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**Reforming the governance of Chinese non-profits: a comparative analysis based  
on the UK's regulatory regime**

By Ruoqi Li

*Submitted in accordance with the requirements for the degree of Doctor of Philosophy*

Durham Law School  
Durham University  
2017

## **Abstract**

China has witnessed a proliferation in the number of non-profits over the past two decades. As the ‘third sector’ that sits between the government, on the one hand, and commercial/for-profits, on the other, non-profit organisations have helped generate revenue for the Chinese Government, increased the number of jobs in this sector and delivered a wide variety of essential services. Notwithstanding these benefits, however, non-profits in China are unlikely to fulfil the increased social, economic or cultural expectations placed upon them, unless their own governance and infrastructure mechanisms are efficient, functional and well-designed.

This throws up important and difficult questions about the role (and design) of board governance for non-profits in modern China. To answer these questions, the thesis seeks to develop an account of what contribution a board can make to the effective governance of non-profits in China, and how certain features of a board might be designed to achieve that. However, whilst the UK benefits from an abundance of academic literature, and regulatory experience, addressing non-profit governance, the Chinese non-profit sector, by contrast, has given such governance much less attention. Hence, this work provides a comparative study on non-profit board governance, drawing on the UK’s richer literature, thought and history in order to analyse better the challenges which China presents.

Within this comparison, a number of social and political characteristics will be emphasised which distinguish the Chinese non-profit sector from that of the UK. Of crucial importance here is the interplay between board governance and social determinants in the Chinese context, especially the relationship between the sector and the Chinese Government. In short, then, the overarching goal of my thesis is to develop a blueprint for an effective board for non-profits, which can be adapted to the distinctive characteristics of the Chinese non-profit sector, and against which current board regulatory requirements in China can be measured.

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## **List of legislations**

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s6

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s214 (4)(a)

Companies Act 2006  
s 5 (3); s154; s172(1); s173; s 174 (1); s 174 (2); s174 (2)(a) and (b); s175 (5); s248-249

Charities Act 2011  
s11; s172; s177; s 178; s179; s180; s188; s 205 (2); s 206 (2)

Trustees Act 2000  
Ch 29, pt1, s1

### **Statutory Instruments**

The Companies (Model Articles) Regulations 2008 (SI 2008/3229)

The Charitable Incorporated Organisations (General) Regulations 2012 (SI 2012/3012)

### **Chinese Statutes**

The Charity Law 2016  
s3 (1); s5; s9; s18(3); s76, s77

General Principles of Civil Law 1988  
s6

People's Republic of China Criminal Law  
s93

### **Chinese Statutory Instruments**

The Regulations on the Management of Foundations  
reg 2 (5); reg 2 (20); reg 3 (1); reg 3 (2); reg 4 (1); reg 5 (3); reg 6 (34); reg7; reg 9 (4);  
reg 22

Regulations on the Registration and Administration of Social Organisations  
reg2; reg3 (29); reg 6; reg10 (1); reg10; reg 11; reg13 (2); reg19; reg 27

Temporary Regulations on Registration and Administration of Civil Non-business  
Institutions  
reg 1; reg 6; reg 7; reg 8 (1)

Measures for the Administration of Foundations  
reg 3 (2)

Donation Law 1999  
reg 3

### List of Technical Abbreviations

Abbreviation	Meaning
NPO	Non-profit Organisations
RD	Resource Dependence
CSR	Corporate Social Responsibility
NICVA	the North Ireland Council for Voluntary Action
CLG	Company Limited by Guarantee
CIO	Charitable Incorporated Organisation
ICNPO	International Classification of Non-profit Organisations
IPS	Industrial and Provident Society
CIC	Community Interest Company
PAPB	Private Action, Public Benefits
OECD	The Organisation for Economic Co-operation and Development
NCVO	the National Council for Voluntary Organisations
SO	Social Organisations
CNI	Civil Non-business Institutions
MoCA	the Ministry of Civil Affair
GONGOs	Government Organized Non-profits
NPC	National People's Congress
INGOs	International Non-governmental Organisations
IP	Intellectual Property
SOEs	State-Owned Enterprises

## **Declaration**

I hereby declare that no portion of the work that appears in this study has been used in support of an application of another degree in qualification to this or any other university or institutions of learning.

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## **Acknowledgment**

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## Chapter 1 | Introduction

### 1.1 Background

The not-for-profit or non-profit sector has witnessed a burgeoning in public interest over the course of recent decades.<sup>1</sup> It has been repeatedly championed as a ‘third sector’ that sits between the government/public sector, and the commercial/for-profit market,<sup>2</sup> and succeeds in making up for at least some of the deficiencies of each of these others. Academics and policy makers proclaim its invaluable contribution to the social and economic life of society.<sup>3</sup> To take just the UK as an example, according to the *UK Civil Society Almanac 2016*,<sup>4</sup> there were approximately 163,000 charities alone in the UK with net assets of approximately £105.1 billion in 2013/2014.<sup>5</sup> The income of charities, which is the most typical form of non-profit organisation, represented over £64 billion in England and Wales until 2014.<sup>6</sup> Alongside this, the *Voluntary Sector Almanac 2016* reported considerable growth in both the number of non-profit organisations in the UK, as well as in that of their income over the past several years.<sup>7</sup> It would seem apparent this has nearly doubled when compared to estimations in 2010, which document a sector income of over £36.7 billion.<sup>8</sup>

Moreover, to cast non-profits merely in terms of their *financial* contribution would also take too limited a view of what such organisations achieve. For non-profits have proved to be of immense *social* value too, in a variety of important and novel ways. The most common among these have been the contribution of UK non-profits to the provision of

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<sup>1</sup> D O Renz, *The Jossey-Bass Handbook of Nonprofit Leadership and Management* (John Wiley & Sons 2016); M E Romero-Merino and Í García-Rodríguez, 'Good Governance in Philanthropy and Nonprofits' (2016) *The Routledge Companion to Philanthropy* 395, 402

<sup>2</sup> Non-profits can be subdivided into various types based on different standards. According to legal forms: trusts, unincorporated associations, or corporate bodies. According to their funding sources, non-profits can be classified as commercial and donative non-profits.

<sup>3</sup> V A Hodgkinson and M S Weitzman, *Dimensions of the Independent Sector: A Statistical Profile* (Independent Sector 1986)

<sup>4</sup> It is the leading annually resource which draws together trends, facts and information, both from the NCVO's own research and other latest data.

<sup>5</sup> S Etherington, *The UK Voluntary Sector Almanac 2016: The State of the Sector* (NCVO, 2016) <<https://www.vonne.org.uk/sites/default/files/files/resources/Intro%20and%20overview.pdf>> accessed 13 September 2016

<sup>6</sup> *ibid*

<sup>7</sup> In 2013/14, there was a notable rise in the number of organisations with an income over £100m.

<sup>8</sup> D K O Reichardt, and K Wilding, *The UK Voluntary Sector Almanac 2010: The State of the Sector* (NCVO 2010) 9

social services (18%), cultural and recreational services (14%) and religious activities (8%), to name just a few.<sup>9</sup> Although the private sector and public sector both, of course, deliver important financial and social benefits, each also possesses a number of alleged serious limitations when compared to non-profits. These points will explore more fully in Chapter 2, but two examples will serve to illuminate the point. Private enterprise being almost entirely driven by profit, cannot be relied on to undertake certain activities, such as pollution control or consumer health and safety protections, which consumers may value highly, but which cannot be delivered profitably.<sup>10</sup> Similarly, the public sector is often the subject of political pressures that render it vulnerable to well-organized demands from industry and other pressure groups, or under-responsive to the interests of poorly organized groups, such as consumers.<sup>11</sup>

To be sure, as Chapter 2 will concede, non-profits do possess shortcomings of their own. Nevertheless, in contrast with purely commercial orientated programs, non-profits seem to enjoy a clear advantage in serving important social and cultural aims, whilst also pursuing commercial or business related objectives—a commitment neither a wholly private sector nor public sector organisations are often adequately positioned to fulfil.<sup>12</sup>

These heightened claims for, and expectations of, non-profits have, unsurprisingly led to an increased focus on the way in which non-profits actually operate and perform. And as part of this, increased attention has been given to, specifically, their *governance*.<sup>13</sup> By governance here is meant those systems of control which are designed to ensure that a non-profit fulfils its objectives.<sup>14</sup> Questions of organisational governance have been prominent in recent years, both in respect of for-profit enterprises and non-profits.<sup>15</sup> Notwithstanding many of the aforementioned benefits,

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<sup>9</sup> R Keen, *Charity and the Voluntary Sector: Statistics* (2015) 5

<sup>10</sup> H K Anheier, *Nonprofit Organizations: Theory, Management, Policy* (Routledge 2014); and see further in Chapter 2.

<sup>11</sup> See Anheier, *ibid*

<sup>12</sup> B A Weisbrod, *The Voluntary Nonprofit Sector: An Economic Analysis* (Lexington Books 1977)

<sup>13</sup> Anheier, (n10); I Filatotchev and C Nakajima, 'Corporate Governance, Responsible Managerial Behavior, and Corporate Social Responsibility: Organizational Efficiency Versus Organizational Legitimacy?' (2014) 28 *The Academy of Management Perspectives* 289

<sup>14</sup> C Mallin, *Corporate Governance* (Oxford University Press 2016); J A Miles, *Management and Organization Theory: A Jossey-Bass Reader*, vol 9 (John Wiley & Sons 2012)

<sup>15</sup> Renz, (n1)

non-profit organisations are unlikely to entirely fulfil the increased social, economic or cultural expectations placed upon them, unless their own governance and infrastructure mechanisms are efficient, functional and well-designed.

A governance regime for any organisation encompasses a wide range of both legal and non-legal mechanisms designed to ensure the organisation's effective fulfilment of its objectives.<sup>16</sup> To study them all would be beyond the scope of a single work. However, the board of directors is undoubtedly one key element of any organisation's governance system, and it is the board which forms the focus of this thesis.<sup>17</sup> In a nutshell, then, the thesis seeks to develop an account of what contribution a board can make to the effective governance of non-profits and, how certain features of a board might be designed to achieve that. Moreover, it seeks to adapt and then apply this theoretical blueprint to non-profits in one particular country, namely contemporary China, and to measure the extent to which China's currently regulatory structure for non-profits satisfies the requirements of this blueprint. Let me unpack and expand a little on these aims.

What does an effective non-profit board look like? What should it do? What should be its membership and characteristics? The first major task of the thesis is to address these questions. In seeking to do that, two problems immediately arise. The first is that, despite a wealth of literature addressing good board design for for-profits,<sup>18</sup> even for that sector there has been little agreement among either academics or commercial practitioners as to what an 'ideal board' might look like.<sup>19</sup> Some even question whether

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<sup>16</sup> C Caldwell and M H Hansen, 'Trustworthiness, Governance, and Wealth Creation' (2010) 97 *Journal of Business Ethics* 173; P M Guest, 'The Impact of Board Size on Firm Performance: Evidence from the UK' (2009) 15 *The European Journal of Finance* 385; P M Guest, 'The Determinants of Board Size and Composition: Evidence from the UK' (2008) 14 *Journal of Corporate Finance* 51

<sup>17</sup> J L Coles, N D Daniel and L Naveen, 'Boards: Does One Size Fit All?' (2008) 87 *Journal of Financial Economics* 329; G O Jobome, 'Management Pay, Governance and Performance: The Case of Large UK Nonprofits' (2006) 22 *Financial Accountability & Management* 331; J Kaler, 'Differentiating Stakeholder Theories' (2003) 46 *Journal of Business Ethics* 71

<sup>18</sup> C Weir, D Laing and P J McKnight, 'Internal and External Governance Mechanisms: Their Impact on the Performance of Large UK Public Companies' (2002) 29 *Journal of Business Finance & Accounting* 579; E W Orts and A Strudler, 'The Ethical and Environmental Limits of Stakeholder Theory' (2002) 12 *Business Ethics Quarterly* 215; M Tan and B Liu, 'CEO's Managerial Power, Board Committee Memberships and Idiosyncratic Volatility' (2016) 48 *International Review of Financial Analysis* 21; G P Martin, R M Wiseman and L R Gomez-Mejia, 'The Interactive Effect of Monitoring and Incentive Alignment on Agency Costs' (2016) *Journal of Management* 14

<sup>19</sup> J Ma and Y Jing, 'Mission Alignment as a Substitute or Incentive: How Nonprofits Utilize the Alignment between Mission Statement and Daily Operation' (2017)



a board really matters or has much impact on the actual operation of companies.<sup>20</sup> For some, boards are in many cases regarded as little more than a ‘rubber-stamp’ function within the governance and management of companies,<sup>21</sup> or simply an apparatus of legal necessity (something akin to the wearing of wigs in English courts; a rule only followed because it is a requirement).<sup>22</sup>

I shall argue that such a view of the board is untenable: when things go wrong, the board naturally become the point of focus, and rightly the very centre of public attention.<sup>23</sup> Examples of this can be observed in the commercial context, such as scandals involving Volkswagen and emissions,<sup>24</sup> FIFA and corruption,<sup>25</sup> Toshiba and accounting,<sup>26</sup> and BHS with pensions and ‘greed’ allegations.<sup>27</sup> Boards matter, in other words. To be sure, given that the functioning of a board depends to some extent on an organisation’s individual characteristics, type or feature, board design must vary in some measure to reflect such differences: there cannot be a ‘one size fits all’ approach.<sup>28</sup>

However, this merely brings us on to our second problem: we cannot even safely transpose our limited knowledge of for-profit boards onto non-profit boards, about

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<[https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2915677](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2915677)> accessed 13 March 2017; M J Worth, *Nonprofit Management: Principles and Practice* (Sage Publications 2016)

<sup>20</sup> Worth, (n19)

<sup>21</sup> *ibid*

<sup>22</sup> C Marquis and M Lee, 'Who Is Governing Whom? Executives, Governance, and the Structure of Generosity in Large Us Firms' (2013) 34 *Strategic Management Journal* 483, 493

<sup>23</sup> C Cornforth and N Chambers, 'The Role of Corporate Governance and Boards in Organisational Performance' in K Walsh, G Harvey and P Jas (eds), *Connecting Knowledge and Performance in Public Services: From Knowing to Doing* (Cambridge University Press 2010); F Ostrower and M M Stone, 'Governance: Research Trends, Gaps, and Future Prospects' (2006) 2 *The nonprofit sector: A research handbook* 612; D R Young, *If Not for Profit, for What? A Behavioral Theory of the Nonprofit Sector Based on Entrepreneurship* (Lexington Books 1983) 101

<sup>24</sup> H Kretchmer, 'The Man Who Discovered the Volkswagen Emissions Scandal' (*BBC News*, 2015) <<http://www.bbc.co.uk/news/business-34519184>> accessed 12 May 2016

<sup>25</sup> G Jorge, 'Fixing Fifa: The Experience of the Independent Governance Committee' (2014) 21 *Southwestern Journal of International Law* 165

<sup>26</sup> M M Jennings, 'Toshiba Lessons: On Not Being So Judgmental of the Company or Japan' (2015) 20 *Corporate Finance Review* 36

<sup>27</sup> J Moore, 'Frank Field Is Right: Sir Philip Should Hand a £15m “Rebate” from His Bhs Pension Scheme Settlement Back to Members' (*Independent*, 2017)

<<http://www.independent.co.uk/news/business/comment/bhs-sir-philip-green-could-get-as-much-as-15m-back-from-settlement-with-pension-scheme-a7641656.html>> accessed 01 April 2017

<sup>28</sup> B Groyberg, P M Healy and R Vijayaraghavan, 'What Factors Drive Director Perceptions of Their Board's Effectiveness?' (2016) <[https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2731512](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2731512)> accessed 25 September 2016

which we know even less. We have seen already that governance is about ensuring organisations achieve their purposes.<sup>29</sup> The board is part of the governance system. But the design of the board must reflect the purpose which the organisation is supposed to achieve.<sup>30</sup> We cannot, then, sensibly discuss good principles for board-design in respect of non-profits without fully taking into account the distinctive purposes of non-profits.<sup>31</sup> The unique nature and character of the non-profit sector, and the organisations contained within it, necessarily require a specifically designed board structure and governance.<sup>32</sup> Or so I shall argue in this thesis. If this is correct, it makes it essential to build principles of good board design for non-profits on a firm foundation of theoretical analysis of what is distinctive and special about the role of non-profits, as this thesis attempts to do. Indeed, as much as I would argue that the board is an important institution in all companies, for-profit or non-profit, it can also be claimed, as does Rosenthal, that ‘despite the common ancestry and legal underpinnings, non-profit corporate governance places heightened demands on its board: a larger mix of stakeholders, a more complex economic model, and a lack of external accountability’.<sup>33</sup>

I have, so far, emphasised the importance of understanding what is distinctive about non-profits if we are successfully to address their effective (board) governance. But what is truly distinctive about non-profits is largely dependent on the society in which those organisations operate. This is starkly evident if we compare the role of the non-profit sector in, say, the UK and China, each of which has its own unique culture, legal system and ideology.<sup>34</sup> A number of social and political characteristics distinguish Chinese non-profits from those in, say, the UK.<sup>35</sup> And yet, perhaps surprisingly, research on the non-profit sector in China is barely in its infancy.

