)* paras 9.1-9.32.

⁴⁰ *Charities SORP (FRS 102)* Appendix 1.

⁴¹ CL 2016 (China), s 13.

related parties.⁴²

As noted in Chapter 5, Chinese law can require charity accounts to contain the legal authority under which the payment was made, the name of the remunerated trustee, details of why the remuneration was paid, the amount of remuneration paid and other information.⁴³ Meanwhile, the definition or scope of ‘remuneration’, ‘related parties’ and any other important term should be clarified.

7.2.3.2 Strengthening the Requirements on the Contents of the Financial Reports and Annual Work Reports of Larger Charities

Here it is necessary to clarify the standard utilised to distinguish larger charities from smaller ones. For the purposes of this thesis, a reasonable standard to evaluate the size of a charity is its income and assets. From a comparative perspective, English law provides a good example, which regards a charity as a larger one if:

- (a) the charity’s gross income in that year exceeds £1 million, or
- (b) the charity’s gross income in that year exceeds the accounts threshold and at the end of the year the aggregate value of its assets (before deduction of liabilities) exceeds £3.26 million.⁴⁴

China can adjust the specific amount by taking into account its current economic and social conditions.

For key stakeholders, it is apparent that ‘[a] greater degree of public accountability and stewardship reporting is expected of larger charities’.⁴⁵ In contrast to smaller charities, larger charities usually face more risks, uncertainty and challenges. In this context, once there is any misconduct or

⁴² *Charities SORP (FRS 102)*, paras 9.1-9.32.

⁴³ *Charities SORP (FRS 102)*, paras 9.6-9.7.

⁴⁴ CA 2011, s 144, substituted (with application in accordance with art. 5 of the commencing S.I.) by the Charities Act 2011 (Accounts and Audit) Order 2015 (S.I. 2015/321), arts 1 and 3.

⁴⁵ *Charities SORP (FRS 102)* para 1.34.

mismanagement by those charities' trustees, the residual loss will be huge, greatly damaging the public confidence and trust. Accordingly, key stakeholders can be reasonably expected to have the motivation to require more information regarding the governance, management and operation of those larger charities.

Nevertheless, a strengthened requirement on the contents of the accounts and reports of larger charities may bring more costs relating to the negative effects of external intervention. In this context, it is of value for the law to balance its costs of the negative effects of external intervention and its benefits (such as reducing the charity trustees' moral hazard and the supervisory costs of key stakeholders).

In respect of a larger charity, once any misconduct or mismanagement exists, the charity will suffer a huge loss of charitable resources. Meanwhile, key stakeholders need more information to efficiently evaluate and supervise the performance of charity trustees, and the bad performance of charity trustees in a larger charity, with which the general public is usually familiar, will severely damage public trust and confidence in this charity in particular, and the charitable sector as a whole. In addition, larger charities often have more resources (such as sufficient money and professional employees) available to provide more detailed and complete information, which may not bring too many costs relating to the negative effects of external intervention relative to the charities' size.

Hence, in contrast to the costs of the negative effects of external intervention, the high costs of the charity trustees' moral hazard and the high supervisory costs of the general public and other key stakeholders in respect of larger charities should be given priority in practice.

In this respect, in England, the *Charities SORP (FRS 102)* does consider the costs and benefits relating to information: 'the preparer should also balance the cost of obtaining information with the benefit it provides both internally

to management and externally to funders and other stakeholders.⁴⁶ Following this logic, the *Charities SORP (FRS 102)* distinguishes larger charities from other charities, and imposes more requirements on the former's accounts and reports.⁴⁷

By contrast, Chinese law does not provide any different requirement in terms of charity accounting and reporting, which may not effectively regulate the charity trustees' performance in larger charities, thus increasing the supervisory costs of key stakeholders. Hence, to reduce the high costs relating to the charity trustees' moral hazard in larger charities in order to satisfy the information needs of those charities' key stakeholders, Chinese law should strengthen the charity accounting and reporting requirements on larger charities.

7.2.4 Promoting the Understandability of the Information Contained in Charity Accounts

Due to the inherent problems associated with the understandability of charity accounts, it may be necessary to develop a narrative report facilitating the general public in understanding information in charity accounts, which will eventually reduce the public's supervisory costs.

7.2.4.1 The Problems Relating to the Understandability of Charity Accounts

As noted above, key stakeholders are usually concerned about how a charity's trustees perform their fiduciary duties for the charity's purposes. For the general public and the financial supporters of a charity, one major concern is not about how much the charity has spent, but 'how much has been achieved in affecting the issues being addressed and meeting the charity's objectives'.⁴⁸ In this regard, one vital drawback of charity accounts

⁴⁶ *Charities SORP (FRS 102)* para 3.10.

⁴⁷ For example, in terms of the extra requirements on larger charities relating to annual reports, see *Charities SORP (FRS 102)* paras 1.34-1.53.

⁴⁸ Paul Palmer and Adrian Randall, *Financial Management in the Volunteer Sector* (Routledge 2002) 135.

is that they ‘too rarely contain qualitative information that is essential for a full understanding of the figures’.⁴⁹ In other words, the information contained in charity accounts cannot itself ‘give the user a rounded overview of what has been achieved from the charity’s activities and the resources used in their delivery’.⁵⁰

Accordingly, if charity accounts themselves cannot satisfy the information needs of the general public in evaluating whether charity trustees have performed their duties properly, the supervisory costs of the society as a whole will be increased: the general public, donors and volunteers may have to choose other methods to obtain the relevant information to facilitate the assessment of the charity trustees’ performance, thus increasing their supervisory costs.

7.2.4.2 Developing a Narrative Report to More Clearly Reflect the Charity Trustees’ Performance in Achieving their Charity’s Purpose

To cope with this problem, it is necessary to provide the information in a more understandable manner. In this context, whether charity accounts are contained in annual work reports, a narrative report supporting charity accounts should be set up to assist the general public in understanding the information contained in them. And the requirements contained in this narrative report itself, if well-designed and effectively implemented in practice, can help the key stakeholders and other stakeholders of a charity to make a better evaluation of the effectiveness of its performance,⁵¹ and accordingly ‘form the basis for discharging accountability by the charity’,⁵² thus reducing the supervisory costs of key stakeholders.

In this respect, Chinese law requires charities to include information relating to annual fund-raising activities, donations, implementation of charitable projects, and wages and benefits of the staff in their financial reports and

⁴⁹ *ibid.*

⁵⁰ *Charities SORP (FRS 102)* para 1.12.

⁵¹ Con Alexander and Jos Moule, *Charity Governance* (Jordan Publishing Limited 2007) 290.

⁵² Connolly and Hyndman (n 12) 19.

annual work reports.⁵³ However, it does not require charity trustees to explain how they realise the charitable purposes and public benefit through their activities. Accordingly, the public benefit report required in English law can bring a great deal of insight to improving the annual work reports in China.

To address the problems regarding charity accounts, English law has developed a narrative annual report which ‘assist[s] the user to make economic decisions in relation to the charity and to assess the charity’s progress against its objectives and to understand its plans in relation to its purposes’.⁵⁴ On this basis, in England, a public benefit report has been incorporated into the annual reports of charities, to strengthen their public accountability.⁵⁵ Under this report, ‘public benefit is no longer an abstract concept, but rather a requirement on which every registered charity—small or large—must report every year’.⁵⁶ However, in accordance with a recent report on behalf of the Charity Commission, the practice relating to the public benefit report does not perform quite well even in England.⁵⁷

One reason may be that, in respect of charity governance, in contrast to corporate governance, there is a lack of sufficient evaluation methods to accurately judge the performance of charity trustees. For a charity, ‘the multiplicity of objectives, outputs and outcomes; different outputs at differing organisational levels; and the allocation of joint costs to various outputs’⁵⁸ may negatively affect an accurate and objective evaluation of it. In this context, a public benefit report that does not provide sufficient or

⁵³ CL 2016 (China), s 13.

⁵⁴ *Charities SORP (FRS 102)* para 1.2.

⁵⁵ Lord Hodgson (n 2) 27.

⁵⁶ Gateth G. Morgan and Neil J. Fletcher, ‘Mandatory Public Benefit Reporting as a Basis for Charity Accountability: Findings from England and Wales’ (2013) 24 *Voluntas* 805, 827.

⁵⁷ Gateth G. Morgan and Neil J. Fletcher, ‘Public Benefit Reporting by Charities: Report of a Study Undertaken by Sheffield Hallam University on behalf of the Charity Commission for England and Wales’ (2011) Centre for Voluntary Sector Research of Sheffield Hallam University 2011 <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/284708/public_benefit_reporting_shu.pdf> accessed 20 September 2017.

⁵⁸ Ciaran Connolly, Noel Hyndman and Danielle McConville, ‘Conversion Ratios, Efficiency and Obfuscation: A Study of the Impact of Changed UK Charity Accounting Requirements on External Stakeholders’ (2013) 24 *Voluntas* 785, 789.

clear standards with which charity trustees should comply may not contribute much to the effective public accountability of charity trustees.

To deal with this problem, some advanced evaluation measures can be taken in practice, such as social return on investment (SROI)⁵⁹ ‘which blends traditional stock reporting with an assessment of social costs and benefits’.⁶⁰ Although those measures may also not be perfect, the overall aim behind them, i.e., making the evaluation standards clearer, more understandable and practicable, is worth pursuing.⁶¹

In addition, as mentioned in Chapter 3, given the abstract nature of the charitable purposes and public benefit, it is of value for charity trustees to establish more specific objectives or plans relating to their annual activities and to make them more measurable and understandable in practice, further reducing the general public’s supervisory costs.

7.3 Improving the Rules Governing Charity Auditing

7.3.1 Introduction

If there is a lack of objective review, examination or evaluation of financial reports, in particular those of larger charities, the submission or disclosure of accounts and reports to regulators or the public itself may not ensure public confidence in charities automatically. In terms of external audit, according to the Charity Commission, an auditor should ‘express [his or her] professional opinion as to whether the accounts are “true and fair” and undertake procedures necessary to form that opinion in accordance with International Standards on Auditing (UK and Ireland)’.⁶²

⁵⁹ Jeremy Nicholls and others, *A Guide to Social Return on Investment* (The SROI Network 2012).

⁶⁰ Evelyn Brody, ‘Accountability and Public Trust’ in Lester M. Salamon (ed), *The State of Nonprofit America* (Aspen Institute & Brookings Institute Press 2002) 490.

⁶¹ Some scholars expect that, in practice, ‘the SROI evaluation method is likely to become increasingly popular’. Huajun Gao, ‘The Charity Industry Network: A New Driving Force in China’s Nonprofit Sector’ in Chien-Chung Huang and others (eds), *China’s Nonprofit Sector: Progress and Challenges* (Transaction Publishers 2014) 137.

⁶² Charity Commission, *Internal Financial Controls for Charities* (Charity Commission 2012) 3.

Here, it is worth noting that, external auditors are not persons voluntarily providing charitable resources to charities ('key stakeholders' defined in Chapter 3). Hence, similar to charity members and supervisory boards/trust supervisors (who fall within the scope of 'other selected stakeholders'), their supervisory rights are given directly by operation of law, making them act as an independent governance mechanism which helps reduce the charity trustees' moral hazard and the monitoring costs of key stakeholders.⁶³ the 'strict professional regulation of the independent exercise of informed judgement provides credible public assurance that charity accounts really do show the general reader an unbiased, thus "true and fair", view'.⁶⁴ In the meantime, the law has to take account of the costs of this mechanism in applying it to monitoring charity trustees. In this respect, Chinese practice has much to learn from that in England.

7.3.2 Building a Comprehensive Regulatory Framework of Charity Auditing

First, it is necessary to build a comprehensive regulatory framework of charity auditing. In England, there is updated guidance on charity auditing, i.e., the '*Practice Note 2011: the Audit of Charities in the United Kingdom*',⁶⁵ which provides detailed guidelines on how to apply the *International Standards on Auditing (UK and Ireland)* in the charitable sector. By contrast, China has not built a regulatory framework focusing on charity auditing,⁶⁶ which means that the general principles applying to all audit activities also directly regulate charity auditing.

The main problem relating to this regulatory approach lies in the fact that

⁶³ Of course, different from members and the supervisory board/trust supervisors, external auditors act as an external governance mechanism.

⁶⁴ Greyham Dawes, 'Charity Commission Regulation of the Charity Sector in England and Wales: the Key Role of Charity Audit Regulation' in Klaus J. Hopt and Thomas von Hippel (eds), *Comparative Corporate Governance of Non-Profit Organizations* (CUP 2010) 861.

⁶⁵ Auditing Practices Board, *Practice Note 2011: the Audit of Charities in the United Kingdom* (Financial Reporting Council 2012).

⁶⁶ One exception may be the Guidance on the Audit of Financial Reports of Foundations 2012 ('基金会财务报告审计指引'), which was implemented in 2013 and only regulates charitable foundations.

the general principles may not take account of the special considerations relating to charity auditing and thus sometimes cannot work well in practice. For example, according to the Auditing Standards for the Chinese Certified Public Accountants No. 1323 (Related Parties), the auditor should review the records relating to investors and check the minutes from shareholder meetings.⁶⁷ This cannot be realised in the charitable sector because charities do not have owners (investors) and many charities do not have members, making it impossible in practice to review the minutes from shareholder meetings.

Therefore, since the implementation of the Charity Law 2016 (China), to facilitate external auditors in efficiently supervising charity trustees in order to control those trustees' moral hazard and the supervisory costs of the general public, it has become urgent to build a comprehensive framework focusing on the regulation of charity auditing, similar to the above guidance in the United Kingdom, which can help clarify the roles, rights, duties, liabilities and relevant procedures relating to external auditors.

7.3.3 Extending the Scope of External Audit to Larger Charities

Second, the scope of the external audit mechanism in Chinese law should pay special attention to larger charities, the definition of which has been given above. The justification for this argument is similar to that for supporting strengthening the requirements relating to the contents of charity accounts and reports of larger charities. For larger charities, if any mismanagement or misconduct exists, it will greatly increase the costs of the charity trustees' moral hazard and damage the realisation of those charities' purposes. That may be why in England all larger charities should be audited.⁶⁸

By contrast, for smaller charities, having an external auditor may be a great

⁶⁷ See Auditing Standards for the Chinese Certified Public Accountants No. 1323 (Related Parties), s 7 ('中国注册会计师审计准则第 1323 号----关联方').

⁶⁸ CA 2011, s 144.

burden to bear, resulting in high costs relating to the negative effects of external intervention. Meanwhile, in a smaller charity which has less income or fewer assets, even if there is any misconduct or mismanagement by the charity trustees, it may not bring too many costs of moral hazard. Therefore, from the perspective of controlling the whole agency costs, the external audit mechanism should focus on larger rather than smaller charities.

However, in contrast to English law, in accordance with the Charity Law 2016 (China), only charities having the authorised status of public fundraising ('public fundraising charities') should have their accounts audited.⁶⁹

Similar to public collections certificates⁷⁰ in English law, a Chinese charity needs to apply for public fundraising status before it can carry out fundraising activities with the public.⁷¹ Although it is understandable for the law to strengthen the regulation of public fundraising charities based on the considerations of protecting the large number of donors and maintaining public order, it is unreasonable to confine the scope of the statutory audit to those charities. This is because charities with large assets may not apply for the legal status of public fundraising whilst public fundraising charities may not have many assets or much income. To reduce the costs of the charity trustees' moral hazard and the supervisory costs of key stakeholders in larger charities, the thesis argues that in China, larger charities, including those which are not public fundraising charities, should be audited.

7.4 Enhancing Public Access to Information

7.4.1 Introduction

'Sunlight is said to be the best of disinfectants; electric light the most

⁶⁹ CL 2016 (China), s 72.

⁷⁰ CA 2006, ss 47 and 51-57.

⁷¹ CL 2016 (China), s 22.

efficient policeman'.⁷² Public disclosure of accounts, annual reports and other relevant information plays a very significant role in enhancing charity governance. Although it may increase the burden on charity trustees and their charity, those costs are necessary because they can usually bring more benefits.⁷³

For example, an effective public disclosure system can reduce the costs of the charity trustees' moral hazard and force them to perform better for their charity;⁷⁴ it will relax the difficulty for the public to supervise and support the relevant charity⁷⁵ and accordingly reduce the public's supervisory and supporting costs;⁷⁶ and, in contrast to a mechanism authorising a number of stakeholders with the rights to directly enforce the fiduciary duties of charity trustees, public access to information is more moderate and will not place too much pressure on charity trustees to carry out their activities independently (i.e., reducing the costs of the negative effects of external intervention).

In this context, this section will discuss how to improve Chinese law and practice in this respect to reduce those costs. In terms of public access to information, it can be further divided into two parts. First, the legal rights of the general public to access information provided by charities. Second, the charity trustees' voluntary disclosure of extra information to the public. In either situation, the law or regulators should take a range of measures to reduce the supervisory costs of key stakeholders and other relevant costs.

7.4.2 Protecting the Rights of the General Public to Access Information

The general public has the right to have direct access to information as

⁷² Louis D. Brandeis, *Other People's Money and How the Bankers Use It* (Frederick A. Stokes Company 1914) 92.

⁷³ Lord Hodgson (n 2) 24.

⁷⁴ Connolly and Hyndman (n 12) 22.

⁷⁵ The role of public disclosure lies in the fact that it can help donors, beneficiaries and the general public ensure that the contributions to a charity 'are devoted in their entirety to the services that the organization promises to provide'. Henry Hansmann, 'Reforming Nonprofit Corporation Law' (1981) 129 *University of Pennsylvania Law Review* 497, 615.

⁷⁶ Lord Hodgson (n 2) 65.

required by law. However, to facilitate the general public's exercising of this right, the persons and methods to make charity accounts and reports public must be clarified and most of the information required by law to be made public should be incorporated into the contents of financial reports and annual work reports.

7.4.2.1 Identifying Charity Trustees as the Persons Having the Duty to Disclose Information to the Public

In China, according to the Public Benefit Undertakings Donations Law 1999 (China), the donee of charitable donations should make the matters relating to those donations and their use and management public and accept the supervision of the public.⁷⁷ And there are similar rules in the Regulation on the Registration and Administration of Associations 1998 (China, revised in 2016), the Regulation on the Administration of Foundations 2004 (China), the Provisional Regulation on the Registration and Administration of Civil Non-commercial Units 1998 (China), and the Charity Law 2016 (China).⁷⁸ In this respect, although it is clear that the charity itself has a duty to publish the relevant information, it is not clear which individuals should be personally responsible for doing so.

The relevant problem is that, according to the Charity Law 2016 (China) and the Regulation on the Administration of Foundations 2004 (China), if the duties to publish the relevant information are not carried out or sufficiently carried out, the charity itself will be warned and required to end its activities; and, in serious cases, its registration will be revoked.⁷⁹ For example, Ageing Development Foundation of Sichuan Province, a charitable foundation in Sichuan Province, was recently deregistered due to a violation of its duty to make information public and other duties.⁸⁰

⁷⁷ PBUDL 1999 (China), s 22.

⁷⁸ For example, see RRAA 1998 (China, revised in 2016), s 26; RAF 2004 (China), s 25; PRRACNU 1998 (China), s 21; CL 2016 (China), s 72.

⁷⁹ For example, see CL 2016 (China), ss 99-100; RAF 2004 (China), s 42.

⁸⁰ Dan Li, 'Two Foundations Were Deregistered due to Serious Violation of Laws' *Xinhua* (Beijing, 11 January 2017) <http://news.xinhuanet.com/gongyi/2017-01/11/c_129441239.htm> accessed 20 September 2017.

However, there is no clear rule about whether charity trustees will have to accept any legal consequence if their charity breaches this duty. In this respect, although the Charity Law 2016 (China) provides that the chief officers and other staff directly responsible for (‘直接负责的主管人员和其他责任人员’) the public disclosure of information will be punished in violation of their duty,⁸¹ it is unclear who and whether charity trustees are among the so-called ‘chief officers and other staff’. At least in the charity scandal relating to Ageing Development Foundation of Sichuan Province, as noted above, no charity trustee was punished. Therefore, the law may not encourage charity trustees to publish the relevant information and accordingly may increase their moral hazard.

By contrast, in England, the Charities Act 2011 requires that charity trustees have a duty to provide a copy of the most recent annual report or accounts to a member of the general public.⁸² A violation of this duty may make them guilty of an offence and accordingly they may be punished by law.⁸³

Drawing on the experience of English law in this respect, Chinese law should clarify a charity’s trustees as the persons finally responsible for issues relating to publishing the relevant information of this charity. Meanwhile, Chinese law should impose the related legal consequences to ensure that those charity trustees perform their duties to prepare the charity accounts and reports, to submit them to the regulator or to disclose them.

7.4.2.2 Detailing the Methods to Disclose Information to the Public

‘To encourage participation and confidence in the non-profit sector, the public must have access to accurate, clear, timely, and adequate information about the programs, activities, and finances of all charitable organizations.’

⁸⁴ However, unless there is a pragmatic and accessible way for the general

⁸¹ CL 2016 (China), ss 99-100.