For China, the Government – with its single-party political system, and determination

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<sup>29</sup> Cornforth and Chambers, (n23)

<sup>30</sup> *ibid* ; D Cumming, W Hou and E Lee, 'Sustainable and Ethical Entrepreneurship, Corporate Finance and Governance, and Institutional Reform in China' (2016) 134 *Journal of Business Ethics* 505

<sup>31</sup> This is not to say, of course, that board design for non-profits cannot draw on, and learn from, theory and practice in the for-profit sector; see A M. Viader and M I. Espina, 'Are Not-for-Profits Learning from for-Profit-Organizations? A Look into Governance' (2014) 14 *Corporate Governance* 1

<sup>32</sup> Groysberg, Healy and Vijayaraghavan, (n32)

<sup>33</sup> L Rosenthal, *Good Counsel: Meeting the Legal Needs of Nonprofits* (John Wiley & Sons 2011) 45

<sup>34</sup> R Hasmath and J Y Hsu, *NGO Governance and Management in China* (Routledge 2015)

<sup>35</sup> For example, the establishment of *guanxi*, the face saving social strategies, the Chinese collectivism, and the government control; see W R Vanhonacker, 'Guanxi Networks in China' (2004) 31 *China Business Review* 48

to secure its nationwide authority and power<sup>36</sup> – impacts hugely upon the majority of national activities, across most aspects of social and economic life.<sup>37</sup> This inevitably makes for a significant difference in the role of non-profits, as well as the modes of non-profit governance available in China, especially when compared to the UK.<sup>38</sup> At the same time, there is strong evidence indicating that the increase in the range of social issues to be solved is encouraging more individuals' to participate, or at least develop public interest, in the non-profit sector in China. And yet, during the last two decades, the development of the non-profit sector has been disappointingly slow, owing to political suppression and strict legal regulations surrounding their development.<sup>39</sup>

All this throws up important and difficult questions about the role of the sector in modern China, and the role (and design) of board governance therein. This thesis attempts, in at least a modest way, to start to fill this gap. Interestingly, during the writing of it, the Chinese Government made its own contribution to what might be called the non-profit governance gap in China by introducing a New Chinese Charity Law ('the Charity Law 2016'), enacted in April 2016. Perhaps paradoxically, this also immediately raised public and academic concern, having altered the situation for Chinese non-profits to a certain degree.<sup>40</sup> Indeed, it can be implied from a number of relevant articles in the Charity Law 2016 that there has been a strong sense on the Chinese Government's part towards reconsidering its position and attitude in relation to non-profits, which could represent a promising and new phase in Chinese non-profit history. At this point, it is highly possible that non-profit related academic research in China would strongly influence the Government towards opening the door to reform. In this respect, based upon the findings of research carried out during this project, the thesis shall look to posit several blueprints, which it intends to be developed in response to what may contribute to the improved governance or management of non-profit organisations; with a view to detailing what an ideal or improved Chinese non-profits model might also look like, and how this might adapt or improved ways of

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<sup>36</sup> C Guo, 'When Government Becomes the Principal Philanthropist: The Effects of Public Funding on Patterns of Nonprofit Governance' (2007) 67 *Public Administration Review* 458

<sup>37</sup> J Han, 'The Emergence of Social Corporatism in China: Nonprofit Organizations, Private Foundations, and the State' (2016) 16 *China Review* 27

<sup>38</sup> C Guo and Z Zhang, 'Mapping the Representational Dimensions of Nonprofit Organizations in China' (2013) 91 *Public Administration* 325

<sup>39</sup> Hasmath and Hsu, (n34)

<sup>40</sup> The New Chinese Charity Law 2016

working in China.

## **1.2 Research questions**

To recap on what I have sketched out above, the overarching goal of my thesis is to develop a blueprint for an effective board for non-profits, which can be adapted to the distinctive characteristics of the Chinese non-profit sector, and against which current board regulatory requirements in China can then be measured. To achieve this overarching goal, my thesis in turn identifies, and addresses, the following individual research questions:

1. Why do non-profit organisations exist as a separate sector, and what distinguishes them from the ‘commercial’ sector on the one hand, and the public sector (government) on the other hand? To this end, what is the nature of the non-profit sector, and how does this impact upon or influence the governance mechanism adopted by such organisations?
2. What attributes should an optimal board in this sector possess? Indeed, if this work is to present prospective blueprints in order as to guide the board’s actions and performance, what might this look like? And, how easily can this be transplanted into the Chinese context?
3. Does the non-profit sector merely grow to play the same function in China as their Western counterparts? Can non-profits in China effectively fill the gaps left by the failings of the commercial and governmental sectors?
4. What are the contextual determinants of Chinese non-profits, and how could these elements be adapted to promote better governance practices in the Chinese non-profit sector? How does the reality (regulations and legal practices) of board performance in the UK and in China compare to such a model? That is to say, how large is the ‘gap’ between the ideal and reality in this context?
5. What reforms to the legal framework are necessary to close such a gap, if any? Which type of reform is more practical, specifically in the Chinese context? What are the potential gaps between the blueprint and the Charity Law 2016 in China?

### 1.3 Thesis design and structure

The thesis is divided into four parts, comprising nine chapters (plus an introduction in Chapter 1). The first part (Chapters 2-3) provides the theoretical foundation of the thesis, in the following sense. They set out and explain current theorising about the nature of non-profits (Chapter 2) and the role of the board in non-profit governance (Chapter 3).

To address the first of my research questions, Chapter 2 explains the essence and unique nature of the non-profit sector. More specifically, it does two things. First, it provides a brief overview of the non-profit sector. Second, it highlights the points of difference between non-profit organisations and organisations in both the public and private sectors. By identifying these differences, it helps identify how far one might apply *for-profit* corporate governance ideas and practices in the *non-profit* sector. Enriched by the content and nature of non-profit literature, Chapter 3 examines *board governance theories* specifically within the non-profit context. Following a selection, adjustment and combination of these individual theories widely applied in the public and private sectors, a comprehensive theoretical framework will then be outlined in relation to non-profit organisations.

Part 2 (Chapter 4) concentrates on the second research question. Before attempting to compare non-profit board governance between the UK and China, Chapter 4 develops a blueprint for an effective non-profit board on the basis of non-profit distinctiveness (Chapter 2) and the theoretical framework established in Chapter 3. To achieve this, this chapter first identifies four essential attributes for non-profit boards (board size, characteristics, structure and process, for example). Within each attribute, this work investigates the essential elements/mechanisms contributing to an optimal board structure. Subsequently, a combining these four attributes is used with a view to informing the development of a guide toward board performance and operation in the non-profit sector and organisations.

With this blueprint in mind, and before turning to China, Part 3 (Chapter 5) measures the UK against that blueprint. It does so for three reasons. First, the UK is itself a well-developed legal regime (far more so, for example, than China). Given that, it is

intrinsically interesting to understand its current regulatory regime for board governance. Second, through this investigation, we shall see how far the actual regulatory regime in the UK does indeed either conform with, or depart from, that suggested by the blueprint I have developed. Third, and finally, China seeks to develop its own non-profit sector, it is likely to look to other regimes – including the UK – for inspiration. Since I hope my research will have some real impact on Chinese regulation and practice, showing the extent to which my proposals correspond to UK practices will likely add to their plausibility with this potential audience. Chapter 5 focuses upon two main legal forms used in the UK non-profit sector, namely the *Company Limited by Guarantee (CLG)* and the *Charitable Incorporated Organisation (CIO)*.

Part 4 - Chapters 6, 7, 8, and 9 - turns to focus on China. In order to ensure that the UK-based blueprint may be properly applied to Chinese non-profits, a variety of social characteristics are carefully taken into account, and any necessary elements of non-profit governance are considered in full. With respect to research questions 3 and 4, the thesis first reviews the Chinese non-profit system, and identifies its principle foundations and characteristics. Following this, the work then adapts my earlier blueprint to the Chinese context. So, Chapter 6 identifies the distinctive nature of non-profits in China. On the basis of this distinctiveness, Chapter 7 then outlines a series of prospective modifications or additions to the blueprint designed in Chapter 4, adapting it to the Chinese context. Through this process, a range of important social determinants essential to Chinese non-profit performance are taken into account. Applying a modified blueprint, Chapter 8 then examines the three most typical legal forms of non-profit organisations in the Chinese legal system, with their accompanying regulatory framework, and compares the same to the UK regulatory framework. The analysis focuses specifically upon Chinese law up to the enactment of the new (2016) Act. Naturally, the Charity Law 2016 represents a new phase in the Chinese context, and therefore an entire chapter (Chapter 9) shall be dedicated to discussing and considering the prospective changes, contributions and deficiencies apparent within the Chinese legal and social context. Chapter 10 provides a concluding evaluation.

## 1.4 Research method

### 1.4.1 Methodologies

The methods which I have used to develop the argument in this thesis are those which are appropriate to the different strands that make up my work. So, in exploring the role of the non-profit, both in the UK and in China, the work adopts a socio-legal approach. This entails understanding the institution of the non-profit in its social context. In doing so, it was inevitably necessary to draw on other disciplines outside of law to better understand how non-profits function: economics, sociology and politics all help this understanding of the non-profit. Similarly, my account of the function of boards also required insights from management/governance theorists. Alongside this socio-legal material, other parts of my project necessitated more traditional doctrinal exposition. So, Chapter 5 examines the UK regulatory approach to non-profit boards, Chapters 8 and 9 do the same for China.

This work also clearly provides a comparative study on non-profit board governance that offers comparisons between the approach adopted by the UK and China. These two comparator countries are chosen based on several considerations. First, the primary objective of this thesis is to improve academic literature and consideration of the Chinese non-profits approach to governance. By comparing non-profits governance in the UK and China, potential difficulties and shortcomings, which challenge China's non-profit enterprises, can thereby be identified. Such a work shall provide an invaluable opportunity for Chinese non-profits to advance their board governance mechanisms, modelling themselves on materials and legislation which have been developed for a number of decades within the UK regime.<sup>41</sup> The UK non-profit sector has already theorized governance mechanisms and benefits from advanced practices and experiences.<sup>42</sup> It offers a rich body of knowledge to improve the operation of China's non-profit sector. By contrast, the Chinese non-profit sector, with a less improved regime and short history, has had several difficulties advancing itself. Hence, borrowing and adapting from the UK methods and mechanisms could prove beneficial to this project (and the blueprint it seeks to develop).

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<sup>41</sup> C C Huang and others, *China's Nonprofit Sector: Progress and Challenges* (Transaction Publishers 2013)

<sup>42</sup> Anheier, (n10)

It might be objected that this work adopts only a one-direction comparison from the UK to China. Surely, my critic might complain, each country can learn from the other. After all, the UK non-profit system likely harbours many of its own pitfalls and disadvantages, some of which might be addressed by drawing lessons from, say, China. Whether or not this is true, my reason for adopting a one-directional comparative study is more practical: owing to limited space, and my overriding goal of improving board governance for non-profits in China, my focus must be restricted to this comparison. Others may address how much the UK might be improved by looking eastwards.

Although taking a comparative approach to study between UK and China is an opportunity to improve the Chinese non-profit sector, such work of course presents challenges as well. One challenge is methodological. Hoecke and Warrington, like many, emphasise ‘the problems caused by analysing foreign legal systems through one’s own doctrinal concepts’.<sup>43</sup> Any comparative study, especially insofar as it recommends ‘borrowing’ or ‘transplanting’ elements of one country’s regime by another, must be sensitive to the distinctive features – culture, history, and so on – of each country.<sup>44</sup> Comparatists must recognise the context in which comparisons are being made, and should take into account and ‘grasp their legal styles’.<sup>45</sup> This concept of ‘style’ here encompasses much more than the word would first appear to suggest, and includes history, modes of thought, institutions, legal sources, and ideology.<sup>46</sup> Such warnings are important, and hopefully reflected throughout Part 4, and especially within Chapter 7.

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<sup>43</sup> M Van Hoecke and M Warrington, 'Legal Cultures, Legal Paradigms and Legal Doctrine: Towards a New Model for Comparative Law' (1998) 47 *International and Comparative Law Quarterly* 495, 501

<sup>44</sup> *ibid* 502

<sup>45</sup> K Zweigert and H Kötz, *Introduction to Comparative Law* (Oxford University Press 1992) 89

<sup>46</sup> *ibid* 90



### 1.4.2 Library search

This thesis primarily consists of library-based research, which shall offer a comprehensive engagement with existing literature, from a wide range of sources.<sup>47</sup> Through the process of carrying out library-based research so far, a serious dearth in Chinese literature and the relative scope of non-profit organisational governance had been identified. This is, of course, in stark contrast to the voluminous amount of resources available in the UK: where there are at least 30 leading digital libraries/academic websites, which supply non-profit related journals, books, as well legislation.<sup>48</sup>

Access to research in the Chinese context is comparatively more challenging, owing to the limited and restricted academic resources available on the non-profit sector. The particular Chinese social and historical context (further investigation shall be given in Chapters 6-9) even restricts the resources relevant to the non-profit research. First and foremost, there are fewer digital libraries supplying literature of this kind, with even fewer that consider matters such as board governance.<sup>49</sup> In terms of other sources in China, although non-profit-related regulations, policies and guidance are open and available to the public, most of these comprise of legislative materials which provide a general and vague description on relevant issues, which fail to adequately support the

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<sup>47</sup> It shall consist of books, journals, magazines, newspapers and websites of both Western and Chinese origin.