⁸² CA 2011, ss 171-172.

⁸³ CA 2011, s 173.

⁸⁴ Panel on the Nonprofit Sector, *Strengthening Transparency, Governance, Accountability of Charitable Organizations: A Final Report to Congress and the Nonprofit Sector* (Independent Sector

public to easily receive the information contained in the financial reports and annual work reports of a charity, disclosure may not be effectively implemented in practice.

In this respect, currently, Chinese law does not specify the methods to disclose information to the general public. By contrast, in English law, charity trustees must provide a copy of the most recent annual reports or accounts to a person within two months if this person requests it in writing and pays a reasonable fee, if any, for the relevant costs.⁸⁵

To make disclosure effective, Chinese law should draw on the experience of English law, further clarifying the specific methods of disclosing the above information. For example, the law should require charity trustees to provide a printed or electronic copy upon request by a member of the general public, or to publish the information on their charity's official website.

7.4.2.3 Incorporating the Main Information to Be Disclosed into Financial Reports and Annual Work Reports

In terms of the contents of the information to be disclosed to the public, in English law, the main contents are contained in charities' accounts and annual reports.⁸⁶

By contrast, there is no unified rule in Chinese law. In 2011, the Ministry of Civil Affairs issued the Guideline on Disclosure of Information concerning Charitable Donations 2011 (China) ('公益慈善捐助信息公开指引'),⁸⁷ which set up the principles, contents, time and methods of disclosure of information for charities receiving donations. According to this guideline, the information to be disclosed to the public includes basic information relating to the party disclosing the information, information relating to

2005) 21.

⁸⁵ CA 2011, ss 171-172.

⁸⁶ *ibid.*

⁸⁷ Its English version is available at <<http://www.lawinfochina.com/display.aspx?lib=law&id=9142>> accessed 20 September 2017.

fundraising, information relating to receiving and using donations, financial information on donees, and necessary updated information, etc.⁸⁸

However, the contents of the information required in the Charity Law 2016 (China) are different from those in this guideline. In accordance with this new law, the information required to be disclosed to the public includes charities' governing documents, information relating to the members of their decision-making, implementation and supervision bodies, and other information required by the Ministry of Civil Affairs along with their annual work reports and financial reports.⁸⁹ However, the relationship between the information relating to a charity's governing documents and internal bodies and that contained in its annual work reports and financial reports is not clear.

This arrangement increases the costs for the general public to collect and analyse the information provided by charities. For example, because the information to be disclosed to the public may or may not be contained in a charity's accounts and reports, the public has to collect this information from this charity's accounts and reports, and information published on its website (if any) or provided in any other manner, which will definitely increase their information collection costs. In addition, given the disclosure of a range of information based on different disclosure requirements, key stakeholders, if they want to, have to further analyse which information has already been included in the related charity's accounts and reports, and whether the information describing the same issue but published in different places differs.

In the meantime, for charity trustees, to satisfy different disclosure requirements means that there are high costs relating to the negative effects of external intervention in practice. They have to deal with those issues instead of focusing on the realisation of the charitable purposes their charity pursues. And their altruistic spirit may also be hurt, negatively affecting the

⁸⁸ Guideline on Disclosure of Information concerning Charitable Donations 2011 (China), s 10.

⁸⁹ CL 2016 (China), s 72.

efficient use of charitable resources.

To reduce those costs, Chinese law can draw on the experience of English law, incorporating the main information required by law to be disclosed to the general public into the charity accounts and reports as far as possible. On this basis, Chinese law can focus on designing and developing the contents of charity accounts and annual reports as noted above, and accordingly making them public. Following this approach, the information to be prepared, evaluated or published is usually contained in financial reports and annual work reports, which can be used and examined by charities, their financial supporters, regulators and the general public, reducing the supervisory costs of key stakeholders along with the costs of the negative effects of external intervention.

7.4.3 Encouraging Voluntary Disclosure of Extra Information by Charity Trustees

7.4.3.1 The Role of Voluntary Disclosure in Reducing the Supervisory Costs of Key Stakeholders

The focus of the above discussion in this chapter was on legal requirements. However, sometimes voluntary public disclosure beyond the legal requirements is of vital importance to satisfy the general public's need for information and to strengthen public confidence and trust.⁹⁰

In this respect, a famous recent example in China is the dispute relating to Smile Angel Foundation (whose Chinese name is '嫣然天使基金'). Yapeng Li, who was a well-known Chinese actor and also the founder of this charity was suspected of utilising it for illegal purposes. But Li did not address this suspicion at the outset and then responded that 'from the legal perspective, we have no further duty to disclose other information'.⁹¹ Although the final

⁹⁰ Generally see Christopher D. B. Burt, *Managing the Public's Trust in Non-profit Organizations* (Springer 2014).

⁹¹ Bo Liang, 'Misappreciation? False Fundraising? The Dispute Is Continuing' *West China City Daily*

auditing result indicated that the suspicion was incorrect, Li's tardy response greatly damaged his personal fame⁹² and the reputation of the charity.

From an economic perspective, although voluntary disclosure is not required by law, it is directly associated with reducing the agency costs relating to charity governance. If a charity does not disclose or interpret its essential information in a timely, proper and transparent manner, thus raising public concern, its reputation will be damaged or even ruined in a very short period.

This will not only greatly increase the supervisory costs of the general public in supervising this charity (information required to be disclosed by law is insufficient to meet the needs of the public), but also result in the residual loss (such as fewer charitable donations due to distrust). In this context, the charity trustees of any charity must be aware of this risk and are recommended to actively disclose extra information to satisfy the public demand, in particular in dealing with any trust crisis.

7.4.3.2 How to Stipulate that Charity Trustees Disclose Extra Information to the General Public

Voluntary disclosure need to be encouraged in practice to satisfy the information need of key stakeholders. First, in guiding charity trustees to disclose extra information to the general public, the government or charity umbrella organisations can develop guidance and voluntary codes of conduct⁹³ dealing with voluntary disclosure.

(Chengdu, 24 March 2014) <<http://wccdaily.scol.com.cn/shtml/hxdsb/20140324/197238.shtml>> accessed 20 September 2017.

⁹² Mixing celebrity and charity can also be a tricky business in England. For example, see Karl Wilding, 'Mo Farah Foundation Closure Holds Lessons for Other Charities' *The Guardian* (London, 1 June 2016) <<https://www.theguardian.com/voluntary-sector-network/2016/jun/01/mo-farah-foundation-close-charity>> accessed 20 September 2017.

⁹³ For example, see Charity Governance Code Steering Group, *Charity Governance Code for Larger Charities* (Charity Governance Code Steering Group 2017); Charity Governance Code Steering Group, *Charity Governance Code for Smaller Charities* (Charity Governance Code Steering Group 2017).

Second, it is also necessary for charity trustees themselves to be aware of their ‘moral duties’ relating to voluntary disclosure. As a matter of fact, ‘[i]n a public accountability relationship, the accountee is a “forum” or “moral community”’.⁹⁴ Therefore, in the charitable sector, in order not to damage the public trust and confidence in charity trustees, it is of great value for those charity trustees to regard themselves as having the moral duty to provide the general public with access to extra information about their charity.⁹⁵

Of course, its success needs the efforts of the whole society, including but not limited to the guidance and support from the government, the codes of conduct from the charitable sector and the cultivation of a charity culture which recognises voluntary disclosure as part of the moral duty of charity trustees.

7.5 Conclusion

This chapter has provided a comprehensive economic and comparative study of the legal rules regarding the accountability of charities to the public in both jurisdictions and a range of specific reform suggestions for reforming Chinese law and practice. In this chapter, public accountability mainly refers to charity accounting and reporting, auditing and public access to information.

First, in terms of charity accounting and reporting, although both China and England have some problems with which to cope (such as the fact that the contents of the information required to be made public cannot meet the needs of the public in some situations), the current legal arrangement in China is less cost-effective than English law and practice in satisfying the information needs of the general public and other key stakeholders. Similar to charity accounts and annual reports in English law, there is a distinction

⁹⁴ Flack (n 23) 27.

⁹⁵ Kate Kirkland, ‘In Trust: the Changing Role of Trustees’ in Chris Hanvey and Terry Philpot (eds), *Sweet Charity: the Role and Workings of Voluntary Organisations* (Routledge 1996) 106.

between financial reports and annual work reports in China. The current problems regarding financial reports and annual work reports in Chinese law can be concluded as follows.

Firstly, in terms of the comparability of information, Chinese law does not incorporate charitable trusts into its regulatory framework governing other charities and non-profit organisations and, in the meantime, the current relationship between financial reports and annual work reports in China is not clear or unified. In respect of associations and civil non-commercial units, financial reports seem to be part of annual work reports; as to foundations, it is clear that financial reports are contained in annual work reports; with regard to charitable trusts, their relationship is not clarified.

Those arrangements increase the difficulty for the general public and other key stakeholders to compare the achievements of charity trustees between charitable trusts and other charities, leading to unnecessary supervisory costs. By contrast, in England, charitable trusts are also regulated by the same charity accounting and reporting system and there is a clear relationship between charity accounts and annual reports: an annual report supplies ‘a context within which to interpret the accounts’.⁹⁶

Secondly, with respect to the relevance of information, Chinese law does not provide sufficient and relevant information to satisfy the needs of the public, resulting in more supervisory costs for key stakeholders. For example, neither the Private Non-profit Organisations Accounting System 2005 (China) nor the recently enacted Charity Law 2016 (China) provides sufficient rules relating to the disclosure of the remuneration of charity trustees and other staff and the transactions with related parties. In addition, there is no further requirement for the accounts and reports of larger charities to meet the public’s expectation for them to disclose more information.

⁹⁶ *Charities SORP (FRS 102)* para 1.12.

By contrast, there are a variety of more detailed rules governing the benefits of charity trustees and other staff, and a clear distinction between larger charities and smaller charities along with a strengthened requirement for the annual reports and accounts of larger ones in the *Charities SORP (FRS 102)*.

Thirdly, in terms of the understandability of information, the current reporting system in China does not require charity trustees to explain how they realise the charitable purposes and public benefit through their activities. By contrast, to reduce the problems regarding charity accounts in this regard, English law has not only developed an annual report to make it easier for the public to understand the performance and achievement of charity trustees, but also requires charity trustees to provide a public benefit report, explaining how they realise the public benefit their charity aims to deliver.

Hence, to reduce those problems, Chinese law should apply the current charity accounting and reporting system to charitable trusts, and further clarify and unify the relationship between financial reports and annual work reports. Meanwhile, China should draw on the experience of English law, detailing the rules governing the remuneration and other benefits of charity trustees and strengthening the accounting and reporting requirements on larger charities. Furthermore, it is necessary to develop a narrative report which facilitates the general public to more easily understand the performance of charity trustees in achieving the charitable purposes of their charity.

Second, with respect to external auditing, in England, there is a comprehensive regulatory framework for charity auditing, i.e., the '*Practice Note 2011: the Audit of Charities in the United Kingdom*', and the scope of external auditing extends to larger charities. By contrast, China has not established a comprehensive regulatory framework for charity auditing and the scope of external auditing is limited to public fundraising charities. In contrast to English law and practice, the current legal rules in China can neither contribute to facilitating the role of external auditors in reducing the

supervisory costs of key stakeholders, nor control the high costs relating to the charity trustees' moral hazard in larger charities which do not fall within the scope of public fundraising charities.

To reduce those costs relating to charity auditing, it is necessary for China to draw on the experience of the '*Practice Note 2011: the Audit of Charities in the United Kingdom*', and build a comprehensive regulatory framework for charity auditing. Meanwhile, the scope of the external audit mechanism should be extended to larger charities.

Third, concerning public access to information, it can be further divided into the rights of the public to access information and the voluntary disclosure by charity trustees of extra information. In terms of the legal rights of the public to access charities' information, in contrast to English law, Chinese law does not clarify whether charity trustees have a responsibility for the public disclosure, what methods charities should take to disclose the information, and the relationship between the information that charities should disclose to the public and the contents of their financial reports and annual reports. This arrangement may result in higher costs relating to the charity trustees' moral hazard, along with higher supervisory costs for the general public and higher costs relating to the negative effects of external intervention.

Therefore, it is necessary for Chinese law to clarify the duty of charity trustees to make charity accounts and reports public and the specific disclosure methods, and to incorporate the main information to be disclosed into the contents contained in financial reports and annual work reports.

In addition, based on the previous poor performance of charity trustees in this area, it is critical for charity regulators in China to further encourage voluntary disclosure of extra information by charity trustees, especially in dealing with any trust crisis, to reduce the supervisory costs of the general public, donors, the government and other stakeholders, and the residual loss (such as fewer donations).

In the next chapter, the thesis will summarise the core arguments in the above chapters and comment on the possibility of realising the above reform suggestions in practice and the need for any further study to be carried out in the future.

Chapter 8 Concluding Remarks

8.1 Introduction

This final chapter aims to summarise the core points in the previous chapters, to comment on whether and how the reforms suggested in this thesis can be implemented in practice, and to further point out what further work needs to be done beyond this study.

Here, it is worth noting that, in terms of charity governance, in contrast to governmental regulation which is closely associated with Chinese politics, the legal rules concerning internal governance, supervision by third parties and public accountability do not have a direct relationship with the current political arrangement in China. In this context, it is helpful to discuss governmental regulation separately, with a focus on any specific policy consideration of the government.

Hence, this chapter will assess the economic and comparative perspectives, governmental regulation and other governance mechanisms, along with an overall conclusion.

8.2 Economic and Comparative Perspectives

8.2.1 Economic Analysis

In terms of an economic analysis of charity governance, this thesis has developed a theoretical framework ('the revised agency theory') incorporating the traditional agency theory with other related theories to better guide legal reform and practice in China. In this revised agency theory, the charitable purpose/public benefit of a charity plays the role of the charity trustees' (persons who govern this charity) principal, whilst persons who are not the charity trustees but who provide charitable resources to this charity ('key stakeholders') and other selected stakeholders (by operation of law) should act as the supervisors with the rights to make the charity trustees

accountable for the charitable purpose/public benefit. And the human nature of those charity trustees (who are often volunteers) should be understood in a more pragmatic manner, which means that they can usually be trusted but should be monitored in some circumstances to control serious moral hazard.

On this basis, although agency costs continue their role in evaluating charity governance, their contents should be extended to the costs relating to co-ordinating the supervisors and their collective decision-making process; the costs of supervision, support and enforcement; the costs of the supervisors' moral hazard; the costs of the negative effects of external intervention (the above four types of costs are called the 'monitoring costs' in this thesis); and the residual loss (including both the costs of the charity trustees' misconduct or mismanagement due to ineffective accountability and the costs relating to the inefficient use of charitable resources because of insufficient support). Accordingly, the legal reform regarding charity governance should take account of and sometimes strike a balance between those costs.

In this context, along with the assessment of fiduciary duties in Chapter 5 and the analysis of charity accounts and reports in Chapter 7, this thesis has examined the roles of and legal rules regarding two types of supervisors. The first is key stakeholders who provide charitable resources voluntarily to charities, such as the government (Chapter 4), donors (Chapter 6) and the general public (Chapter 7). Conferring some types of supervisory rights upon those key stakeholders can reduce the costs of the charity trustees' moral hazard, and the supervisory costs of those key stakeholders (for example, the right of the public to access charity accounts and reports reduces the costs for each donor to collect information regarding the performance of charity trustees).

Second, other selected stakeholders who can make charity trustees accountable for the charitable purpose/public benefit based on a special legal arrangement (whether they provide charitable resources or not in practice), such as supervisory boards/trust supervisors as a self-regulatory mechanism of charity trustees (Chapter 5), charity members as an internal

governance mechanism (Chapter 5), and external auditors (Chapter 7). Accountability to those selected stakeholders can help reduce the costs of the charity trustees' moral hazard and the monitoring costs of key stakeholders.

In addition, this thesis also emphasises and evaluates the supportive functions of some stakeholders (including but not limited to key stakeholders), such as governmental regulators (Chapter 4), internal auditors (Chapter 5), and beneficiaries (Chapter 6). Those supportive mechanisms can play a vital role in supporting charity trustees to perform their duties and in reducing the residual loss due to insufficient support.

Meanwhile, a range of reform suggestions regarding the above governance mechanisms have been offered to further reduce the relevant agency costs in any special context or as a whole. However, the economic analysis in this thesis does not include all aspects of the legal rules regarding charity governance. Other governance mechanisms, such as self-regulation by the charitable sector itself, accountability to volunteers and supervision by the media, do not fall within the scope of this study. Accordingly, a future study is necessary to explore other governance mechanisms ensuring the sound performance of charity trustees.

Furthermore, this revised agency theory is only an initial attempt to provide a range of reasonable solutions to the problems relating to charity governance in China. Although it clarifies the roles of the charitable purpose/public benefit, key stakeholders, other selected stakeholders and charity trustees, the contents of the agency costs to be reduced, and the methods to reduce those costs, a further study is still needed to improve and develop this theory in order to provide more detailed and practical recommendations on the future legal reform in China.

In this respect, one area to be further developed concerns how to balance the rights between different types of stakeholders (such as the government and

donors) in supervising charity trustees.¹ To reduce the whole agency costs (mainly including supervisory costs due to conflicts between those stakeholders), there should be some legal rules addressing this problem. Take charitable trust governance in China for example. In the context of Chinese law, there remains a difficult question to be answered, i.e., how to balance the rights of settlors,² trust supervisors³ and governmental regulators⁴ in charitable trust governance, especially when they have totally different views in judging the performance of trustees.⁵ To reduce the supervisory costs, it may be helpful to clarify that trust supervisors are a self-regulatory mechanism of charity trustees; settlors have rights conferred by law or arising from the trust contract⁶/trust document to supervise both trustees and trust supervisors; and governmental regulators (including the courts) are the final supervisors of the performance of trustees, trust supervisors and settlors.

In addition, more empirical study is also needed to improve this revised agency theory. For example, this theory only points out the necessity of disclosing detailed information relating to remuneration and other benefits obtained by charity trustees in order to reduce the supervisory costs of the general public and donors. An empirical study is required to provide more accurate knowledge of what other information Chinese donors and the general public would like to know when deciding whether to support and fund a charity.

8.2.2 Comparative Study

In terms of the comparative analysis of charity law, with the development of charity law as an emerging research area in China, there will be an

¹ In this thesis, the rights of those stakeholders are analysed respectively in Chapters 4-7.

² The role of settlors has been examined in Chapter 6.

³ Trust supervisors have been analysed in Chapter 5.

⁴ Government regulators have been assessed in Chapter 4.

⁵ Stakeholders may often 'bargain over the best way to use the invested resources for the organization's mission--and even over the interpretation of the mission itself'. Gerhard Speckhacher, 'Nonprofit Versus Corporate Governance: An Economic Approach' (2008) 18(3) *Nonprofit Management & Leadership* 295, 313.

⁶ In China, a trust can be created by a contract ('trust contract'). TL 2001 (China), s 8.

increasing need for scholars, especially Chinese scholars and foreign scholars interested in Chinese charity law, to have a comparative analysis of Chinese law and laws in any other jurisdiction. In this respect, this thesis can form a basis for, or at least provide related knowledge or experience to, any further comparative study.

Meanwhile, from a comparative perspective, this thesis, with its focus on several aspects of charity governance, is only a start in carrying out a comparative study of charity law in China and England. A range of interesting subjects relating to charity law do not fall within this study's remit and thus are not dealt with comprehensively, such as how to understand public benefit,⁷ how to regulate the trade, investment and public fundraising of charities, and how to address the problems regarding governmental funding. Furthermore, even for the subjects that have been discussed in this thesis, such as charity regulators, charity accounts and accountability to donors, any further specific study would be beneficial to deepening the understanding of how those governance mechanisms work under different legal, political and social circumstances.

8.3 Governmental Regulation and Agency Costs

8.3.1 Abandoning the Traditional Strict Control Approach

In contrast to English law which allows and protects the establishment and independent governance of charities, the traditional 'dual administrative system' in China strictly limits the existence of independent charities, and keeps direct control over the internal governance issues of a legally established charity, leading to the existence of a large number of government-controlled charities. The recently enacted Charity Law 2016 (China) does not fundamentally change this situation.

⁷ Although English scholars have already carried out a comparative analysis of the legal rules governing public benefit in a more detailed manner, such as Jonathan Garton, *Public Benefit in Charity Law* (OUP 2013) and Mary Syngé, *The 'New' Public Benefit Requirement: Making Sense of Charity Law?* (Hart Publishing 2015) Chapter 7, there is no similar comparative analysis of public benefit in Chinese law and English law.

From an economic perspective, the strict limitations on the establishment and governance of charities in China may lead to high agency costs in practice. For example, based on the fact that regulators frequently replace the role of charity trustees in a charity and strictly limit competition, in practice there are increased conflicts of interest arising from the dual roles of those regulators and a lack of external pressure for them to efficiently use charitable resources, resulting in high costs relating to the regulators' and charity trustees' moral hazard.