<sup>48</sup> Some of the most commonly searched libraries include, but are not limited to, SSRN, JSTOR, SpringerLink, Lexis Library, Wiley Online Library, HeinOnline, SAGE, Blackwell Publishing Ltd, Oxford Journals, Westlaw. A variety of pioneer journals shall frequently be found cited in this work, including: Non-Profit and Voluntary Sector Quarterly, *Voluntas*, *The Journal of Law and Economics*, *Nonprofit Management and Leadership*, *Journal of Corporate Law Studies*, *Academy of Management Journal*, *Journal of Business Ethics*, *Academy of Management Review*, *Harvard Law Review*, *Journal of Law & Economics*. In addition, a number of up-to-date information, report and data sources concerning non-profit organisations in the UK have also been accessed through a variety of different websites and research institutions. These include: NCVO, [www.gov.uk](http://www.gov.uk), The Charity Commission, Institute for Volunteering Research, the UK Civil Society Almanac, the Nonprofit Almanac.

<sup>49</sup> There are essentially three digital libraries that may be used for this purpose; these are China Academic Journals, China Yearbook Full-text Database and Wanfang Data. As international research rankings would suggest, these are only two core research institutions in China — Qinghua University and Perking University, both of which have a long established history in academic research and specifically in relation to non-profit organisations. The ‘China Non-profit Review’ serves as a forum for researchers specializing in the undertakings and organisation of Chinese non-profits, and is the only international level journal with an English version published in China.

arguments or concepts discussed by this work.<sup>50</sup> Accordingly, whilst the research considering the Chinese aspect of this thesis has required a considerable degree more effort, this has also contributed to providing a greater degree of originality and thus significance in the claims made by this work.

### **1.4.3 Empirical materials**

In the UK, there has been a great deal of empirical research in relation to the performance of non-profit organisations. In the Chinese context, although non-profit performance has gained increasing academic attention over recent years, relevant empirical literature exploring the non-profit board governance aspect of corporations has been much less common. Therefore, in an attempt to probe the performance of non-profit board governance, and close the gap between UK and China, the thesis has relied upon empirical evidence which supplements relevant chapters throughout. In doing so, this study aims to achieve a twofold purpose. First, it intends to introduce empirical evidence on the non-profit board governance both in the UK and in China. Second, the study compares the legal frameworks (e.g. Acts, codes of practices, regulations) of both the UK and China, to see how their performance may be assessed using empirical evidence. However, this project does not itself generate new empirical data; but instead, it relies upon existing sources.

The justification for taking the aforementioned approach is supported by an attempt to avoid several apparent difficulties or hurdles that shall impact upon the study otherwise. With respect to the Chinese aspect of research, collecting first-hand empirical data appears to be impractical owing to the time and space limitation placed upon this work. The non-profit-related issue has long since been, and remains, a sensitive topic in China, and would therefore confound this aspect of research.<sup>51</sup> Since this is subject to the strict control of academic resources,<sup>52</sup> this would very likely

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<sup>50</sup> Supporting documents, such as the numbers of non-profits, annual income, funding resources, director numbers or similar information can be easily accessed in the UK, whilst comparable information is considerably more difficult to obtain in China.

<sup>51</sup> Y Jing, 'Between Control and Empowerment: Governmental Strategies Towards the Development of the Non-Profit Sector in China' (2015) 39 *Asian Studies Review* 589

<sup>52</sup> A great deal of non-profit information and data are categorized as confidential, and filed and accessible only to specialist Chinese government departments. Furthermore, the official system

impinge upon the sorts of data access required for a project of this kind. Similarly, the non-profit development in China is in its initial phase. Accordingly, the majority of the organisations involved are grassroots non-profit based, and are either unregistered or registered as corporate/commercial enterprises.<sup>53</sup> Consequently, defining and categorizing non-profit organisations in China is a problem, especially insofar as it prevents the conducting of empirical research from the outset. Interestingly, the majority of non-profits are located in the most deprived areas of China, where there is a significant lack of public transport and telecommunication.<sup>54</sup> This brings added difficulties, such as locating them, collecting data, and maintaining contact in order to update research in this area. These challenges seriously impair the conducting of first-hand empirical research in this context, especially owing to the time, sample size and scope required for this to be effective, which would mean a failure to ensure a robust or convincing conclusion drawn from an effective framework.

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regulating the non-profit sector in China fails to record the non-profit information systematically and accurately, upheld by a system that lacks transparency.

<sup>53</sup> This issue shall be further discussed in Chapters 6-8.

<sup>54</sup> J Y Hsu and R Hasmath, 'The Local Corporatist State and NGO Relations in China' (2014) 23 *Journal of Contemporary China* 516

## Chapter 2 | The roles of non-profit organisations: a theoretical analysis

### 2.1 Introduction

As argued in Chapter 1, we cannot sensibly discuss good board design for non-profits without first identifying the proper role of a non-profit board. And we cannot do that without first identifying the proper role of the non-profit itself. This chapter, therefore, now begins that task of identifying the role of non-profits.

It does so by focusing on what we might, for convenience, call the ‘Western’ literature addressing this issue. Given, however, that the overarching purpose of this thesis is to develop a blueprint for good board governance in *Chinese* non-profits, this approach might seem rather inappropriate, and requires some justification. As noted in Chapter 1, Chinese literature addressing non-profits remains limited, and this is especially true of literature theorising about the nature and the role of non-profits.<sup>55</sup> By contrast, Western literature is much richer, and offers much deeper insights into the role played by non-profits specifically, and the ‘Third Sector’ more generally.<sup>56</sup> Moreover, this literature, whilst it focuses on the role of these organisations in Western societies, is by no means merely attempting to ‘survey’ or ‘map’ what role or ‘functions’ the existing population of non-profits happens to play in Western societies. As we shall see, the best of the literature is much deeper or more ‘fundamental’ than that. It focuses on the essential economic relationships between individuals, organisations, and Government, relationships which give rise to the type of organisation that a non-profit represents. And, crucially, there is good reason to think that many (though not all) aspects of these relationships are replicated in contemporary Chinese society.

Nevertheless, we certainly cannot take for granted that these theories, developed in the context of Western societies, will *fully* explain the role of non-profits in China. My approach therefore must, and does, involve two steps. In this Chapter 2, I focus on the Western theories, for the reasons just noted. Then, in Chapter 6, I revisit and revise the account of the role of non-profits developed in this Chapter 2, by placing it within the

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<sup>55</sup> Hasmath and Hsu, (n34); Q Hui, 'NGOs in China: The Third Sector in the Globalisation Process and Social Transformation' (2004) <[http://web.mit.edu/newmediaactionlab/www/papers/qinhui\\_ngo.pdf](http://web.mit.edu/newmediaactionlab/www/papers/qinhui_ngo.pdf)> accessed 19 July 2015

<sup>56</sup> S Hasan and J Onyx, *Comparative Third Sector Governance in Asia: Structure, Process, and Political Economy* (Springer 2008)

context of current Chinese society.

The chapter focuses on the three leading theories have been developed in the literature. The first (and arguably most influential) is the *market failure theory*.<sup>57</sup> This argues, essentially, that non-profits exist to fill the gap that arises in certain situations where the private market struggles to supply the goods or services that consumers demand.<sup>58</sup> The second theory I shall call the *government failure theory*. This is particularly associated with Weisbrod,<sup>59</sup> although it has been developed further by later writers, including James,<sup>60</sup> Anheier,<sup>61</sup> Ben-Ner and Hoomissen,<sup>62</sup> and Frumkin.<sup>63</sup> It accepts, like the first theory, that the market may sometimes fail to deliver the services that consumers demand, but asks why government does not then step in to fill that gap. In answering that question, it both offers reasons why governments may fail to meet such consumer demands, and why non-profits may succeed where governments fail.

The third theory I shall call the *participatory/expressive* theory. It evaluates the social role of non-profits more from what we might call the 'supply side'. It is associated with the work of Ben-Ner,<sup>64</sup> Frumkin,<sup>65</sup> Riley<sup>66</sup> and Anheier.<sup>67</sup> They emphasize the role of non-profits less in meeting the otherwise unmet demands of consumers, and more in meeting the interests or needs of those who 'supply' non-profits – social entrepreneurs, non-profit volunteers, donors, and the like. Thus, essentially, non-profits provide

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<sup>57</sup> I shall use the terms market failure theory, and contract failure theory, here interchangeably.

<sup>58</sup> H B Hansmann, 'The Role of Nonprofit Enterprise' (1980) 89 *The Yale Law Journal* 835, 840; Romero-Merino and García-Rodríguez, (n1); R Steinberg and B H Gray, "' The Role of Nonprofit Enterprise" in 1993: Hansmann Revisited' (1993) 22 *Nonprofit and Voluntary Sector Quarterly* 297, 302

<sup>59</sup> See B A Weisbrod, 'Toward a Theory of the Voluntary Non-Profit Sector in a Three-Sector Economy', *The Economics of Nonprofit Institutions : Studies in Structure and Policy* (Oxford University Press 1986); B A Weisbrod, 'The Future of the Nonprofit Sector: Its Entwinning with Private Enterprise and Government' (1997) 16 *Journal of Policy Analysis and Management* 541 549

<sup>60</sup> E James, 'Comments on Nonprofit Theories' in S Rose-Ackerman (ed), *The Economics of Nonprofit Institutions: Studies in Structure and Policy* (Oxford University Press 1986)

<sup>61</sup> Anheier, (n10)

<sup>62</sup> A Ben - Ner and T Van Hoomissen, 'Nonprofit Organizations in the Mixed Economy' (1991) 62 *Annals of Public and Cooperative Economics* 519

<sup>63</sup> P Frumkin, *On Being Nonprofit: A Conceptual and Policy Primer* (Harvard University Press 2009)

<sup>64</sup> Ben - Ner and Van Hoomissen, (n62)

<sup>65</sup> P Frumkin, 'Between Nonprofit Management and Social Entrepreneurship' (2013) 73 *Public Administration Review* 372

<sup>66</sup> C A Riley, 'The Not-So-Dynamic Quality of Corporate Law: A UK Perspective on Hansmann's 'Corporation and Contract'' (2010) 21 *King's Law Journal* 469

<sup>67</sup> H K Anheier and J Kendall, *Trust and Voluntary Organisations: Three Theoretical Approaches* (London School of Economics and Political Science 2000)

opportunities for those stakeholders<sup>68</sup> of non-profits to achieve self-fulfilment/accomplishment, gather ‘a sense of belonging’, or express the values they hold and cherish.<sup>69</sup>

A final word of introduction is appropriate. Though in one sense each of these three theories is in competition with the others, I shall argue that these theories are in fact *inter-connected* and, moreover, *complementary* to one another in their attempts to explain the non-profit sector. As Riley has argued, each of these theories adds ‘something significant to the other. Taken together, they offer a valuable account of not-for-profits’.<sup>70</sup> More importantly still for the purpose of this thesis, it is only by building on the insights of each of these three theories that we can fully understand the role of non-profits, and thus, the role of their boards. Thus, the multiple-explanation for the role of non-profits that I argue for here should be understood as related to the multiple-account of the role of the board that I shall put forward, and defend, in Chapter 3.

## **2.2 The definition and categories of non-profit organisations**

### **2.2.1 Definition**

According to Hansmann, Salamon and Anheier, non-profits may be defined as organisations that use surplus revenues to achieve various ‘positive’ or non-commercial orientated goals, in place of distributing surplus revenue as profit or dividends.<sup>71</sup> This core feature of non-profit operations is reflected in US law, which provides that although non-profit enterprises are permitted to generate surplus revenues, such revenues must be retained by non-profits for the purposes of self-preservation,

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<sup>68</sup> Here we define stakeholders of non-profits as anyone involves/participant in the non-profit relevant activities.

<sup>69</sup> See e.g. Riley, (n66) 56

<sup>70</sup> C A Riley, 'Theorising the Governance of Not-for-Profits' (2007) 16 Nottingham Law Journal 44, 49

<sup>71</sup> Salamon and Anheier have also suggested the use of a seven-fold test to distinguish non-profits from other organisational forms in Western culture. In their study, non-profits are deemed as ‘formal; private; non-profit-distributing; self-governing; voluntary; non-religious; [or] non-political’. Hansmann, (n58); H B Hansmann, R Kraakman and R Squire, 'Law and the Rise of the Firm' (2006) Harvard Law Review 1333; H B Hansmann, 'The Role of Trust in Nonprofit Enterprise' in A B-N Helmut K. Anheier (ed), *The Study of the Nonprofit Enterprise* (Springer 2003); L M Salamon, S W Sokolowski and H K Anheier, *Social Origins of Civil Society: An Overview* (Johns Hopkins Center for Civil Society Studies Baltimore 2000) 6

expansion, or associated plans.<sup>72</sup> Broadly speaking, they are not permitted to be formed of or operated for the purpose of pecuniary gains, unless those gains are devoted/restricted to the aforementioned causes.<sup>73</sup> In this context, the term ‘*non-distribution constraint*’ (often referred to as a ‘*lock on assets*’ in the UK)<sup>74</sup> was first employed by Hansmann to describe this most crucial aspect to non-profits.<sup>75</sup> This criterion prevents non-profit institutions from distributing their net earnings (not gross) to individuals who exercise control over the institution itself.<sup>76</sup> This may include directors, managers or other members.<sup>77</sup>

Interestingly here, lay observers may, and often do, mistakenly believe that non-profits are organisations that do not charge others for what they provide, or pay others (individuals or institutions) for the services they supply.<sup>78</sup> But this is clearly not so.<sup>79</sup> Even non-profits must cover the cost of the resources they consume.<sup>80</sup>

### **2.2.2 Categories of non-profits**

Having understood the distinguishing feature shared by all non-profits (the non-distribution constraint), how might we now sub-divide or ‘categorise’ them? One way might be according to the activities they pursue, and thus the sectors within which they operate. They are most prevalent in sectors such as health (hospitals, nursing homes), education (universities, research institutions), citizen welfare (libraries and trade unions and associations), and the performing art (theatres and arts centres).<sup>81</sup> Along such lines, the International Classification of Non-profit Organisations (ICNPO) classifies non-

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<sup>72</sup> Hansmann, (n58)

<sup>73</sup> *ibid*

<sup>74</sup> I Snaith, 'Recent Reforms to Corporate Legal Structures for Social Enterprise in the UK: Opportunity or Confusion?' (2007) 3 *Social Enterprise Journal* 20; ‘Asset Lock’ is a term used to cover all the provisions designed to ensure that the assets of the CIC are used for the benefit of the community.