Accordingly, the general public and donors have to pay extra supervisory costs due to the inefficient governmental regulation in this area. In addition, the government's excessive control in the internal governance of either government-controlled or independent charities may also bring high costs of the negative effects of external intervention: it restricts the participation of potential volunteers in charity governance and the active performance of current charity trustees in realising the charitable purposes of their charities.

To reduce those agency costs relating to this restrictive regulatory approach in China, it is necessary to relax the legal limitations on the establishment of independent charities and to further protect their independent governance. This is because, in contrast to government-controlled charities, to maintain an independent charity's existence and further its charitable purpose, the charity trustees have to compete in attracting donations and voluntary participation. This will help enhance the efficient use of charitable resources and make the charity trustees more accountable, transparent and user-oriented to maintain their charity's reputation, finally reducing their moral hazard. Meanwhile, without the direct participation of regulators in the internal governance of charities, the costs of those regulators' moral hazard arising from conflicts of interest will also be greatly reduced. In addition, motivated by non-monetary factors, charity trustees in independent charities are more likely to efficiently perform in the best interests of those charities.

Accordingly, Chinese law should draw on the experience of English law, protecting the independent governance of charities and reducing the

limitations on the establishment of charities. First, all Chinese charities should be recognised as independent by law, like those in England. Charity law should protect the rights of charity trustees to govern their charity independently on the one hand and prohibit the direct control by regulators over any charity's internal governance issues on the other. On this basis, any governmental regulator, such as a professional administrative unit in China, should not directly participate in the management and administration of a charity.

Second, Chinese law should reduce any undue legal restrictions on the existence, establishment or registration of independent charities. For example, the law should detail the rules governing the registration procedures, promote fairness of the registration procedures themselves and further protect the legal rights of those unregistered non-profits which carry out charitable activities.

However, the above suggestions may be compromised in practice based on Chinese politics. Therefore, it is necessary to further discuss the political factors which may negatively affect the reforms suggested above.

8.3.1.1 Independent Governance?⁸

Given the current political system in China, to what extent charity trustees can achieve independent governance will depend on the attitude of the leadership of the Communist Party of China. Without introducing a Western democratic model, the Party and the government make political and social stability the priority of their policy. More accurately, 'maintaining economic growth with social stability has been and will continue to be [the Communist Party of China] central leadership's political priority'.⁹

⁸ Some of the above material discussing this issue has been published in Dejian Li, 'Comments on the Emerging Law on the Administration of Foreign NGOs in China: Based on Its Historical, Political, Social and Legal Contexts' (2015) 13(1) *International Journal of Charity Sector Law* 15.

⁹ Xian Huang, 'The Politics of Social Welfare Reform in Urban China: Social Welfare Preferences and Reform Policies' (2013) 18 *Journal of Chinese Political Science* 79.

On this basis, although China permits the existence of, and in more recent times promotes the development of, human rights protection,¹⁰ the rule of law,¹¹ and direct democratic electoral systems at local level,¹² the Party and the government do not accept and will prohibit any action directly challenging the authority of the fundamental political system or harming political or social stability.

In this context, as long as one new phenomenon does not negatively influence, but instead contributes to, the political and social stability, the Party and the government usually allow for or even promote its development, and accordingly adjust their previous policies in this area. Accordingly, for independent charities as well as other non-charitable non-profits:

as China continues to allow nonprofits to expand their role, the government has begun to shift the balance, opening space for nonprofits to solve social problems while maintaining control over the growth and development of civil organizations that could become a threat to societal control and stability.¹³

¹⁰ In the past, human rights were regarded as the privilege of the capitalist class and therefore could not be accepted in a socialist country such as China. However, with a long-term effort from scholars, governmental reformers and other stakeholders, human rights were accepted by the Constitutional Law 1982 (China, revised in 2004), which provides that ‘the State respects and preserves human rights’. CL 1982 (China, revised in 2004), s 33. And a host of specific measures have been put in place to protect human rights in China. Concerning human rights with Chinese characteristics, see Phil C.W. Chan, ‘Human Rights and Democracy with Chinese Characteristics?’ (2013) 13(4) Human Rights Law Review 645, 645-689.

¹¹ For example, see the Opinions of the State Council on Strengthening the Building of a Government which Complies with the Rule of Law (No.33 [2010] of the State Council) (《国务院关于加强法治政府建设的意见》(国发[2010]33号)). Here, it is worth noting that, there is a total difference between the rule of law (‘法治’) and the rule by law (‘法制’) in China. In principle, the rule of law means that law rather than any individual government official should govern a nation and no one is beyond the law, while the rule by law refers to the legal system as an instrument for social control. For example, see Linda Chelan Li, ‘The “Rule of Law” Policy in Guangdong: Continuity or Departure? Meaning, Significance and Processes’ (2000) 161 *The China Quarterly* 199, 199-220.

¹² For example, currently any head at the village level is directly voted for and selected by all capable villagers through a direct democratic procedure. Its legal foundation is the Organic Law of Village Committees 1998 (China, revised in 2010) (‘村民委员会组织法’). In respect of rural democracy in China, generally, see Baogang He, *Rural Democracy in China: the Role of Village Elections* (Palgrave Macmillan 2007).

¹³ Lincoln C. Chen, Jennifer Ryan, and Tony Saich, ‘Introduction: Philanthropy for Health in China: Distinctive Roots and Future Prospects’ in Jennifer Ryan, Lincoln C. Chen and Tony Saich (eds),

In this context, for charities which are aimed at providing public goods and do not damage political and social stability, so far the general attitude of the Party and the government is to allow for their existence and accordingly to reform the current laws and policies to provide a more relaxed and enabling legal environment for their development. A recent example in this respect is the enactment of the Charity Law 2016 (China).

However, although the Charity Law 2016 (China) regulates all types of charity, charities which may challenge the authority of the Party or affect the political and social stability can be reasonably expected to continue to be strictly controlled and monitored by the government in practice.

In this context, although in principle maintaining the independence of charity trustees may contribute to the reduction of agency costs relating to charity governance, the Party and the government may continue to set some extra limitations on the independent decision-making of charity trustees,¹⁴ especially those working in some charities carrying out politically sensitive activities. This will definitely make Chinese charity trustees enjoy less autonomy than those in England in practice.

8.3.1.2 Co-existence of Promoting the Establishment of Independent Charities and Maintaining the Existence of Government-controlled Charities?

In terms of promoting the establishment and development of independent charities, it has been more or less supported by Chinese legislators for a long time. For example, their encouragement of the development of independent charities has even been confirmed by an unpublished draft of charity law as early as 2006: one aim of this draft is ‘that charity should

Philanthropy for Health in China (Indiana University Press 2014) 8.

¹⁴ A recent policy in this area is the Opinions on Reforming the Regulatory System of Social Organisations and Promoting the Healthy and Orderly Development of Social Organisations (21st August 2016) (关于改革社会组织管理制度促进社会组织健康有序发展的意见), which was jointly issued by the Office of the Central Committee of the Communist Party of China and the Office of State Council. This guidance emphasises the role of any party branch (established inside a social organisation) in ensuring the political correctness of this organisation.

become more of a private venture instead of being state-controlled'.¹⁵

Ten years later, after the coming into force of the Charity Law 2016 (China), which gives a legal definition of charities, empowers organisations complying with its legal requirements to register as charities and identifies the department of civil affairs as the regulator of charitable trusts, the limitations on the establishment of independent charities in China have been gradually changed. Although the relevant laws, regulations and policies need to be revised according to the spirit and principles of this new law, the task relating to 'giving charity back to charities' can be accomplished much more easily than before.

However, although this new law does contribute to the establishment of independent charities in China, it does not mention whether government-controlled charities should be transformed into independent charities or not. In this respect, as a comparison, it is worth noting that, in reforming China's for-profit enterprise system, the policy of the Chinese leadership was not to purely transform all state-owned enterprises into privately owned enterprises. Instead, the leadership encouraged the establishment and development of privately owned enterprises on the one hand and maintained the existence and prosperity of a variety of large state-owned enterprises on the other. Therefore, it remains to be seen whether those government-controlled charities, such as Red Cross Society of China (and its branches) and Song Qingling Foundation of Henan Province mentioned several times in this thesis, will be changed into independent organisations or continue to co-exist with other newly established independent charities.

Nevertheless, although it is still uncertain how much independence charity trustees can enjoy and whether government-controlled charities will be transformed into independent charities in China, it is quite clear that, after the enactment of the Charity Law 2016 (China), charity trustees will enjoy more autonomy and there will be an increasing number of independent non-

¹⁵ Karla W. Simon, *Civil Society in China: The Legal Framework from Ancient Times to the 'New Reform Era'* (OUP 2013) 271-272.

profits to be registered and recognised by the government as charities.

8.3.2 Implementing Modern Regulatory Principles

In terms of governmental regulation, purely ensuring the autonomy of charity trustees is insufficient to reduce agency costs. To further control the agency costs in respect of governmental regulation, it is necessary to promote efficient regulation. One good approach is to clarify and further implement the basic regulatory principles relating to charity regulation, which, this thesis argues, include co-operative, proportional and accountable regulation, along with balancing the supportive and regulatory roles of charity regulators. Those ideas should be incorporated into Chinese law and the specific regulatory mechanisms implementing them should also be put in place.

8.3.2.1 Co-operative Regulation

In terms of co-operation between different regulators, although both England and China have to tackle a variety of problems, such as a lack of efficient co-operative supervisory mechanisms, China is facing more challenges due to the existence of a large number of professional administrative units with different regulatory standards or procedures.

To reduce the costs associated with the co-ordination of different regulators, the next reform in China should identify the regulatory functions, powers and duties held by different governmental regulators accurately, and further establish a range of co-operative supervisory mechanisms between those regulators, such as joint registration and information sharing mechanisms. In this respect, it is helpful for Chinese regulators to draw on the experience of the memoranda of understanding signed between the Charity Commission and other regulators, which usually detail the related contents, procedures, methods and other matters regarding information transferred to each other.

In practice, although this principle is not mentioned by Chinese charity

regulators, those regulators are gradually implementing it. Recently, a good phenomenon has emerged that, as long as an issue relating to charity regulation concerns the power or duty of another governmental regulator, the Ministry of Civil Affairs will choose to co-operate with this regulator to jointly issue a policy or guideline.

For example, on 25th August 2016, the Ministry of Civil Affairs and the China Banking Regulatory Commission jointly issued the ‘Circular on the Issues concerning Filing of Charitable Trust Documents’ (‘关于做好慈善信托备案有关工作的通知’),¹⁶ providing detailed rules relating to the filing of charitable trust documents. This can assist in reducing the conflicts between the department of civil affairs (regulating charitable trusts) and the China Banking Regulatory Commission (regulating all trusts).