<sup>75</sup> Hansmann, (n58)

<sup>76</sup> Hansmann, Kraakman and Squire, (n71) 1356

<sup>77</sup> *ibid*

<sup>78</sup> *ibid*

<sup>79</sup> Steinberg and Gray, (n58)

<sup>80</sup> *ibid*

<sup>81</sup> Hansmann, Kraakman and Squire, (n71) 1376

profit institutions into 11 different groups ranging from ‘culture and recreation’, ‘education and research’, ‘health’, to ‘social services’, ‘environment’ and ‘religion’.<sup>82</sup>

A more useful categorisation, for our purpose, however, examines not the activities they tend to pursue, but rather who ‘demands’, and thus pays for, their activities. So, Hansmann, expanding on the categorization found in the IRS rules,<sup>83</sup> divides non-profits into ‘donative’ and ‘commercial’ non-profits.<sup>84</sup> *Donative* non-profits get most or all of their income from grants or donations, while *commercial* non-profits derive their income from selling their goods or services.<sup>85</sup>

### 2.3 Why theorise non-profits?

I have explained already why an understanding of the role of non-profits is essential for a proper understanding of the role of the board. Without repeating that argument here, a little elaboration is appropriate.

It might be argued that understanding the proper role of non-profits is crucial to understanding, or improving, *any* aspect of the operation of non-profits, including say how they are managed, as much as how they are governed by their boards. There is some truth in this. But it is arguable that the *governance* of non-profits is particularly, intensely, dependent on the role they perform.<sup>86</sup> This is because, as Cornforth and Brown have convincingly shown, *non-profit governance will often be more complicated than non-profit management*.<sup>87</sup> Compared to day-to-day management, the board, as a governing body, must govern; it must provide leadership and strategy, and must focus on the ‘big picture’.<sup>88</sup> Accordingly, governance is about planning the framework for work, and ensuring such an approach is followed. It is distinct from

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<sup>82</sup> The International Classification of Non-profit Organisations (ICNPO) was developed through a collaborative process involving a team of scholars across 13 different countries; see L M Salamon and H K Anheier, 'The International Classification of Nonprofit Organizations: Icnpo-Revision 1, 1996', *Working Papers of the Johns Hopkins Comparative Nonprofit Sector Project* (Baltimore 1996)

<sup>83</sup> Internal Revenue Service, s501 (c) (3)

<sup>84</sup> Hansmann, (n58) 861

<sup>85</sup> *ibid* 861

<sup>86</sup> C Cornforth and W A Brown, *Nonprofit Governance: Innovative Perspectives and Approaches* (Routledge 2013); R P Chait, W P Ryan and B E Taylor, *Governance as Leadership: Reframing the Work of Nonprofit Boards* (John Wiley & Sons 2011)

<sup>87</sup> Cornforth and Brown, (n86)

<sup>88</sup> *ibid*



management ('organizing the work') and operations ('doing the work').<sup>89</sup>

One consequence of the complexity of governance is that, so far as possible, the governing body of an organisation should steer clear from making managerial decisions or from getting involved in the day-to-day implementation of strategy.<sup>90</sup> As Rosen notes, if the board trespasses into management, it could make things even worse, and in many cases may lead to rifts between the board and executive management.<sup>91</sup>

Another consequence of the complexity of governance is that we cannot assume that governance will be the same, or require the same mechanisms, in for-profits as in non-profits. To be sure, corporate governance mechanisms in the for-profit sector have been well developed for decades. However, there remains a danger that in only looking at for-profit based governance, we may overlook the subtle and important differences between the for-profit and non-profit sectors, as well as the means by which these differences boards of governance operate, especially in the non-profit sector.<sup>92</sup> A vast array of literature has detailed these differences. For example, scholars such as Hung,<sup>93</sup> Riley and Cornforth<sup>94</sup> have each examined this phenomenon in terms of the essential roles or characteristics that the organisation's nature plays in influencing governance strategies, and have insisted that borrowing and adapting governance mechanisms from the profit based sector may well be a shortcut to improve non-profit governance. Indeed, through an analysis of these literatures, it may well be possible to develop an overarching understanding of the non-profit sector and its governance mechanisms.

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<sup>89</sup> *ibid*

<sup>90</sup> N Kapucu, F Yuldashev and E Bakiev, 'Collaborative Public Management and Collaborative Governance: Conceptual Similarities and Differences' (2016) 2 *European Journal of Economic and Political Studies* 39

<sup>91</sup> R Rosen, 'Risk Management and Corporate Governance: The Case of Enron' (2003) 35 *Connecticut Law Review* 1

<sup>92</sup> M. Viader and I. Espina, (n31)

<sup>93</sup> H Hung, 'A Typology of the Theories of the Roles of Governing Boards' (1998) 6 *Corporate Governance* 101

<sup>94</sup> C A Riley, 'The Case for Non-Governing Directors in Not-for-Profit Companies' (2010) 10 *Journal of Corporate Law Studies* 119; C Cornforth, *The Governance of Public and Non-Profit Organisations: What Do Boards Do?* (Taylor & Francis 2004)

## 2.4 The role of non-profits

As noted, we shall focus here on three theories: *Market Failure*, *Government Failure* and '*Participatory/Expressive*'. Before addressing each in turn, it might be worth noting an overarching distinction between them, alluded to already.

The Market Failure and Government Failure theories are both, in one sense, 'demand side' theories. They each suggest that non-profits arise, and flourish, because of a demand for their goods and services from consumers, a demand which the private market, and government, are sometimes, in some circumstances, unable to meet. By contrast, the participatory/expressive theory can be characterised as a 'supply side' theory. It focuses not on why others demand/favour the outputs of non-profits, but rather why anyone chooses to create (and thus supply) a non-profit in the first place. This categorisation of the three theories is captured in Table 2.1 below.

**Table 2.1 Theories explaining nature/social functions of non-profits**

<b>Points of view</b>	<b>Theories</b>	<b>Contributors</b>	<b>Contributions</b>
<b>Demand-side</b>	Market (contract) failure theory	Hansmann	Explains failures in the commercial market and advantage of non-profits
	Government failure (public good) theory	Weisbrod	Explains failures in the public sector and advantages of non-profits
<b>Supplier-side</b>	Participatory and expressive role	Riley, Frumkin and Anheier	Explains why suppliers have the incentive to set up non-profits

### **2.4.1 The Instrumental role of non-profits in Hansmann's 'contract failure' theory**

Hansmann's work was the first to have proposed a 'contract failure' theory of non-profits, and thus to focus on how non-profits address the apparent shortcomings inherent within 'market relationships' (i.e. relationships with for-profit enterprises).<sup>95</sup> In doing so, his work insisted that the non-profit sector plays an important role in compensating for market failures in society, and especially for 'asymmetric information'.<sup>96</sup> Essentially, where problems of *asymmetric information* are sufficiently great, consumers will be reluctant to trust a for-profit organisation, fearing it will exploit the consumer's ignorance in the pursuit of profit.<sup>97</sup> A non-profit, by contrast, will have less incentive to take advantage of the consumer's ignorance, and will in consequence be more trustworthy.

#### **2.4.1.1 Explaining contract failure**

The essence of this market-failure explanation is captured in Table 2.2.

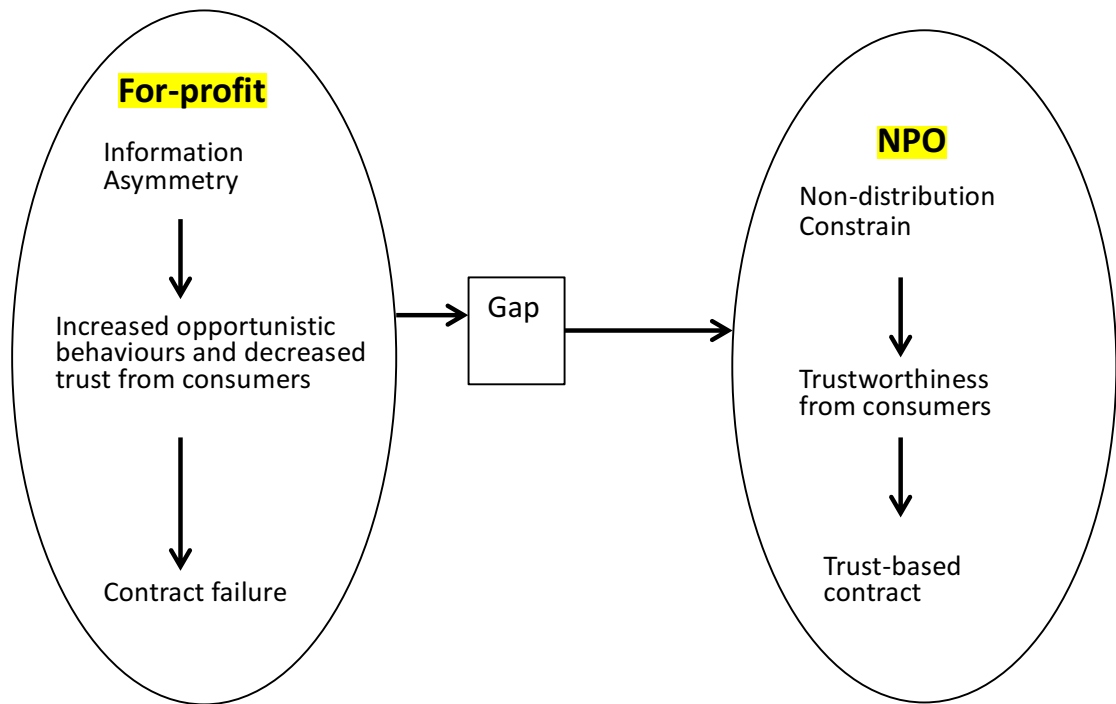
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<sup>95</sup> H B Hansmann, *The Ownership of Enterprise* (Harvard University Press 1996)

<sup>96</sup> *ibid*

<sup>97</sup> Hansmann, (n58); Steinberg and Gray, (n58)

**Table 2.2 Social roles of non-profit and for-profit sector**



#### **2.4.1.1.1 Asymmetric information and contract failure**

Economic theories explain how, once certain conditions are satisfied, the competitive commercial market is able to provide for the majority of products and services ‘at the quantity and price that represents maximum social efficiency’.<sup>98</sup> Consumers can, for themselves, choose between the most desirable products, by comparing prices and product qualities, thereby reaching a reasonable agreement with suppliers while, finally, considering whether suppliers comply with the agreements and how they might apply for redress, if they do not.<sup>99</sup> During such a process, contracts may help prevent the interests of the consumers from being exploited.

However, consumer interests cannot be ensured through market contracts in all situations. Rather, contract failure may sometimes occur, with information asymmetry being one of the principal reasons for this shortcoming.<sup>100</sup> Information asymmetry refers to the circumstance in which one party to a contract knows significantly less

<sup>98</sup> C Cornforth, J P Hayes and S Vangen, 'Nonprofit–Public Collaborations: Understanding Governance Dynamics' (2015) 44 Nonprofit and Voluntary Sector Quarterly 775, 789

<sup>99</sup> Hansmann, (n58); Renz, (n1)

<sup>100</sup> Donative non-profits are more clearly linked to the concept of contract failure; see Hansmann, (n58) 847

(about matters relevant to the contract) than the other does.<sup>101</sup> Where the consumer is significantly under-informed, compared to the producer-organisation, then there is the danger that the organisation will act ‘opportunistically’, taking advantage of its superior information to promote its own interests (say its own profits) at the expense of the consumer.<sup>102</sup>

Two clear examples of asymmetrical-information situations that are relevant to our analysis of non-profits might include:

(a) Where purchasers of services are *separated from beneficiaries*. The clearest example of this may be charities, who receive much of their funding from individual donations, and then deliver services or goods to people in need, such as the relief of aid of poverty (i.e. CARE and Oxfam).<sup>103</sup> The ‘purchaser’ (donor) will typically be far-distant from the recipients (or beneficiaries), and unable to see or discover how their contributions to the charity’s work have been spent.<sup>104</sup>

(b) The second example concerns *complex personal services*. Some personal services – intricate surgery might be the best example – require a level of knowledge and expertise that the consumer (the patient in my example) is unlikely to possess, but which the providing organisation would be expected to have.<sup>105</sup> Education provides a similar example. How can a student assess the quality of a teacher or lecturer’s guidance, when almost by definition the teacher or lecturer is more knowledgeable than the student?<sup>106</sup>

#### **2.4.1.1.2 Trustworthiness in non-profits**

Why might some consumers or donors, aware of their relative ignorance, prefer to deal with a non-profit rather than a for-profit? Hansmann’s answer is that they will trust

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<sup>101</sup> Hansmann, (n71); S E Permut, 'Consumer Perceptions of Nonprofit Enterprise: A Comment on Hansmann' (1980) 90 Yale Law Journal 1623, 1645

<sup>102</sup> Permut, (n101) 1636

<sup>103</sup> B Breeze, 'How Donors Choose Charities: The Role of Personal Taste and Experiences in Giving Decisions' (2013) 4 Voluntary Sector Review 165, 176

<sup>104</sup> *ibid* 177

<sup>105</sup> Hansmann, (n58) 847

<sup>106</sup> *ibid* 847

non-profits more.<sup>107</sup> They will reason that an organisation that is committed to maximising its profits will have a strong incentive to exploit the consumer or donor's ignorance.<sup>108</sup> By contrast, organisations that do not have profit-maximization as their chief purpose have less incentive to expropriate consumers' or donors' benefits.<sup>109</sup>

Thus, non-profits are, according to Hansmann, more trustworthy than for-profits in situations where asymmetric information is a significant problem,<sup>110</sup> and where that is indeed so, non-profits may flourish at the expense of for-profits.<sup>111</sup> Non-profits are more trustworthy because they are subject to the feature which defines the sector: the non-distributional constraint.<sup>112</sup> Managers of non-profits have less incentive to exploit consumers' or donors' ignorance, because they cannot extract the fruits of doing so. Within the non-profit sector, consumers believe that they are protected by a '*trust-based implicit contract*' in which non-profit institutions promise to devote their entire profits to service production.<sup>113</sup> In short, Hansmann claims, 'consumers can and will trust organisations that wear the non-profit label over those organisations that exist to earn a profit'.<sup>114</sup>

It is important to stress that the argument here is not that non-profits are always entirely trustworthy, with the non-distribution constraint completely negating any incentive to exploit consumers' ignorance. The non-distribution constraint cannot prevent all personal profiting by managers of non-profits.<sup>115</sup> They may pay themselves excessively. They may benefit from services provided by the non-profit at reduced rates (such as free child care) whilst consumers are over-charged.<sup>116</sup> Hansmann's argument is only that, where information asymmetry is a significant problem, then sufficient consumers or donors will think that non-profits are sufficiently more trustworthy than

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<sup>107</sup> *ibid*

<sup>108</sup> For some thoughts on whether even for-profits have reputational reasons not to act opportunistically; see N Lin-Hi, J Hörisch and I Blumberg, 'Does CSR Matter for Nonprofit Organizations? Testing the Link between CSR Performance and Trustworthiness in the Nonprofit Versus for-Profit Domain' (2015) 26 *International Journal of Voluntary and Nonprofit Organizations* 1944; Hansmann, (n58)

<sup>109</sup> Hansmann, (n58) 851; Lin-Hi, Hörisch and Blumberg, (n108)

<sup>110</sup> Hansmann, (n58)

<sup>111</sup> Lin-Hi, Hörisch and Blumberg, (n108)

<sup>112</sup> *ibid*

<sup>113</sup> Caldwell and Hansen, (n16)

<sup>114</sup> Hansmann, (n71); Permut, (n101); Caldwell and Hansen, (n16) 180

<sup>115</sup> Lin-Hi, Hörisch and Blumberg, (n108)