In addition, on 11th October 2016, the Ministry of Civil Affairs, the Ministry of Finance, and the State Administration of Taxation jointly issued the ‘Rules on the Annual Expenditure and Management Expenses for Charitable Activities of Charities’ (‘关于慈善组织开展慈善活动年度支出和管理费用的规定’),¹⁷ clarifying the requirements carried out by those three regulators who have the power relating to charities’ expenditure and expenses.

In contrast to the lack of co-operation between the department of civil affairs of Henan Province and other regulators in investigating the charity scandal relating to Song Qingling Foundation of Henan Province, which was discussed in Chapter 4, those measures will definitely relax the conflicts between regulators and reduce the related co-operative costs in the future.

¹⁶ Circular on the Issues concerning Filing of Charitable Trust Documents (25th August 2016) <<http://www.mca.gov.cn/article/zwgk/mzyw/201608/20160800001587.shtml>> accessed 20 September 2017.

¹⁷ Rules of Taxation on the Annual Expenditure and Management Expenses for Charitable Activities of Charities (11th October 2016) <<http://xxgk.mca.gov.cn:8081/newgips/contentSearch?id=82663>> accessed 20 September 2017.

8.3.2.2 Proportional and Accountable Regulation

In terms of the principles of proportionality and accountability, although regulators in both jurisdictions are facing several problems in improving their performance (such as undue intervention in the decision-making of charity trustees in some circumstances), English law and practice perform better than those in China.

For example, English law provides that those two principles should be complied with by the Charity Commission,¹⁸ and establishes a special tribunal to make the Commission accountable. In addition, the Charity Commission takes a risk-based approach in supervising charity trustees and provides comprehensive public disclosure of its reports, guidance and related information. All those measures, if effectively implemented, can reduce the costs of the regulators' moral hazard, their supervisory costs, and the costs of the negative effects of external intervention.

Therefore, Chinese regulators should take the Charity Commission's risk-based regulatory approach, assessing the risks proactively and responding to the related problems effectively. Furthermore, to strengthen the accountability of the government in order to reduce its moral hazard in regulating charity trustees, the law should require governmental regulators to disclose more detailed, timely and accurate information to the general public on the one hand and provide charity trustees with effective legal remedies, in particular low-cost and user-friendly judicial mechanisms, on the other.

However, in contrast to co-operative regulation and governmental support (as noted below), it may be more difficult for the Chinese government to implement those two principles in practice. This is because, in terms of charity regulation, the government took a strict control approach for a long time, so it is difficult to change the traditional ideas, methods and systems in

¹⁸ CA 2011, s 16.

this area within a short period, and it is also very challenging for governmental officials working in the department of civil affairs to accumulate new skills and experience associated with proportional and accountable regulation. That may be a very important reason why the Ministry of Civil Affairs organised a range of training courses and seminars relating to the new charity law for its staff,¹⁹ including sending a delegation to visit the Charity Commission, as noted in Chapter 1.

In addition, because there was neither a legal definition of charity nor a specific regulatory procedure governing charity regulators in China until the enactment of the Charity Law 2016 (China), even judges have little, if any, experience in identifying a charity or monitoring the misconduct of charity regulators. Accordingly, it is necessary to carry out a further investigation of whether the current court system can provide effective judicial remedies to charity trustees when they seek to challenge the decisions of charity regulators in accordance with this new law.

Despite this, it is forecast that the Chinese leadership is abandoning its traditional separated supervisory functions within the Community Party of China and the government, and instead is establishing a comprehensive Committee for Inspection of State Affairs (‘国家监察委员会’) at the national level to strengthen the accountability of governmental regulators themselves.²⁰ In terms of charity regulation, a further investigation is needed to assess to what extent this new institutional arrangement will encourage the department of civil affairs to take a more proportional and accountable approach.

8.3.2.3 Governmental Support

¹⁹ China Community Newspaper, ‘What Has the Ministry of Civil Affairs Done to Implement the Charity Law 2016’ *China Community Newspaper* (Beijing, 6 September 2016) <<http://mzzt.mca.gov.cn/article/qgmzxxcsf/mtpl/201609/20160900886170.shtml>> accessed 20 September 2017.

²⁰ Shu Wang and others, ‘The Timetable to Establish the National Committee for Inspection of State Affairs Has Been Clarified’ *The Beijing News* (Beijing, 20 January 2017) <<http://www.bjnews.com.cn/feature/2017/01/20/431271.html>> accessed 20 September 2017.

As regards regulators' supportive role, in contrast to the Ministry of Civil Affairs, the Charity Commission has the advantage of issuing a variety of guidance and reports to support charity trustees in governing their charity. However, due to the limited budgets, the Commission has to focus on regulatory issues.

From an economic perspective, governmental support may not lead to costs arising from the negative effects of external intervention but instead will help reduce the residual loss by supporting charity trustees to efficiently use charitable resources. Meanwhile, given that the development of the charitable sector in China remains in its initial stage, in contrast to England, it is more urgent for China to provide a range of supportive measures assisting charity trustees in performing their duties.

In this context, Chinese regulators should provide guidance, education and training in support of charity trustees and to encourage capable volunteers to act as charity trustees. Of course, Chinese regulators should draw on the lessons of the Charity Commission, which misinterpreted legal rules governing public benefit in its previous guidance. In this respect, Chinese regulators should clarify the legal requirement and the recommended practices in their guidance, in support of charity trustees to efficiently perform their duties. In the meantime, to reduce the supporting costs of governmental regulators, charity umbrella organisations and other professional organisations in China can be stimulated to play a more active role in supporting charity trustees in order to ensure sound charity governance.

In this regard, the Ministry of Civil Affairs has made a great deal of progress in encouraging the development of charities and their charity trustees. For example, after the enactment of the Charity Law 2016 (China), it issued a number of implementation policies for this new law, detailing the rules associated with the contents and procedure of charity registration and

providing a comprehensive guideline relating to identifying charities.²¹

In addition, given that this new charity law promotes charity umbrella organisations to play a significant role in supporting charities,²² it can be expected that those organisations will also facilitate the development of charities in the future. As a matter of fact, some organisations had carried out a great deal of work in guiding the governance and operation of charities even before the implementation of this new charity law. For example, on 26th April 2014, Capital Philanthropy Federation (‘首都慈善公益组织联合会’), a non-profit incorporated association, issued the first industry standard of the charitable sector in China, i.e., the ‘*Guidelines for the Management of Charities*’ (‘慈善公益组织管理流程指引’).²³ With the establishment and prosperity of those organisations, it can be reasonably expected that they will greatly promote the ability of Chinese charity trustees to efficiently govern and manage their charities.

8.4 Other Governance Mechanisms and Agency Costs

8.4.1 Internal Governance

The focus of this thesis in this respect has been on the fiduciary duties of charity trustees and on the internal bodies supervising or supporting those charity trustees. The following discussion summarises the main points based on an economic and comparative analysis.

8.4.1.1 Fiduciary Duties

In respect of the fiduciary duties of charity trustees, in contrast to Chinese law, English law not only provides more detailed rules governing those

²¹ The related materials can be easily found on the official website of the Ministry of Civil Affairs. For example, see <<http://www.mca.gov.cn/article/yw/shjzgl/bsfw/201701/20170100003051.shtml>> accessed 20 September 2017.

²² CL 2016 (China), s 19.

²³ Ke Kan (ed), *Interpretation of the Charity Law of the People's Republic of China* (Law Press 2016) 263-264 (闾珂主编：《中华人民共和国慈善法释义》，法律出版社 2016 年版，第 263-264 页)。

duties, but also balances the costs of the charity trustees' moral hazard and the related monitoring costs in designing its rules. For example, in detailing its rules relating to fiduciary duties in both case law and statutes, English law relaxes the liability of charity trustees under some circumstances by allowing the purchase of indemnity insurance and empowering the Charity Commission to relieve the whole or part of charity trustees' legal liability. This arrangement makes English law perform better in reducing the agency costs relating to fiduciary duties. Therefore, Chinese law can draw on the experience of English law in this respect, improving its current legal rules governing fiduciary duties.

For example, Chinese law should introduce the principle of voluntary trusteeship into its legal mechanisms and clarify the exceptions to this principle and the related procedures regulating the situations in which charity trustees can obtain benefits. Meanwhile, in terms of the legal consequences for violation of fiduciary duties, Chinese law can further divide them into two types, i.e., 'liability relating to unintentional violation' and 'liability relating to intentional violation'.

Given that the first type is not associated with the serious moral hazard of charity trustees, to reduce the costs of the negative effects of external intervention (the threat of legal burdens and risks in this context), it should be reasonably limited by indemnity insurance, regulators' relief of liabilities, and other mechanisms. However, for the second type, the law should not relax the liability of charity trustees due to the existence of severe moral hazard. Instead, Chinese law should further clarify and impose the related civil and criminal consequences in order to control those costs arising from the charity trustees' moral hazard.

In addition, in contrast to English law, given its civil law tradition, China should further codify those rules governing fiduciary duties along with more detailed and unified requirements. As a matter of fact, codification of the fiduciary duties of the governing body has been done by Chinese regulators of the for-profit sector, such as the Code of Corporate Governance for Listed

Companies 2002 (China) (‘上市公司治理准则’), which was issued by the China Securities Regulatory Commission in 2002.²⁴ Therefore, in practice, charity regulators can codify those fiduciary duties by issuing policies or model governing documents with little difficulty.

However, in respect of the content of the fiduciary duties of charity trustees, it may be difficult to introduce the principle of voluntary trusteeship. Although as justified in Chapter 5, this principle contributes to the reduction of agency costs, so far it seems that neither Chinese charity regulators nor ordinary charities truly realise the significance of voluntary trusteeship in promoting sound charity governance. Meanwhile, except for the rules in the Regulation on the Administration of Foundations 2004 (China), which requires that supervisors and directors who do not serve a full-time position cannot be paid,²⁵ the Charity Law 2016 (China), along with other related laws and regulations, does not require charity trustees to be volunteers.

Despite this, given that this principle is beneficial to charity governance in China, charity regulators and charity umbrella organisations can incorporate it into part of their recommended practice, and encourage capable individuals to actively participate in charity governance as voluntary charity trustees. If this practice proves to be effective in ensuring sound charity governance and reducing the related agency costs, it will be more acceptable by the Chinese charitable sector as a whole in the future.

8.4.1.2 Internal Bodies

To reduce the agency costs relating to internal bodies supervising or supporting charity trustees, it is essential for Chinese law to further identify the role of, and reasonably design the rights and duties relating to, internal bodies in different types of charity. In this respect, the focus of this thesis was on members in membership charities (i.e., charitable associations in

²⁴ Its full content is available on the official website of the China Securities Regulatory Commission: <http://www.csrc.gov.cn/pub/newsite/flb/flfg/bmgf/ssgs/gszl/201012/t20101231_189703.html> accessed 20 September 2017.