<sup>116</sup> R B Denhardt, J V Denhardt and M P Aristigueta, *Managing Human Behavior in Public and Nonprofit Organizations* (Sage Publications 2015)

for-profits to allow non-profits to out-compete for-profits.<sup>117</sup> And, Hansmann argues, empirical evidence confirms a correlation between those situations where information asymmetry is a significant problem, and the predominance of non-profits.<sup>118</sup>

#### 2.4.1.2 Gap filling or increasing options?

We can now state more clearly what *role* the ‘market failure’ theory claims for non-profits. It is essentially two-fold. First, many non-profits, and particularly those that are largely reliant upon donations, play a significant role in filling the gap in the commercial market, where profit-based institutions are simply unable to secure the trust of donors, for reasons identified already. Again, we can concede that non-profits may also sometimes prove untrustworthy, as many recent headlines attest: the collapse of Kid’s Company amid allegations of financial mismanagement,<sup>119</sup> the suicide of Olive Cooke,<sup>120</sup> and other charities’ fundraising practices<sup>121</sup> In the Chinese non-profit sector, as we shall see later, has suffered its own fundraising scandals (e.g. the Guo Meimei scandal,<sup>122</sup> the corruption scandals following the Wenchuan earthquake,<sup>123</sup> and the Smile Angle Foundation scandal<sup>124</sup>). Nevertheless, the ‘gap filling role’ for non-profits depends only on non-profits being *comparatively* more trustworthy, not *absolutely* trustworthy.<sup>125</sup>

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<sup>117</sup> Steinberg and Gray, (n58); Hansmann, (n95)

<sup>118</sup> Steinberg and Gray, (n58)

<sup>119</sup> G Jamie, 'Kids Company Faces Investigation over Financial Collapse' (*The Guardian*, 2015) <<https://www.theguardian.com/uk-news/2015/aug/21/kids-company-faces-investigation-over-financial-collapse>> accessed 13 March 2016

<sup>120</sup> M Steven, 'Poppy Seller Who Killed Herself Got 3,000 Charity Requests for Donations a Year' (*The Guardian*, 2016) <<https://www.theguardian.com/society/2016/jan/20/poppy-seller-who-killed-herself-got-up-to-3000-charity-mailings-a-year>> accessed 25 April 2016

<sup>121</sup> M Aimee, 'Everything You Need to Know About the Charity Fundraising Crisis' (*The Guardian*, 2015) <<https://www.theguardian.com/voluntary-sector-network/2015/jul/10/everything-you-need-to-know-charity-fundraising-crisis>> accessed 25 July 2016

<sup>122</sup> SCMP, 'Guo Meimei Scandal Shows Chinese Red Cross Must Clean up Its Act' (*South China Morning Post*, 2014) <<http://www.scmp.com/comment/insight-opinion/article/1570876/guo-meimei-scandal-shows-chinese-red-cross-must-clean-its>> accessed 13 April 2016

<sup>123</sup> T Shannon, 'Charities and Corruption in China' (*The Diplomat*, 2014) <<http://thediplomat.com/2014/08/charities-and-corruption-in-china/>> accessed 25 April 2015

<sup>124</sup> R Zhang, 'Faye Wong Denies Charity Fund Scandal' (*China.org.cn*, 2014) <[http://www.china.org.cn/arts/2014-02/21/content\\_31552525.htm](http://www.china.org.cn/arts/2014-02/21/content_31552525.htm)> accessed 15 April 2015

<sup>125</sup> B R Kingma, 'Public Good Theories of the Non-Profit Sector: Weisbrod Revisited' (1994) 8 *Voluntas: International Journal of Voluntary and Nonprofit Organizations* 135; B Weisbrod, *The Voluntary Non-profit Sector*, (D.C. Health and Company, Lexington, 1980)

The second role for non-profits, according to the market failure theory, is subtly different. It is not to fill a gap where for-profits *cannot* operate. Rather, it is to increase the choice available to consumers. So, in some sectors, the problems of market failure, and lack of trustworthiness, are not so great as wholly to prevent for-profit enterprises existing.<sup>126</sup> Here, for-profits will exist alongside non-profits, providing more purchasing options for consumers.<sup>127</sup> Profit-based firms and (usually commercial, rather than donative)<sup>128</sup> non-profits may thus coexist in some industries, producing a competitive relationship of different forms.<sup>129</sup>

#### 2.4.2 Weisbrod's 'Governmental Failure' theory

We now turn to the second of our three theories, which focuses upon 'government failure'. In essence, the theory goes as follows. Like the market failure theory we have just examined, it accepts that there may be failings in the 'market' – in the ability of for-profits to satisfy consumers' demands (although it tends to emphasise the problem of 'public goods', which are explained below, as a key instance of such failure).<sup>130</sup> However, the government failure theory then asks why the government – the state – does not intervene to 'fill the gap' where for-profits are unable to do so. Where non-profits thrive, then, they must do so not only because the market fails, but also because government fails too in meeting consumer demands.<sup>131</sup> Table 2.3 sketches out this basic idea, noting the sources of this governmental failure, and reasons for the comparative superiority of the non-profit sector.

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<sup>126</sup> G G Morgan, 'The Use of Charitable Status as a Basis for Regulation of Nonprofit Accounting' (2010) 1 Voluntary Sector Review 209

<sup>127</sup> J B Hamilton and L A D Slatten, 'A Nonprofit's Practical Guide to Resolving Ethical Questions' (2013) 18 Journal of Applied Management and Entrepreneurship 39

<sup>128</sup> *ibid* P J DiMaggio and H K Anheier, 'The Sociology of Nonprofit Organizations and Sectors' (1990) Annual Review of Sociology 137; Steinberg and Gray, (n58)

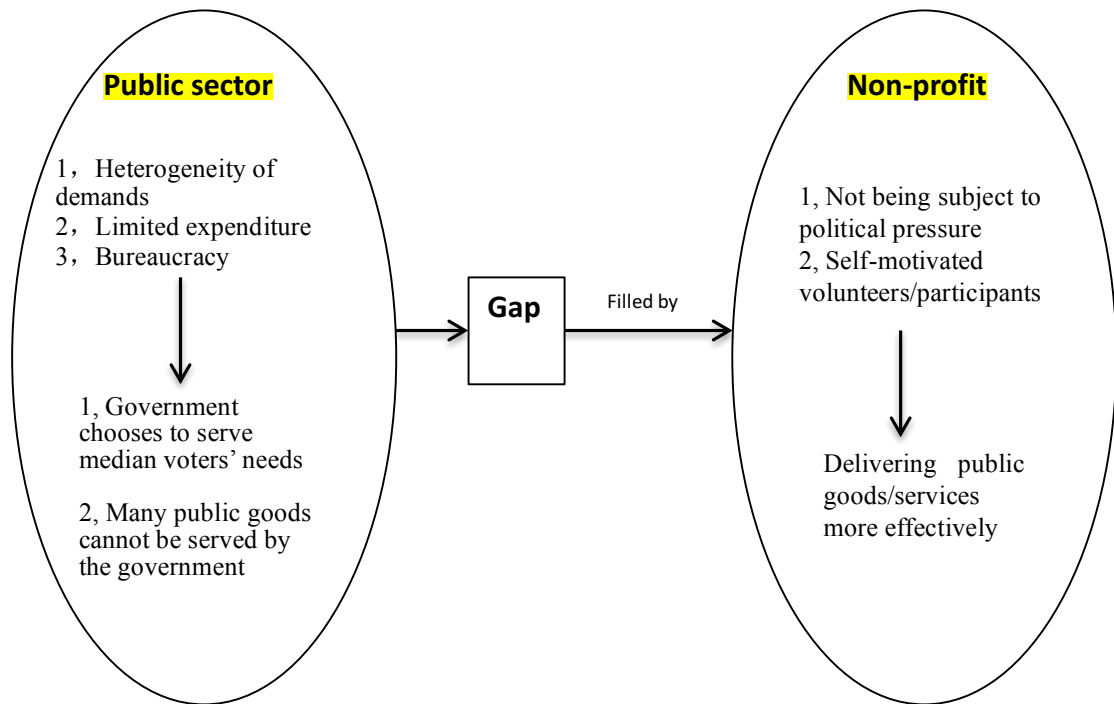
<sup>129</sup> Commercial non-profits mostly tend to exist in the following situations: first, services that commercial non-profits supply are complex and difficult for consumers to assess. For instance, it is apparently difficult for normal people to analyse and evaluate the quality of services and health care that hospitals provide. Second, they emerge in the industry where the beneficiaries are not purchasers (e.g. nursing care). Thirdly, commercial non-profits in many cases provide continuing long-term services, which makes it difficult for purchasers to change due to high cost and complex procedures.

<sup>130</sup> A Slivinski, 'The Public Goods Theory Revisited', *The Study of the Nonprofit Enterprise* (Springer 2003) 103; S C Mendel and J L Brudney, 'Doing Good, Public Good, and Public Value' (2014) 25 Nonprofit Management and Leadership 23, 39

<sup>131</sup> Mendel and Brudney, (n130)



**Table 2.3 Non-profits and the public sector**



As noted, this theory places heavy emphasis on the concept of ‘public goods’. We should begin by clarifying their meaning and significance. Weisbrod describes their two key features.<sup>132</sup> First, their consumption is ‘non-rivalrous’: ‘one person’s consumption of the good does not preclude another person’s consumption’.<sup>133</sup> Indeed, the cost of producing a public good would not change significantly with the quantity of the good or the number of consumers. Clean air and national defence are good examples. Second, usage is ‘non-excludable’; it is not easy to prevent someone who refuses to pay for the good from nevertheless consuming it.<sup>134</sup> Once air quality in Birmingham or Beijing has been improved, it would be impossible to restrict the benefit to those residents who somehow pay for the privilege. Another less obvious example of a public good is, according to Slavinski, ‘material aid to the indigent, from the point of view of the non-recipients of that aid.’<sup>135</sup>

The upshot of the foregoing is that for-profit providers will prove reluctant to supply public goods. Given their non-excludable quality, for-profit providers will doubt that anyone will actually pay for them. The market, in other words, will fail. In response,

<sup>132</sup> Kingma, (n125)

<sup>133</sup> B A Weisbrod, *The Nonprofit Economy* (Harvard University Press 1988) 14

<sup>134</sup> Mendel and Brudney,(n130) 27; Weisbrod, (n133) 178

<sup>135</sup> Slivinski, (n130)

government-supply has often been seen as the obvious solution to this market failure.<sup>136</sup> Government can provide clean air, national defence, or aid to the impoverished, and then *compel* people to pay for them, through compulsory taxation.<sup>137</sup> In this way, Government can overcome the non-excludability problem of public goods.

Weisbrod, however, questioned this assumption that Government always could, and always did, solve the public goods problem in this way.<sup>138</sup> He argued that there are limits to what Government can (and does) provide, and that non-profits are sometimes able to make up these shortcomings, filling the gap left by governmental failure.<sup>139</sup>

Within his theory, the concept of ‘heterogeneity of demands’ is the ‘core feature’ behind the governmental failure).<sup>140</sup> Heterogeneity of demands here refers to the different levels of demand different sections of the public have for any public good (such as clean air, defence, policing, public broadcasting, and so on). The different levels of demand depend on population characteristics (age, education, diversity of religion, or race, and, significantly, wealth).<sup>141</sup>

Given then, that some citizens may prefer, say, high levels of expenditure on public service broadcasting, or on universities, whilst other voters prefer less expenditure, how might government respond? Weisbrod argued that, at least in democracies, they are likely to make the provision that satisfies the ‘median voter’.<sup>142</sup> This will be more than some voters would prefer but, crucially, less than others want.

This inevitably leaves unsatisfied the demands of all those voters who preferred a level of provision in excess of that favoured by the ‘median voter’ – who favour, say, more expenditure on the arts, or more overseas aid, than the Government is willing to fund. In response to this gap, *four potential solutions* have been identified by scholars such as

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<sup>136</sup> Mendel and Brudney, (n130)

<sup>137</sup> *ibid*

<sup>138</sup> Weisbrod, (n133)

<sup>139</sup> *ibid* Mendel and Brudney, (n130)

<sup>140</sup> The concept used by Weisbrod to conclude the model and design of this theory; see Weisbrod, (n133) 180

<sup>141</sup> R J Freeman and others, 'Governmental and Nonprofit Accounting: Theory and Practice' (2014) 20 *Journal of Public Affairs Education* 441

<sup>142</sup> Weisbrod, (n59)

Weisbrod, Anheier, Young, Salamon and Toepler.<sup>143</sup> First, dissatisfied consumers could migrate to another new government that might better represent their interests. Second, those wanting more provision could form a lower-level, and more ‘generous’, tier of government. Apparently these two are not reasonable and practical choices as there are too many uncertainties within the solutions: the government would not ensure that the interests of both the over-satisfied and under-satisfied people were considered.<sup>144</sup> A third alternative is for the private sector to step in, but this merely takes us back to where we began: the reluctance of for-profit providers to deliver public goods, given the non-excludability problem.<sup>145</sup>

The fourth solution focuses upon the non-profit sector. Non-profits can step in to meet the demands of ‘supra-median’ voters which the government, and for-profits, refuse to satisfy.<sup>146</sup> For in doing so, non-profits have advantages compared both to government, and to for-profits. So, they do not have the political constraints upon them which force governments to ‘play’ to the median voter. And they are better able than are for-profits to persuade others to pay for the goods or services they supply, even when the goods are technically ‘non-excludable’.<sup>147</sup> To be sure, non-profits cannot compel payment: they do not have the power to tax. But they can use their higher moral standing, their mission, the sense of community they foster with their donors, and so on, to pressurise and encourage others to pay for what they do.<sup>148</sup>

This median voter explanation predicts ‘a greater abundance of not-for-profits where communities are more heterogeneous (and thus have more diverse demands for public goods)’.<sup>149</sup> The USA, with its relatively diverse population, and rich heritage of non-profits, seems to support this prediction. Whether it explains other countries experiences is less clear. Riley, for example, suggests that ‘it is legitimate to criticise the limited significance of the median voter explanation for not-for-profits (especially

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<sup>143</sup> Weisbrod, (n59); H K Anheier, *The Study of Nonprofit Enterprise: Theories and Approaches* (Springer Science & Business Media 2003); Young, (n23); L M Salamon and S Toepler, ‘Government–Nonprofit Cooperation: Anomaly or Necessity?’ (2015) 26 *International Journal of Voluntary and Nonprofit Organizations* 2155

<sup>144</sup> This will be further argued in Chapters 6-9; DiMaggio and Anheier, (n128) 141

<sup>145</sup> Salamon and Toepler, (n143) 2165

<sup>146</sup> Anheier, (n10) 78

<sup>147</sup> Salamon and Toepler, (n143) 2166

<sup>148</sup> Salamon, Sokolowski and Anheier, (n71)

<sup>149</sup> Riley, (n70) 48; Kingma, (n125)

for the UK)'.<sup>150</sup> However, it is also argued that, whilst the median voter explanation may not fully explain why governments tend to undersupply public goods, there are nevertheless other compelling reasons why governments fail to do so, and why non-profits prove more effective in filling this gap.<sup>151</sup> So, governments face problems of inefficiencies when delivering public goods or services. They are big and complex. They often struggle to incentivise their employees.<sup>152</sup> By contrast, as Frumkin notes, non-profits do not coerce participation, thus creating a reservoir of goodwill which often attracts and sustains broad involvement.<sup>153</sup> Non-profits, as relatively small organisations, are often able to make their goals more specific and flexible, which demonstrate an obvious advantage to the commercial context. Clark posited conceiving the non-profit organisation as a 'mini government', with more diverse objectives.<sup>154</sup> Accordingly, scholars such as Hood, Kettl, and Osborne & Gaebler<sup>155</sup> have suggested that a 'third sector' is needed to introduce a better market orientation in the delivery of market goods, in order to enhance its effectiveness; a coincidence considering that the non-profit sector is already often regarded as the 'third sector'.

#### **2.4.3 Participatory and expressive role (supplier-side theory)**

The third theory we shall address arises out of a criticism common to each of the two preceding theories. Each explains why consumers or donors may demand the outputs of non-profits, but neither explains why anyone would choose to form, or sustain, non-profits so that they are able to meet that demand.<sup>156</sup> Why do social entrepreneurs form non-profits? Why do employees choose to work for non-profits, even when their salary, as well as other monetary forms of compensation, is much less in non-profit

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<sup>150</sup> Riley, (n70) 49

<sup>151</sup> *ibid*

<sup>152</sup> Mendel and Brudney, (n130)

<sup>153</sup> Frumkin, (n63) 86

<sup>154</sup> R Clark, 'Moral Systems in the Regulation of Nonprofits: How Value Commitments Matter' (2006) Hauser Center for Nonprofit-Organizations, Working Paper 157

<sup>155</sup> C Hood, 'A Public Management for All Seasons?' (1991) 69 *Public Administration* 3; W B Perkins, 'The Global Public Management Revolution: A Report on the Transformation of Governance' (2000) 28 *Policy Studies Journal* 879; D Osborne and T Gaebler, 'Reinventing Government: How the Entrepreneurial Spirit Is Transforming the Public Sector' (1994) 21 *The Journal of Sociology & Social Welfare* 154

<sup>156</sup> N H Mohd Noor, S A Hajar and M A Idris, 'The Determinant of Nonprofit External and Internal Effectiveness: The Role of Knowledge Sharing, Collaborative Culture, and Beneficiary Participation' (2015) 39 *Human Service Organizations: Management, Leadership & Governance* 459

organisations, compared with the commercial market. Indeed, a great proportion of volunteers in non-profit organisations choose to work without any monetary return *at all*. Becchetti's research indicates that in the non-profit sector, 'a large share of voluntary movers do not end up with higher wages but, surprisingly, do have higher job satisfaction'.<sup>157</sup>

The answer, according to this theory, is to be found in two important aspects of the relationship which those who create or support such organisations have with it – their 'participatory' and 'expressive' roles within the organisation's activities.<sup>158</sup> The participatory value means 'any close involvement in the life of the organisation. It includes taking part in company decision-making (through whatever organ of the company), but would extend beyond this to, say, a personal relationship between a donor and a not-for-profit under which the former makes repeated gifts to the latter'.<sup>159</sup> Leete and Sen insist, in spite of the less attractive wages, a great portion of people are more willing to work in non-profits for the reason that 'they have a stronger correlation between the goals of the organisation and their moral motivations'.<sup>160</sup> To be sure, this type of participation does not occur only in the non-profit sector. For instance, employees and investor/suppliers might sometimes also participate in for-profits. Nevertheless, the value of the participation will vary between different sectors. Riley believed that, 'the claim here is only comparative. On average, participation is more significant to those who say, donate to, or consume the output of, not-for-profits than it is for those who consume the goods or services of for-profits. And the same for those who work for not-for-profits compared to those who work for for-profits'.<sup>161</sup>

Participating in the governance process of a non-profit enables suppliers to have a sense of belonging and existing within given communities, proximate to their sector or the organisation in question. In the case of non-profits, with common interests and preferences, being part of a team will mean members may work collectively to manage

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<sup>157</sup> L Becchetti, S Castriota and S Depedri, 'Working in the for-Profit Versus Not-for-Profit Sector: What Difference Does It Make? An Inquiry on Preferences of Voluntary and Involuntary Movers' (2014) 23 *Industrial and Corporate Change* 1087, 1102

<sup>158</sup> Riley, (n70) 49

<sup>159</sup> Mohd Noor, Hajar and Idris, (n156)

<sup>160</sup> L Leete, 'Wage Equity and Employee Motivation in Nonprofit and for-Profit Organizations' (2000) 43 *Journal of Economic Behavior & Organization* 423, 435; A Sen, 'Well-Being, Agency and Freedom: The Dewey Lectures 1984' (1985) 82 *The Journal of Philosophy* 169

<sup>161</sup> Riley, (n70) 56

their institutions, and to chase or achieve their goals.<sup>162</sup> Whether one is a volunteer, donor, manager or other type of stakeholder, every contribution is likely to be better valued in this sector.<sup>163</sup> By contrast, stakeholders are likely more apathetic, and their opinions more easily marginalised, in for-profits.<sup>164</sup> Whereas, in non-profits, participants' expressions and opinions are probably more likely to be appreciated.

In terms of the expressive value, it could be defined as 'the project of making sense of the self'.<sup>165</sup> Through people's decisions/behaviours, they attempt to express themselves to the public about their cherished values, 'and thus the sort of people they are'.<sup>166</sup> Indeed, once suggestions and thoughts by stakeholders are taken seriously, then they will more likely get the feeling of control over, and involvement in, their organisation's governance. As Frumkin has noted, 'the not-for-profit sector can be seen as valuable because it allows individuals to express their values and commitment through work, volunteer activities, and donations.'<sup>167</sup> By committing to broad causes that are close to the heart or by giving to an effort that speaks directly to the needs of the community, non-profit and voluntary action answers a powerful expressive urge'.<sup>168</sup> In addition, as research by Weisbrod and others note, joining in the activities of non-profits could help them develop the sense of honour and achievement they seek.<sup>169</sup> Supporting non-profits thus enables them to release their minds, and at the same time gain the respect of their friends and neighbours.<sup>170</sup> People feel proud to tell others that they support and participate in non-profits.<sup>171</sup> Participants in non-profit organisations can thus benefit from 'the gratitude, esteem and plaudits of his neighbours and fellow citizens—rewards which to some extent even show up as financial returns and act to internalize what would otherwise be external benefits to the donor'.<sup>172</sup>

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<sup>162</sup> M L Vecina and others, 'Volunteer Engagement and Organizational Commitment in Nonprofit Organizations: What Makes Volunteers Remain within Organizations and Feel Happy?' (2013) 41 *Journal of Community Psychology* 291

<sup>163</sup> *ibid*

<sup>164</sup> H Bang, S Ross and T G Reio Jr, 'From Motivation to Organizational Commitment of Volunteers in Non-Profit Sport Organizations: The Role of Job Satisfaction' (2012) 32 *Journal of Management Development* 96

<sup>165</sup> S H Heap, *The Theory of Choice: A Critical Guide* (Blackwell 1992), 78

<sup>166</sup> Riley, (n70) 56

<sup>167</sup> Frumkin, (n63)

<sup>168</sup> Frumkin, (n63) 34

<sup>169</sup> Weisbrod, (n58) 28

<sup>170</sup> Mohd Noor, Hajar and Idris, (n156)

<sup>171</sup> Bang, Ross and Reio Jr, (n164) 110

<sup>172</sup> Weisbrod, (n58) 188

## 2.5 Synthesis and Implications

We have completed our survey of the three leading theories of the role of non-profits. Two tasks remain. The first is to explain how these theories ‘fit together’. The second is to make explicit their relevance to, and implications for, the governance of non-profits (since, recall, that was why we began this theoretical exploration).

So far as the first task goes, I noted earlier in the chapter that these three theories should be seen as complementary. I can now make clearer why this is indeed the case. First, insofar as the market failure and government failure address the *demand* for non-profits, whilst the participatory/expressive role theory addresses the *supply* of non-profits, they offer different, and non-competing, pieces of the jigsaw. Identifying why there is a *demand* for non-profits does not deny that the *supply* of non-profits matters too, and requires explanation. Showing why people are prepared to form and sustain (thus, supply) non-profits does not deny that non-profits will only flourish if there is a demand for their outputs, and that the basis of that demand needs explaining. Second, although the market failure theory and the government failure theory do seem to address the same phenomenon – the demand for non-profits – and in doing so might seem to offer rival explanations, we should not overstate the conflict between them. For whilst each seeks to show how non-profits may have advantages over alternative providers of goods or services, each also tends to demonstrate this comparative superiority in respect of *different* alternative providers. For the market failure theory, the priority is demonstrating the superiority of non-profits over for-profit providers. For the government failure theory, the priority is demonstrating the superiority of non-profits over governmental provision.

What, now, about the governance implications of these complementary theories of the role of non-profits? Each theory has significant implications. Those implications are, like the underlying theories, largely complementary, rather than competitive.<sup>173</sup> But in one respect at least, a degree of tension creeps in. The market failure theory suggests

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<sup>173</sup> V Babić, J D Nikolić and J M Erić, 'Rethinking Board Role Performance: Towards an Integrative Model' (2011) 56 *Economic Annals* 140; Hung, (n93)

two governance consequences deserve emphasis. First, since the core feature of non-profits that generates their superior trustworthiness is their reduced incentive to exploit consumers' or donors' relative ignorance, it is essential that non-profits are indeed subject to an effective non-distribution constraint. This must ensure that the assets – including income derived from consumers or donors – is devoted to the organisation's mission, and cannot be appropriated by those who might cause the organisation to act opportunistically.<sup>174</sup>

Second, the non-distribution constraint is essentially negative. It prevents misappropriation of assets, and the incentive this might create to act opportunistically to consumers or donors. But it does not, positively, ensure the non-profit will be well run, and achieve its objectives fairly and efficiently. Governance has, then, also a role to play in ensuring that the non-profit is managed, and operated, in a way that delivers those things too.

The government failure theory largely supports these prescriptions. Non-profits may step in where government fears to tread, but non-profits must still overcome the non-excludability problem. They cannot compel citizens to support their activities. They must rely on trust and persuasion, and an effective non-distribution constraint remains essential to that. And they are unlikely to outperform government if they are incompetent and ineffective in their operations; good governance, in the sense of ensuring operational effectiveness, remains as important under this theory too.

The participatory and expressive theory would find much of that entirely persuasive. However, with its focus on the motivations and interests of those who sustain non-profits, its governance emphasis would change a little too. Most significantly, whilst operational effectiveness is important, so too is ensuring that non-profits deliver on the desires for participation and expression that members of non-profit communities seek. This does not automatically mean board participation, but nor can we rule out the board as the best organ to fulfil these participatory demands. And herein lies the tension. A board composed, structured and functioning to ensure the effectiveness of the

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<sup>174</sup> M Klausner and J Small, 'Failing to Govern: The Disconnect between Theory and Reality in Nonprofit Boards, and How to Fix It' (2004) 7 *International Journal of Not-for-Profit Law* 93; Chait, Ryan and Taylor, (n86)



organisation, in delivering the outputs its consumers and donors demand, may look somewhat different from a board designed to fulfil participatory demands.

## **2.6 Conclusion**

We can summarise our journey quickly. We have focused on three theories which seek to explain the role of non-profits: as a response to market failure, grounded in problems of information asymmetry; as a response to government failure, understood both narrowly in terms of a desire to satisfy only the demands of the ‘median voter’, and more widely in terms of the various inefficiencies which compromise the state’s provision of public services; and as a means of satisfying the desire of human agents to express their values and participate in communities with which they identify.

We noted that these three theories do, in large measure, offer complementary, rather than rival, explanations for the role of non-profits, helping us to see a fuller picture of what non-profits do, and why they exist. This complementarity was further evidenced when we considered the governance implications of the theories. They stood together in prescribing a governance regime that would reassure the public that the organisation’s assets would be protected, and devoted to the organisation’s mission. They advocated a governance regime that would ensure organisational effectiveness in delivering on that mission. And at least one of the theories emphasised the necessity of ensuring that the governance regime (although not necessarily the board) would meet the participatory expectations of those who create and sustain the organisation.

With this journey into the role of non-profits complete, we can now turn our attention to the role of their boards, the subject of Chapter 3.

## Chapter 3 | Theories guiding board governance in non-profit organisations

### 3.1 Introduction

In this chapter we now turn to examine the role of the board itself. Understanding this role is paramount to the functional design of effective governance.<sup>175</sup> It is only by first understanding the role of the board in a non-profit that we can then begin to determine what its size should be, what its composition should look like, what processes it should follow, and so on — all of which form the key ingredients constructing the suggested ‘blueprint’ for a non-profit board.

In spite of its fundamental importance, there exists no unanimity within the literature as to what the role of the board should be. This is true in the case of both profit based and non-profit organisations. Rather, a number of theories speculate on, but typically come to different and apparently conflicting prescriptions for, the role of the board within the modern corporation.<sup>176</sup> Accordingly, in this chapter, we shall focus on four such theories, namely agency theory, stewardship theory, resource dependency theory and stakeholder theory. As such, the first purpose of this chapter shall be to describe the basic content of these theories, and to identify the respective prescription each offers for what it argues to be the most appropriate role of a non-profit board. In doing so, we will draw back on the analysis presented in Chapter 2 about the role of non-profits themselves. I will, in other words, seek to bring together current theorising about the role of boards with my theorising about the role of non-profits. This discussion shall be presented through sections 3.2-3.4.

The second, and equally important, purpose of this chapter, achieved in section 3.5, is to offer a synthesis of these four different theories about the board’s role. Too often, these different theories of the role of the board are presented as ‘competitors’ or ‘rivals’, with their respective proponents arguing that one theory, above all others, is

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<sup>175</sup> K John and L W Senbet, 'Corporate Governance and Board Effectiveness' (1998) 22 *Journal of Banking & Finance* 371; J V Frias Aceituno, L Rodriguez Ariza and I Garcia Sanchez, 'The Role of the Board in the Dissemination of Integrated Corporate Social Reporting' (2013) 20 *Corporate Social Responsibility and Environmental Management* 219

<sup>176</sup> I will briefly summarize three essential roles (the control role, service role and strategic role) of the board by addressing four theories in 3.2-3.5.

correct and should be favoured at the expense of the others.<sup>177</sup> There are echoes here, of course, of how the three theories of non-profits themselves, discussed in Chapter 2, are sometimes presented. However, I shall argue that, just as our best understanding of the role of non-profits was achieved by combining all three theories, so too, as we now turn to the role of the board, our best understanding is achieved by combining elements of all four board-theories. Each theory details important features of the role of boards. And the role of the board must therefore incorporate elements of each of these theories, and the role each theory prescribes. For obvious reasons, this shall be called the ‘integrated model for board governance’.<sup>178</sup>

I should immediately concede that a potential problem with adopting such an ‘integrated model’ may be that it attempts to be ‘have the best of all worlds’. However, it may be argued against me, if there exist unavoidable conflicts between the different roles each theory puts forward, then surely no board can simultaneously pursue all of them.<sup>179</sup> I address this potential criticism of my argument in section 3.5 itself. I concede that there are indeed some conflicts between the different board roles which the different theories prescribe, but these conflicts can to some extent be managed by appropriate forms of board design.<sup>180</sup> Of course, this will not remove all the incompatibilities presented.<sup>181</sup> However, I shall argue that the remaining conflicts are a price worth paying for the clear advantages in having the board play or fulfil multiple functions.<sup>182</sup>

Finally, it is worth stressing one final point. Proponents of each of the four theories sometimes present their theory as a descriptive (or ‘positive’) account of the board, and sometimes as a prescriptive (or ‘normative’) theory.<sup>183</sup> So, descriptively, each theory

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<sup>177</sup> See 3.5.3.