²⁵ RAF 2004 (China), s 23.

China) and supervisory boards in charitable donated legal persons (which are incorporated non-membership organisations created by the recently enacted General Provisions of Civil Law 2017 (China) and mainly include foundations and social service institutes)/trust supervisors in charitable trusts (which are unincorporated), along with internal auditors and audit committees.

In terms of membership charities, in contrast to English law, the relationship between members and charity trustees in Chinese law is not very clear. On the one hand, in civil law jurisdictions (including China), members are usually regarded as the decision-making body in an association. On the other hand, the governance rights are often conferred on the board of directors in practice and those members themselves do not hold any personal responsibility for their decisions. From the perspective of reducing monitoring costs due to such an unclear relationship, Chinese law should clarify that in a membership charity, it is its charity trustees/directors rather than the members that govern this charity. Accordingly, those members should be regarded as an internal governance mechanism supervising the performance of the directors.

With respect to specific rules governing the rights, duties and liabilities of members, in contrast to Chinese law, English law utilises a range of more effective measures in reducing the related agency costs. For example, English law limits the scope and procedure for members to make decisions, and further clarifies the duties of members in a CIO in exercising their rights, which helps reduce the costs of the members' moral hazard, the costs relating to their collective decision-making process and other monitoring costs. Meanwhile, in contrast to Chinese law which requires any amendment to the governing document of an association to obtain consent from regulators, English law only confers the power to approve the amendment to the governing document of a CIO upon the Charity Commission in respect of 'regulated alterations', avoiding the Commission's unnecessary intervention in the internal governance issues of a membership charity and the relevant costs regarding governmental regulation. However, neither

English law nor Chinese law directly allows members to bring a derivative action against charity trustees, which, from an economic perspective, helps reduce the related agency costs.

Therefore, in reforming the legal rules governing charity members in the future, Chinese law should confirm that, in a membership charity, the decision-making rights belong to the board of directors, unless any specific requirement exists in its governing document. As to the specific requirements, the governing document should further make clear the remaining decision-making rights and procedures relating to the charity's members.

On this basis, for some major affairs which are closely associated with charity governance, such as the change of a charity's purpose or the benefit provided to charity trustees, falling within any 'regulated alteration'²⁶ in English law, Chinese law should clarify the power of charity regulators to approve. However, to reduce the costs regarding governmental regulation, this power should be limited to those 'regulated alterations' rather than all amendments to the governing document of a membership charity. Meanwhile, the supervisory rights of members, in particular the rights to take a derivative action, should be limited in order to reduce the agency costs.

Furthermore, to avoid the costs of the members' moral hazard, China can draw on the legal rules governing CIOs, requiring a charity's members to perform in good faith for its best interests in exercising their powers,²⁷ and further clarify the legal consequences for not doing so.

With regard to supervisory boards in donated legal persons and trust supervisors in charitable trusts, it is worth noting that, the dual roles (the decision-making function and the supervisory function) of charity trustees in English law, are played by different internal bodies in Chinese donated legal

²⁶ CA 2011, ss 198 and 226.

²⁷ CA 2011, s 220.

persons and charitable trusts. In those charities, the directors or trustees are responsible for the decision-making issues whilst the supervisors on the supervisory board or the trust supervisors play the supervisory role. Accordingly, it is reasonable to regard a charity's supervisory board or trust supervisors as part of its charity trustees. In this context, they are utilised by their charity as a self-regulatory mechanism of its charity trustees.

On this basis, from the perspective of reducing the agency costs relating to accountability to supervisory boards/trust supervisors, several reform suggestions are given as follows. First, given that the co-existence of supervisors and non-executive directors in a charitable donated legal person will, to some degree, increase the monitoring costs, this mechanism can only be adopted voluntarily. Second, given the role of supervisory boards in monitoring directors and reducing the supervisory costs of key stakeholders and the low monitoring costs for those boards to supervise directors, Chinese law should recognise the rights of a supervisory board to enforce the fiduciary duties of directors. Third, as part of charity trustees, supervisory boards and trust supervisors should also be monitored by the governance mechanisms supervising charity trustees, such as fiduciary duties and liabilities, to control their moral hazard.

In terms of internal audit, neither English law nor Chinese law has designed any rule governing this area. However, to strengthen the governance capacity of charity trustees and reduce the residual loss, regulators and charity umbrella organisations can issue related guidance facilitating the adoption of internal audit mechanisms and encouraging the establishment of an audit committee in larger charities.

Provided that those above reform suggestions will reduce the related agency costs of internal governance, after charity regulators realise the importance of those suggestions, most of those reforms can be carried out easily through policies or model governing documents issued by those regulators. However, in terms of several suggestions, such as transforming a supervisory board as an alternative rather than an essential internal body of donated legal persons,

they can only be realised by revising the General Provisions of the Civil Law 2017 (China). In this respect, in contrast to the policies issued by regulators, legislation may be more time-consuming and thus more difficult to put in place in the near future.

8.4.2 Accountability to Third Parties

In the context of charity governance, providing third parties with the relevant rights is not aimed at delivering private benefits to them but to ensure that trustees of a charity perform efficiently for the charity's purposes and public benefit. Accordingly, in terms of third parties' rights, it is necessary to reduce the agency costs regarding accountability to those parties. In this thesis, the term 'third parties' mainly refers to donors and beneficiaries.

8.4.2.1 Donors

In contrast to English law, Chinese law not only recognises *inter vivos* donations (which do not include initial donations of the founders of a donated legal person) as contracts ('donation contracts'), but also confers a variety of legal rights upon donors to directly or indirectly supervise charity trustees' performance. This arrangement may result in higher agency costs associated with accountability to donors. To reduce those costs, Chinese law should improve its current rules in the following aspects.

First, to deal with donations which may bring legal or moral risks to a charity, the law should make clear that a donation contract should not conflict with the charity's charitable purposes or the fiduciary duties of its charity trustees, otherwise the charity trustees should perform their fiduciary duty to refuse this donation. Second, charitable donors should have similar fiduciary duties to charity trustees in exercising their decision-making or supervisory rights in order to reduce their moral hazard and the related monitoring costs. Meanwhile, if charities do not perform their duties as required by a donation contract, the law should allow donors to transfer the

property to another organisation with similar purposes rather than empower them to recover the donated property directly.

Third, in respect of the cy-près principle, to reduce the costs of the negative effects of external intervention (inefficient use of charitable resources due to strict compliance with the terms and conditions regarding a donation) and the costs of the regulators' moral hazard, Chinese law should draw on the experience of English law, expanding the occasions when the cy-près scheme can be applied and providing the factors regulators should consider in applying this principle. Meanwhile, to control the moral hazard of donors or their heirs, the legal rights of donors to approve the change of purpose of the donated property currently recognised by Chinese law should not be given in the future.

Of course, it is worth noting that, although the above suggestions may help reduce the agency costs relating to the participation of donors in charity governance, they may also curb potential donors' enthusiasm for charitable donations. Hence, a further study is necessary to evaluate to what extent a more restrictive approach regarding donors' role in charity governance will negatively affect their motivation to make a donation as well as the amount of the donation.

8.4.2.2 Beneficiaries

With regard to accountability to beneficiaries, the law in both jurisdictions does not directly give beneficiaries the rights to enforce the fiduciary duties of charity trustees. In practice, English beneficiaries may deploy the 'charity proceedings' and the 'persons affected' rule (which is mainly aimed at making the Charity Commission accountable) to supervise charity trustees indirectly, whilst Chinese beneficiaries of donated legal persons may make use of the 'other interested persons' rule to enforce the duties of charity trustees.

However, both English law and Chinese law take a restrictive approach in

allowing beneficiaries to use those governance mechanisms. For example, the ‘charity proceedings’ need prior approval by the Charity Commission; a legal suit relating to the ‘persons affected’ rule should be brought against the Charity Commission first. Meanwhile, the scope of decisions, directions and orders that can be challenged is also limited. In addition, the ‘other interested persons’ rule recently created by the General Provisions of the Civil Law 2017 (China) only applies to donated legal persons.

Nevertheless, in Chinese law, there is no further explanation of who constitutes ‘other interested persons’. Therefore, an investigation of how the Chinese courts will identify ‘other interested persons’ and whether the courts will identify all beneficiaries or only part of them as ‘other interested persons’ should be carried out in the future.

From an economic perspective, it may be too costly to use beneficiaries as a governance mechanism enforcing the fiduciary duties of charity trustees. First, they are not key stakeholders (voluntary financial supporters) of a charity. Therefore, in contrast to key stakeholders, they are more likely to be concerned about the private benefits they can receive from a charity rather than the best interests of this charity, leading to high costs of moral hazard.

Second, in contrast to other selected stakeholders in this thesis, such as charity members, supervisory boards/trust supervisors and external auditors, beneficiaries of a charity are usually uncertain or may be the general public if their charity is aimed at benefiting the society as a whole. In this context, allowing beneficiaries to enforce the fiduciary duties of charity trustees may result in a similar result to empowering all members of the public to enforce those duties: high monitoring costs.

Third, there are a range of other governance mechanisms monitoring charity trustees, such as governmental regulation, accountability to members and supervisory boards/trust supervisors, contract supervision by donors, and public access to information in Chinese law. Conferring this right on beneficiaries may unnecessarily increase the monitoring costs regarding

charity governance as a whole. Accordingly, to reduce the related monitoring costs, Chinese law should deny or limit the rights of beneficiaries to directly enforce the fiduciary duties of charity trustees.

Meanwhile, in contrast to their supervisory function, the supportive role of beneficiaries may not bring many costs (mainly including costs relating to the establishment and implementation of supportive mechanisms) but can assist charity trustees in efficiently performing their fiduciary duties in order to reduce the residual loss. Hence, a charity can build related mechanisms facilitating its beneficiaries' role in supporting charity governance, such as allowing the beneficiaries to act as the charity's advisors or non-voting members or improving its current complaints procedure to effectively tackle the feedback and needs of the beneficiaries in order to support its charity trustees' effective decisions.

8.4.3 Public Accountability

Given that the public is very unsatisfied with the charitable sector in China in terms of accountability and transparency,²⁸ China can draw on some experience in English law, and establish a comprehensive system governing accounting, reporting, auditing and disclosure of information in relation to charities in order to maintain public confidence in this sector and reduce the related monitoring costs of the whole society. Meanwhile, this system itself must be improved in a cost-effective manner.