<sup>178</sup> See 3.5.2. To review the function of the non-profit board in a comprehensive manner, this part shall try to posit a link between different theories, and test the compatibility between different roles of the governing board.

<sup>179</sup> W A Brown and C Guo, 'Exploring the Key Roles for Nonprofit Boards' (2010) 39 *Nonprofit and Voluntary Sector Quarterly* 536

<sup>180</sup> See 3.5.3.2.

<sup>181</sup> T M Coule, 'Nonprofit Governance and Accountability Broadening the Theoretical Perspective' (2015) 44 *Nonprofit and Voluntary Sector Quarterly* 75

<sup>182</sup> See 3.5.

<sup>183</sup> S Song and others, *Prescriptive Analytics System for Improving Research Power* (IEEE 2013); E W Tsang, 'Organizational Learning and the Learning Organization: A Dichotomy between Descriptive and Prescriptive Research' (1997) 50 *Human relations* 73

argues what the role of boards currently is. Accordingly, the descriptive validity of each theory depends on empirical evidence: whether it is indeed true that boards generally adopt the role described by the theory.<sup>184</sup> The normative validity of each theory depends on whether the arguments in favour of the board playing the role prescribed by the theory are indeed compelling.<sup>185</sup> In this chapter, we are concerned only with the normative aspects of each theory. We are, remember, seeking to offer a blueprint for how boards *ought to be* designed, and to do that, we are focusing our theorizing upon what the role of the board *ought to be*.<sup>186</sup> As such, we are not concerned, here, to provide the most compelling account of how boards currently behave.

### **3.2 Agency theory and stewardship theory**

This section explains, and seeks to combine elements of, agency theory and stewardship theory. Table 3.1 captures the issues we shall address.

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<sup>184</sup> Tsang, (n183) 80

<sup>185</sup> Coule, (n181) 82; R Caers and others, 'Principal - Agent Relationships on the Stewardship - Agency Axis' (2006) 17 *Nonprofit Management and Leadership* 25, 33; P De Andrés-Alonso, V Azofra-Palenzuela and M E Romero-Merino, 'Determinants of Nonprofit Board Size and Composition: The Case of Spanish Foundations' (2009) 38 *Nonprofit and Voluntary Sector Quarterly* 784, 798

<sup>186</sup> The blueprint shall be further discussed in Chapter 4.

**Table 3.1 Agency theory and stewardship theory**

<b>Theory</b>	<b>Objective</b>	<b>Principle</b>	<b>Approaches to deal with agency problem</b>	<b>Difficulties and advantages in non-profits</b>	<b>Relationship with each other</b>
Agency theory	1, deal with principal-agent relationship  2, control agency problems caused by information asymmetry	1, agents are self-interested <i>Homo-economicus</i>  2, goal/interests conflicts between agent and principal	1, boards monitor agents with harsh means (sanctions)  2, less trust, more control	<b>Difficulties:</b> 1, more acute agency problems because of less external assistance (e.g. law, commercial market mechanism) 2, more internal governance difficulties (e.g. uncertainty of non-profit principal)  <b>Advantage:</b> agents focus less on monetary incentive, more on self-fulfilment/dignity	Interactions between two theories  1, share similarities  2, stewardship theory is a limiting case of agency theory
Stewardship theory	3, reduce agency costs	1, goal alignment between principals and agents  2, agents are <i>Homo-sociologicus</i>	1, more trust, less monitor  2, motivate agents with intrinsic rewards  3, Improve goal conformance		

### 3.2.1 Agency theory

Jensen and Meckling characterised a *principal-agent relationship* as referring to ‘a contract under which one or more persons (the principals) engage another person (the agent) to perform some service on their behalf which involves delegating some decision-making authority to the agent’.<sup>187</sup> Such relationships are ubiquitous within any economy in which there is a substantial ‘division of labour’. They do, of course, exist in companies, including non-profits.<sup>188</sup> For us, the agents that are of interest are the non-profit’s employees (and especially its more senior managers). It is slightly more difficult to identify, in the case of the non-profit, who should be understood as ‘the principal’.<sup>189</sup> We can, however, for now, sidestep this difficulty and view the organisation itself (say, the separate legal personality that is the company, assuming the non-profit operates through a company) as the principal, although we will subsequently need to return to this issue (see section 3.4 below).

The central problem raised by agency relationships is this: ‘[h]ow the owners/principals ensure that managers/agents run the organisation in a way and with the results that benefit the owners?’<sup>190</sup> Agency theory argues that, given both parties’ objectives are to maximize their own utilities, when there exists a conflict of interest between principals and agents, agents are likely to pursue their own goals rather than those of the principal’.<sup>191</sup> In other words, *self-interested* agents will act in an opportunistic manner that imposes costs (‘agency costs’) upon those for whom they are working, the principals.<sup>192</sup>

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<sup>187</sup> The principal and agent theory emerged in the 1970s, from the combined disciplines of economics and institutional theory. The most cited reference to the theory, however, applies the work of Jensen and Meckling. The theory has come to extend well beyond economics and institutional studies, to incorporate all aspects of information asymmetry, including uncertainty and risk; see M C Jensen and W H Meckling, ‘Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure’ (1976) 3 *Journal of Financial Economics* 305, 311

<sup>188</sup> Coule, (n181)

<sup>189</sup> J L Miller, ‘The Board as a Monitor of Organizational Activity: The Applicability of Agency Theory to Nonprofit Boards’ (2002) 12 *Nonprofit Management and Leadership* 429

<sup>190</sup> J Solomon, *Corporate Governance and Accountability* (John Wiley & Sons 2007) 68

<sup>191</sup> E F Fama and M C Jensen, ‘Separation of Ownership and Control’ (1983) 26 *The Journal of Law & Economics* 301; E S Herman, *Corporate Control, Corporate Power* (Cambridge University Press 1981) 136; C Sundaramurthy and M Lewis, ‘Control and Collaboration: Paradoxes of Governance’ (2003) 28 *Academy of Management Review* 397

<sup>192</sup> J L Miller-Millesen, ‘Understanding the Behavior of Nonprofit Boards of Directors: A Theory-Based Approach’ (2003) 32 *Nonprofit and Voluntary Sector Quarterly* 521

However, given this potential for agency costs, organisations can then seek to devise appropriate governance mechanism that will control agents in a way that will best reduce these potential agency costs. And, importantly, *the board* becomes one such mechanism for control — with a role that is understood as the reduction/control of agency costs.<sup>193</sup> As Fama and Jensen argued, ‘... [t]he board of directors assumes responsibility for ratification and monitoring of decisions that have been initiated and implemented by the management of the organisation’.<sup>194</sup> In this way, risk-bearing functions are separated from decision structures, and so principals are assured that their organisation is using its resources as they intend.<sup>195</sup> Thus, to clarify, on this theory the central role of the board is not to manage the organisation. Employees and managers do that. Rather, the board’s role is to control those who do manage the organisation, and thereby reduce the agency costs that would otherwise be inflicted by these self-interested, and potentially opportunistic, agents.<sup>196</sup>

This prescription for the board’s role seems quite consistent with the theoretical account of the role of non-profits developed in Chapter 2. We noted that each of the theories requires that the assets of non-profits be devoted to the objectives of the organisation, and not ‘siphoned off’ into the pockets of those running them. We noted that non-profits must be operated effectively, and with competence, so that they actually deliver on their objectives. Agency costs are a threat to all of that. Giving the board the role of controlling such costs, by controlling the non-profit’s agents, is consistent with these different theories’ accounts of the role of non-profits.

### **3.2.1.1 How great is the agency problem in non-profits?**

Since the task of this chapter is only to identify the appropriate *role* of the board, we

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<sup>193</sup> R Hoskisson and others, 'Multiple Agency Theory: An Emerging Perspective of Corporate Governance' in M Wright (ed), *Oxford Handbook of Corporate Governance* (Oxford University Press 2013)

<sup>194</sup> In this respect, risk-bearing functions are separated from decision structures, and so principals are assured that their organisation is using its resources as they intend; see Fama and Jensen, (n191) 310

<sup>195</sup> Agency theory concentrates on the board’s strategic contribution within organisations, particularly in terms of board involvement with the development of its mission, program evaluation, executive recruitment and oversight, and resource allocation; see D Levinthal, 'A Survey of Agency Models of Organizations' (1988) 9 *Journal of Economic Behavior & Organization* 153

<sup>196</sup> D A Bosse and R A Phillips, 'Agency Theory and Bounded Self-Interest' (2016) 41 *Academy of Management Review* 276

don't need to discuss in any depth, at this stage, how a board should be *designed* to fulfil this agency-cost reducing role; this comes later, in Chapter 4. We might however note, in passing, that boards may struggle to fulfil this role if they are radically less informed than the agents (employees and managers) they are supposed to control. Once again, the ubiquitous problem of *information asymmetry* raises its head.<sup>197</sup>

What is more relevant to address immediately, however, is this: just how intense is the agency problem in, specifically, non-profits? I shall argue that the answer to that is actually somewhat complex, and requires a combination of two different factors. One of these factors suggests that non-profits are *more* susceptible to agency costs than are for-profits.<sup>198</sup> The other factor, which is given to us by stewardship theory, points in the opposite direction, suggesting non-profits are *less* susceptible to agency costs, and that the board's role in controlling such costs can and should, therefore, be a more modest/limited one.<sup>199</sup> I'll take the first factor in this section, and the second factor will be addressed in the next section, when we turn to stewardship theory.

Why might agency costs be greater in non-profits? Some have argued that non-profit agents have a greater number of opportunities and incentives to shirk.<sup>200</sup> By contrast, in for-profits, there are more 'external' barriers (i.e. barriers other than the board itself) to prevent agents from shirking.<sup>201</sup> Specifically, economists argue that the threat posed by the capital market, in matters such as takeover, bankruptcy and capital market competition, provide a strict discipline to control the power of the executives of for-profits.<sup>202</sup> As Manne argued, 'only the takeover scheme provides some assurance of

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<sup>197</sup> In the principal-agent context then, information asymmetry seeks to describe a fact that 'when principals have enough information to verify agent behaviour, [then] agents are more likely to behave in the interests of principals'. Fama and Jensen, (n191) 310; E M Fich, J Harford and A L Tran, 'Motivated Monitors: The Importance of Institutional Investors' Portfolio Weights' (2015) 118 *Journal of Financial Economics* 21; D M Van Slyke, 'Agents or Stewards: Using Theory to Understand the Government-Nonprofit Social Service Contracting Relationship' (2007) 17 *Journal of Public Administration Research and Theory* 157, 162; Bosse and Phillips, (n196)

<sup>198</sup> See e.g. Ma and JingM Rivera - Santos, C Rufin and U Wassmer, 'Alliances between Firms and Nonprofits: A Multiple and Behavioral Agency Approach' (2017) *Journal of Management Studies*

<sup>199</sup> S Van Puyvelde and others, 'The Governance of Nonprofit Organizations Integrating Agency Theory with Stakeholder and Stewardship Theories' (2012) 41 *Nonprofit and Voluntary Sector Quarterly* 431

<sup>200</sup> J H Davis, F D Schoorman and L Donaldson, 'Toward a Stewardship Theory of Management' (1997) 22 *Academy of Management Review* 20, 35; Martin, Wiseman and Gomez-Mejia, (n18)

<sup>201</sup> J Kultys, 'Controversies About Agency Theory as Theoretical Basis for Corporate Governance' (2016) 7 *Oeconomia Copernicana* 613

<sup>202</sup> Agents have to prepare to be challenged by all these matters, and thus to be aware of their own performances.



competitive efficiency among corporate managers and thereby affords strong protection to the interest of vast numbers of small, non-controlling shareholders'.<sup>203</sup> By contrast, non-profit agents generally do not need to take on or bear the risks of an enterprise being bought or sold in the marketplace.<sup>204</sup> This would suggest they have therefore increased opportunities to pursue their self-interest.<sup>205</sup> Similarly, it is arguable that, compared to for-profits, external legal regulations on non-profits are also less intense.<sup>206</sup> For instance, the legal requirement for information disclosure in non-profits (annual financial reports, for example) is not as strict as in for-profits (especially where the for-profit's shares are listed).<sup>207</sup>

### 3.2.2 Stewardship theory

#### 3.2.2.1 Introduction

As should be clear from above, agency theory takes a rather negative – perhaps 'jaundiced' – view of agent motivation and behaviour. It assumes pervasive self-interest. Since its disciplinary home is economics, it is no surprise it views agents as examples of *homo economicus* – with all its assumptions of human behaviour.<sup>208</sup>

But these assumptions are of course criticised by many. Such criticisms are evident in *stewardship theory*, which offers a different perspective to the pessimism of agency theory.<sup>209</sup> An agent is no longer to be understood as *homo economicus*, but rather as

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<sup>203</sup> Manne is an early famous commentator on takeovers. H G Manne, 'Mergers and the Market for Corporate Control' (1965) 73 *Journal of Political Economy* 110, 118

<sup>204</sup> Coule, (n181); B Erus and B A Weisbrod, 'Objective Functions and Compensation Structures in Nonprofit and for-Profit Organizations. Evidence from the "Mixed" Hospital Industry' in E L Glaeser (ed), *The Governance of Not-for-Profit Organizations* (University of Chicago Press 2003)

<sup>205</sup> Coule, (n181)

<sup>206</sup> *ibid* 78

<sup>207</sup> *ibid* 79

<sup>208</sup> *Homo economicus* is 'an instrumentally rational and calculating seeker of preference satisfaction'. *Homo economicus* individuals always seek advantage. Occasionally, *Homo economicus* may be altruistic, 'in the sense that the utility of others enters his utility calculation, but it must always be true that he acts on his own preferences'; see Heap, 157; Kultys, (201); R A Peterson and O Ferrell, *Business Ethics: New Challenges for Business Schools and Corporate Leaders* (ME Sharpe 2005)

<sup>209</sup> Stewardship theory, as advanced by Slyke, 'places greater value on collective rather than individual goals, makes decisions he/she perceives to be in the best interests of his/her principals, and views the successes of the organisation or contract as accomplishment and incentive for achieving goal alignment, absent any immediate financial payoff or maximizing of individual utility'; see Van Slyke, (n197) 165; Davis, Schoorman and Donaldson, (n200) 37

*homo sociologicus*.<sup>210</sup> Instead of self-interested agents, ready to act opportunistically to promote their self-interest, it places a much higher value on *goal convergence* between principals and agents, and defines ‘situations in which managers are not motivated by individual goals, but rather are stewards whose motives are aligned with the objectives of their principals’.<sup>211</sup>