8.4.3.1 Financial Reports and Annual Work Reports

With respect to the accounting and reporting system, in contrast to English law, Chinese law does not perform well in promoting the comparability,

²⁸ For example, see Rachel Wang, 'Why No One Trusts Government Charities in China Anymore' *The Atlantic* (Washington, 13 May 2013) <<http://www.theatlantic.com/china/archive/2013/03/why-no-one-trusts-government-charities-in-china-anymore/273989/>> accessed 20 September 2017; Weiyun Tan, 'China's Charities Confront Public Trust Crisis' *Shanghai Daily* (Shanghai, 8 April 2015) <<http://www.shanghaidaily.com/feature/news-feature/Chinas-charities-confront-public-trust-crisis/shdaily.shtml>> accessed 20 September 2017.

relevance and understandability of information regarding financial reports and annual work reports, all of which are mainly aimed at better satisfying the information needs of the general public and other key stakeholders.

For example, Chinese law neither includes charitable trusts in its accounting and reporting system, nor unifies the relationship between financial reports and annual work reports, making it difficult for members of the public to compare information contained in charity accounts and reports between different charities.

In addition, Chinese law neither details the rules governing the information associated with remuneration and other benefits obtained by charity trustees, nor strengthens the requirements on larger charities, which cannot help the general public and other key stakeholders to make decisions based on an effective assessment of the performance of charity trustees in all charities (in respect of the issues relating to remuneration and benefits) or specific charities (with regard to larger charities).

Furthermore, Chinese law does not require charity trustees to explain how they realise the public benefit their charity aims to deliver in their charity accounts and reports, making it more difficult for key stakeholders to understand and further evaluate their performance.

To tackle those problems, Chinese law can draw on the experience of English law. First, it can enhance the comparability of information by applying the charity accounting and reporting system to all charities, including charitable trusts, and further clarifying and unifying the relationship between financial reports and annual work reports. Second, to promote the relevance of information, Chinese law should provide the rules governing the information regarding remuneration and other benefits obtained by charity trustees and the information concerning larger charities in a more detailed manner. Third, Chinese law should further develop a narrative report (or transform the current annual work report of a charity) to facilitate the general public to better understand how charity trustees

perform in the best interests of their charity.

8.4.3.2 Charity Auditing

In respect of charity auditing, English law is more cost-effective than Chinese law in reducing the supervisory costs of key stakeholders and balancing those costs with other costs. For example, in England, there is a unified regulatory system governing charity audit, the '*Practice Note 2011: the Audit of Charities in the United Kingdom*', in support of external auditors in performing their duties. In the meantime, it requires organisations which fall within 'larger charities' to be audited, which not only helps reduce the supervisory costs of the general public in monitoring those larger charities, but also avoids excessive costs relating to the negative effects of external intervention on a number of smaller charities.

By contrast, there is no unified regulatory system governing the external auditing of charities in China, which negatively affects the efficient performance of external auditors in overseeing charity trustees. Meanwhile, in China the scope of charities to be audited is limited to public fundraising charities, which means larger charities that do not carry out public fundraising activities do not need to be audited. This arrangement may increase the costs of the charity trustees' moral hazard in those larger charities which are not public fundraising charities. To deal with those problems, China should build a special framework focusing on the regulation of charity auditing, and meanwhile extend the scope of charities to be audited to include larger charities.

8.4.3.3 Public Access to Information

With respect to public access to information, in contrast to Chinese law, English law clarifies the duties of charity trustees to disclose information to the public and the specific methods, which helps reduce those charity trustees' moral hazard and the supervisory costs due to unclear disclosure methods. Meanwhile, English law also incorporates most of the information

to be disclosed into charity accounts and reports, reducing the supervisory costs of the general public and the costs of the negative effects of external intervention due to different requirements on the contents of information to be disclosed.

Therefore, China should clarify the duty of charity trustees in preparing, submitting and disclosing financial reports and annual work reports, specify the methods to disclose this information, and further integrate information required by law to be made public into the contents of financial reports and annual work reports. In the future, those suggestions can be implemented easily if legislators or governmental regulators realise the fact that those methods can help reduce the related agency costs relating to charity governance.

Meanwhile, in view of the previous poor performance of Chinese charities in terms of information disclosure, it is also helpful to encourage charity trustees to voluntarily disclose related information to the general public, in particular when their charities are facing a serious trust crisis or reputational risk. This will definitely reduce the supervisory costs of the whole society and help maintain public trust in those charities.

However, this suggestion seems very difficult for either government-controlled charities (such as Red Cross Society of China and its branches at local level)²⁹ or independent charities (such as Smile Angel Foundation) to carry out, at least based on recent trust crises. This may be a big obstacle for the general public to trust Chinese charities as a whole. In this context, it is necessary to have a further study of why Chinese charities are often reluctant to make voluntary disclosures to the public, especially when they suffer public distrust, although this study has been beyond the scope of this research.

²⁹ Yajun Hu, '80 Percent of Red Cross Societies Refused to Disclose Information' *21st Century Business Herald* (Guangzhou, 20 July 2011) <http://gongyi.ifeng.com/news/detail_2011_07/20/7813435_1.shtml> accessed 20 September 2017.

8.5 Overall Conclusion

In developing a multilevel social welfare system, charities will play a significant role in providing public goods to the general public or any subgroup of it in China. However, the current governance system regulating charity trustees in China is inefficient to tackle charity scandals in practice as well as low public trust and confidence in the charitable sector. Against this background, this thesis has sought to deploy an economic and comparative approach to evaluating the current legal rules regarding charity governance in England and China, and further points out a range of more reasonable measures to improve Chinese law and practice in this respect.

However, an economic and comparative analysis should not be the only approach to be taken in studying Chinese charity law and practice. Other perspectives,³⁰ such as civil society, democracy and freedom of religion, can be critical in evaluating or designing the legal rules governing some special types or areas of charity in the future, and thus are worth further studying.³¹

Nevertheless, given that the development of China's charity law is still in its initial stage,³² an economic analysis (aimed at reducing agency costs in ensuring compliance) along with a comparative study of English law and practice can at least bring new ideas and approaches to assist legislators, regulators, the charitable sector and the general public in rethinking the current legal framework regarding charity governance in China.

Hopefully, although as noted above, some of the specific reform suggestions in this thesis may have to be compromised by certain political and social issues in practice, this study may contribute to the future legal reform in

³⁰ For example, see Chris Cornforth and William A. Brown (eds), *Nonprofit Governance: Innovative Perspectives and Approaches* (Routledge 2014); Lloyd Hitoshi Mayer and Brendan M. Wilson, 'Regulating Charities in the Twenty-first Century: An Institutional Choice Analysis' (2010) 85 *Chicago-Kent Law Review* 479, 479-550.

³¹ A good example in this respect is Matthew Harding's *'Charity Law and the Liberal State'* (CUP 2014), although this book does not deal with Chinese charity law.

³² China did not have a comprehensive charity law until the enactment of Charity Law 2016 (China). However, even this law mainly deals with principles rather than detailed rules regulating charities and charitable activities.

relation to charity governance, the healthy development of an increasingly expanding charitable sector in China and any further academic research on Chinese charity law.

Appendix I: List of Tables

Chapter 1

Table 1 The Increasing Number of Registered Non-profits in China

Chapter 5

Table 2 Main Types of Board Structures of For-profit and Charitable Organisations in England and China

Appendix II: Translation of Important Terms Used in this Thesis

English	Chinese Characters
annual work reports	年度工作报告
associations	社会团体
audit committee	审计委员会
being attached to	挂靠
board of directors	理事会
charitable activities	慈善活动
charitable aims	慈善宗旨
charitable purposes	慈善目的
charities	慈善组织
charity governance	慈善组织治理
charity law	慈善法
charity trustees	慈善组织托管人
civil non-commercial units	民办非企业单位
decision-making bodies	决策机构
department of industrial and commercial administration	工商部门
department of civil affairs	民政部门
dual administrative system	双重管理体制
donated legal persons	捐助法人
donors	捐赠人/赠与人
executive bodies	执行机构
external auditors	外部审计师
financial reports	财务会计报告
foundations	基金会
founders	捐助人/创立人
government-controlled charities	政府控制的慈善组织
independent charities	独立的/民间慈善组织

initiators	发起人
intentional violation	故意违反
internal auditors	内部审计师
law	法/法律
major donors	主要捐赠人
managers	管理人员
members	社员/成员/会员
members of the governing body	治理机关成员
Ministry of Civil Affairs	民政部
‘open one eye, and close the other one’	睁一只眼闭一只眼
organisations	组织
planned economy	计划经济
professional administrative units	业务主管单位
public benefit	公共利益/公益
public institutions	事业单位
‘Reform and Opening Up’	改革开放
registration and administration regulators	登记管理机关
responsible persons	负责人
‘self-governance of private law’	私法自治
social organisations	社会组织
social service institutes	社会服务机构
sponsor units	挂靠单位
supervisors (who have the rights to make charity trustees accountable for the charitable purpose/public benefit) defined in this thesis	监督者
supervisory board/supervisors in a donated legal person	捐助法人中的监事会/ 监事
trust supervisors	信托监察人
unintentional violation	过失违反

Appendix III: Abbreviations for Statutes and Regulations Frequently Cited in this Thesis

Year	Title	Abbreviation
2017	General Provisions of the Civil Law 2017 (China)	GPCL 2017 (China)
2016	Charities (Protection and Social Investment) Act 2016	CPSIA 2016
2016	Charity Law 2016 (China)	CL 2016 (China)
2011	Charities Act 2011	CA 2011
2010	Equality Act 2010	EA 2010
2006	Charities Act 2006	CA 2006
2004	Regulation on the Administration of Foundations 2004 (China)	RAF 2004 (China)
2001	Trusts Law 2001 (China)	TL 2001 (China)
1999	Contract Law 1999 (China)	CL 1999 (China)
1999	Public Benefit Undertakings Donations Law 1999 (China)	PBUDL 1999 (China)
1998	Provisional Regulation on the Registration and Administration of Civil Non-commercial Units 1998 (China)	PRRACNU 1998 (China)
1998	Regulation on the Registration and Administration of Associations 1998 (China, revised in 2016)	RRAA 1998 (China, revised in 2016)
1993	Company Law 1993 (China, revised in 2013)	CL 1993 (China, revised in 2013)
1982	Constitutional Law 1982 (China, revised in 2004)	CL 1982 (China, revised in 2004)
1979	Criminal Law 1979 (China, revised in 2015)	CL 1979 (China, revised in 2015)

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McGovern v Attorney General [1982] Ch 321
Mead's Trust Deed, Re [1961] 2 All ER 836
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