### 3.2.2.2 Stewardship theory’s approach to the agency problem

Stewardship theory does not deny that agency costs may arise in agency relationships. It does not deny that agents’ and principal’s interests may conflict. But it suggests the extent to which the goals of agents and principals conflict arises not because of the inherent self-interest of each, but rather depends on a manager’s social ideology and personal worldview, which include various social factors such as motivation, organisational culture, and organisational commitment.<sup>212</sup> It argues that the risks of agent opportunism are correspondingly less than predicted by agency theory. And it warns that the strategies employed to control agency costs must be sensitive to the reality (as stewardship theory sees it) of the agency relationship.<sup>213</sup> So, it opposes the use of governance mechanisms designed to control agents that could destroy the cooperative and harmonious features of agent-principal relationships, and thus ruin the organisational culture and working atmosphere aimed for.<sup>214</sup> In place of excessive

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<sup>210</sup> *Homo sociologicus* individuals consider ‘how freedom of manoeuvre might be bound by the interests of others in society. This sort of person may therefore be distinguished from *Homo economicus* by a stress on the social notion of norms, rather than by the individualistic notion of concept of preferences. As he grows, he must undergo a rites of passage in the transition from boyhood to manhood, having been socialized into the appropriate norms of behaviour’; see Heap, (n165) 157; W Dixon and D Wilson, *A History of Homo Economicus: The Nature of the Moral in Economic Theory* (Routledge 2013)

<sup>211</sup> It is debated to what extent the agent’s goals can be aligned with principals’, and how this would ‘affect the level of benefits streamed toward the principal’; see Miller, (n189) 439; Dixon and Wilson, (n210) 134

<sup>212</sup> When facing the same agency problem, stewardship theory opts to address it from a positive perspective. It argues that two situations can explain the relationship between agent and principal. First, the agent’s goal is perfectly aligned with the organisation’s objective. Second, even where the interests of the agent and the principal are not aligned, then the agent can ‘attain a higher utility level by acting in the principal’s interest, as doing so may lead to opportunities for desired personal outcomes, such as achievement, affiliation, and self-actualization’; see Dixon and Wilson, (n210) 136; Peterson and Ferrell, (n208)

<sup>213</sup> Caers and others, (n); R Bernstein, K Buse and D Bilimoria, 'Revisiting Agency and Stewardship Theories' (2016) 26 *Nonprofit Management and Leadership* 489

<sup>214</sup> Stewardship theory argues that where information is not used for self-interest, and goal alignment is achieved, then providers may be less monitored and receive rewards in the form of enhanced reputation, and involvement in goal setting; see Sundaramurthy and Lewis, (n191) 397

distrust of, and control over, agents, it emphasizes ‘collective, pro-organisational, and contractual behaviours’ between the parties,<sup>215</sup> noting how, as Slyke argues, agents are motivated by intrinsic rewards, for example trust, stability, tenure and mission alignment.<sup>216</sup>

Fundamentally, the core value in stewardship theory is the initial trust disposition between principals and agents.<sup>217</sup> Encouraging *trustworthiness* can serve towards minimizing the side effect of information asymmetry between the board and the agent;<sup>218</sup> too intrusive a monitoring role by the board can destroy the trustworthy relationship between two parties.<sup>219</sup>

### 3.2.2.3 Applying stewardship theory in the non-profit context

Although stewardship theory provides a challenge to the prescriptions of agency theory in respect of *all* organisations, there are good reasons for thinking that its challenge is especially relevant to, and successful in respect of, non-profits in particular. The model of *homo economicus* on which agency theory is built fails to explain why agents who choose to work for non-profits seem often to sacrifice their personal interests by doing so – by foregoing the much higher salary and other compensation benefits they might earn in a for-profit).<sup>220</sup> The principle of *Homo economicus* is that no selfish and rational actor would do so, without expecting some form of return, or gain.<sup>221</sup>

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<sup>215</sup> Research by Miller has indicated that the relationship between non-profit boards and managers is primarily based on trust and mutual respect. Empirical evidence further confirms this practice; that directors ‘possess high confidence and trust in their management and make decisions based primarily on information provided by management and employees; see Miller, (n189) 431; Peterson and Ferrell, (n208)

<sup>216</sup> Van Slyke, (n197) 167; see also Kultys, (n201); Dixon and Wilson, (n210)

<sup>217</sup> Van Slyke, (n197) 169; Kultys, (n201)

<sup>218</sup> Trust can be defined as ‘a major psychological and social process that underlies developing, maintaining, changing and discontinuing contractual relations’; see N Conway and R B Briner, 'A Daily Diary Study of Affective Responses to Psychological Contract Breach and Exceeded Promises' (2002) 23 *Journal of Organizational Behavior* 287; L Donaldson and J H Davis, 'Stewardship Theory or Agency Theory: CEO Governance and Shareholder Returns' (1991) 16 *Australian Journal of Management* 49; Dixon and Wilson, (n210); Peterson and Ferrell, (n208)

<sup>219</sup> Bernstein, Buse and Bilimoria, (n213)

<sup>220</sup> In the frame of *Homo economicus* theory, money is among the most important of human incentives because it provides the means to ‘enable increased consumption, which is itself assumed to be the primary motivating force behind all economic activity’; see Heap, (n165)

<sup>221</sup> *ibid* 72

That stewardship theory is especially compelling within non-profits is also supported by my analysis in Chapter 2, and especially my emphasis upon the participatory/expressive role that non-profits fulfil. As noted there, to explain fully what role non-profits perform, we must understand why individuals create, or collaborate to sustain, non-profits. We stressed that they do so because of their desires to participate in the life of the organisation, and to express their support for the values the organisation represents. All of this is consistent with the sociological view of human action which stewardship theory employs.

### **3.2.3 The relationship between the two theories and implications for the non-profit board's control role?**

Much literature insists that agency theory and stewardship theory hold contradictory views/attitudes towards a board's controlling role. However, I shall argue that these two theories are neither completely distinctive nor mutually exclusive.<sup>222</sup> Rather, they interact and complement each other. Agency theory in fact shares important similarities with stewardship theory, and the distinction between the two can be blurred.<sup>223</sup> Caers<sup>224</sup>, Slyke<sup>225</sup>, Eisenhardt<sup>226</sup> and Klein et al.<sup>227</sup> argue that stewardship theory can potentially be viewed more as a limiting case of the agency framework.<sup>228</sup> Thus, '[o]n an axis of ascending agency conflicts that start from zero at the left-hand side, stewardship theory constitutes the lower end. All other points reside under the agency framework'.<sup>229</sup>

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<sup>222</sup> Bernstein, Buse and Bilimoria, (n213)

<sup>223</sup> K M Eisenhardt, 'Agency Theory: An Assessment and Review' (1989) 14 *Academy of Management Review* 57, 71; Van Slyke, (n197) 163

<sup>224</sup> Caers and others, (n185)

<sup>225</sup> Slyke argues: 'we would expect that principals who provide clear incentives would experience less agent opportunism and goal divergence. For the agent, convergence with the principal's goals can over time lead to trust and reputational enhancement as well as less monitoring and fewer reporting requirements'; see Van Slyke, (n197) 164

<sup>226</sup> Eisenhardt, (n223) 70

<sup>227</sup> Empirical work conducted by Klein et al. further indicates their supportive attitude for both these theories, and implies that there is a need for both agency theory and stewardship theory to explain principal-agent relationships; see K J Klein, H Tosi and A A Cannella, 'Multilevel Theory Building: Benefits, Barriers, and New Developments' (1999) 24 *Academy of Management Review* 248

<sup>228</sup> Caers and others, (n185) 38

<sup>229</sup> *ibid* 29

On this view, there is no obvious reason for us to have to adopt either of these two theories to the exclusion of the other, or to have to decide which one is the more suitable in order to guide the performance of non-profit boards. Instead, different strategies in the light of both these two theories may be taken on a case-by-case basis. For instance, supposing the non-profit organisation is well-developed with a good reputation, with employees who are taken care of and develop within a well-cultivated organisational culture.<sup>230</sup> In such a situation, the relationship between principals and their agents is likely to be more friendly and trustworthy, which in turn will mean monitoring in this specific non-profit context may be stewardship-oriented or led.<sup>231</sup>

Conversely, sometimes, in some non-profits, there may be more intense problems of information asymmetry, less experienced/professional directors, or other factors which undermine agents' goal alignment with their non-profits. In such cases, the harder-monitoring advocated by agency theory may be more appropriate.<sup>232</sup> In short, I conclude that the *combined* use of agency theory and stewardship theory, and a flexible, situation-sensitive, combination of their prescriptions for the role of the board, is essential.

### **3.3 Resource dependence theory**

#### **3.3.1 Resource dependence theory and the board's service role**

Resource dependence theory ('RD theory') has found itself well-entrenched in academic discussions over the last few decades. It addresses 'the ability [of corporations] to acquire and maintain resources'.<sup>233</sup> In essence, as we shall explain

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<sup>230</sup> Bernstein, Buse and Bilimoria, (n212)

<sup>231</sup> J L Callen, A Klein and D Tinkelman, 'Board Composition, Committees, and Organizational Efficiency: The Case of Nonprofits' (2003) 32 *Nonprofit and Voluntary Sector Quarterly* 493

<sup>232</sup> A Toivonen and P U Toivonen, 'The Transformative Effect of Top Management Governance Choices on Project Team Identity and Relationship with the Organization—an Agency and Stewardship Approach' (2014) 32 *International Journal of Project Management* 1358

<sup>233</sup> Resource dependency theory is believed to have its roots in the notion of 'Power Dependence Relations' advanced by Emerson in 1962. It was then enriched by Pfeffer and Salancik in 1978. Further, research by Zald and Jun & Armstrong, and Drees provided a more comprehensive perspective in the boundary spanning role fulfilled by the board; see R M Emerson, 'Power-Dependence Relations' (1962) 27 *American Sociological Review* 31; J Pfeffer and G R Salancik, *The External Control of Organizations: A Resource Dependence Approach* (Harper and Row Publishers 1978) 69; M N Zald, 'The Power and Functions of Boards of Directors: A Theoretical Synthesis' (1969) *American Journal of*

more fully below, it prescribes what might be called a ‘*service role*’ for the board. This role includes representing organisations’ interests in society, linking organisations with their external environment, and securing critical resources.<sup>234</sup>

The theory attempts to advance the board’s service role in two ways. First, the value and importance of outside resources to the board is emphasized. Whilst traditional corporate governance, enlightened by agency theory, insists that the most fundamental mission of the board is to monitor agent behaviours, the survival and development of organisations cannot be determined only by the principal-agent relationship.<sup>235</sup> Resources outside the organisation are important. A single organisation cannot secure all of the resources it may require for its survival alone.<sup>236</sup> Most organisations rely heavily on resources supplied by others; failure to secure those resources leave organisations vulnerable to risky externalities in a competitive market.<sup>237</sup> To facilitate the organisation’s daily operation, improve its long-term prosperity and stability, and reduce its social-environmental uncertainty and transaction costs, the board to any corporation has to take on the role in promoting resource exchange.<sup>238</sup> And, as a descriptive matter, Pfeffer,<sup>239</sup> and Pfeffer & Salancik,<sup>240</sup> developed a set of propositions predicting that, where the organisation was dependent on the environment for resources it needed to survive, boards would indeed tend to focus on external roles.<sup>241</sup>

Second, RD theory also addresses why the board is *the most appropriate organ* in an organisation to play this crucial service role.<sup>242</sup> As Pfeffer and Salancik argued, ‘[w]hen

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Sociology 97, 107; S P Jun and G M Armstrong, 'The Bases of Power in Churches: An Analysis from a Resource Dependence Perspective' (1997) 34 The Social Science Journal 105, 119; J M Drees and P P Heugens, 'Synthesizing and Extending Resource Dependence Theory: A Meta-Analysis' (2013) 39 Journal of Management 1666

<sup>234</sup> D Wheeler and M Sillanpa, 'Including the Stakeholders: The Business Case' (1998) 31 Long Range Planning 201, 204

<sup>235</sup> D Malatesta and C R Smith, 'Lessons from Resource Dependence Theory for Contemporary Public and Nonprofit Management' (2014) 74 Public Administration Review 14

<sup>236</sup> G F Davis and J Adam Cobb, 'Resource Dependence Theory: Past and Future', *Stanford's Organization Theory Renaissance, 1970–2000* (Emerald Group Publishing Limited 2010)

<sup>237</sup> Miller-Millesen, (n192) 522

<sup>238</sup> Davis and Adam Cobb, (n236)

<sup>239</sup> J Pfeffer, 'Size and Composition of Corporate Boards of Directors: The Organization and Its Environment' (1972) Administrative Science Quarterly 218

<sup>240</sup> Pfeffer and Salancik, (n233)

<sup>241</sup> Miller-Millesen, (n192) 534

<sup>242</sup> A J Hillman and T Dalziel, 'Boards of Directors and Firm Performance: Integrating Agency and Resource Dependence Perspectives' (2003) 28 Academy of Management Review 383

an organisation appoints an individual to a board, it expects the individual will come to support the organisation, will concern himself with its problems, and will variably present it to others'.<sup>243</sup> All of these requirements can be satisfied where the individual holds an appointed position on the board.

### 3.3.2 RD theory in the non-profit board

There is good reason to think that RD theory has particular relevance to non-profits, and therefore to think that the inclusion of the 'service role' may be especially important in non-profits.<sup>244</sup> The reason concerns non-profit financing, which has always presented challenges.<sup>245</sup> As noted in Chapter 2, the essence of non-profits is the non-distribution constraint to which they must be subject. But this means that non-profits cannot fund their activities through issuing share capital, since providers of such capital would typically expect to receive the residual profits of the organisation.<sup>246</sup> Consequently, a great many non-profits – and especially those defined as donative ones, in Chapter 2, depend heavily on external financing from supporters – philanthropic donors, volunteers, government, and so on – to maintain their daily-operations. This dependence often leads to the organisations' operational instability. Indeed, it is arguable that the non-profit financial situation in the UK has worsened over recent years, since national governments, who are among the primary funders of such bodies, have gradually withdrawn their support.<sup>247</sup> RD theory therefore acts as a platform offering a variety of approaches to facilitate the board's boundary spanning role.<sup>248</sup>

On the other hand, it must also be noted that there are risks in non-profit boards embracing too fully the service role. Two such risks deserve emphasis. First, there is the risk that non-profits may sometimes *sacrifice their organisational objectives and principals* in exchange for resources.<sup>249</sup> Attracting resources may be allowed to

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<sup>243</sup> Miller-Millesen, (n192) 522

<sup>244</sup> See generally *ibid* 534

<sup>245</sup> Pfeffer and Salancik, (n233) 163; Drees and Heugens, (n233)

<sup>246</sup> Pfeffer and Salancik, (n233)

<sup>247</sup> Malatesta and Smith, (n235)

<sup>248</sup> M Middleton, 'Nonprofit Boards of Directors: Beyond the Governance Function' in W W Powell (ed), *The Nonprofit Sector: A Research Handbook* (Yale University Press 1987) 523

<sup>249</sup> Pfeffer and Salancik, (n233) 2

override pursuit of the organisation's true mission.<sup>250</sup> Non-profits' boards may be tempted to target activities in which funding is easily accessed, for example, irrespective of its organisational and core value.<sup>251</sup> Indeed, substantial evidence exists suggesting that non-profits may change their goals and their services to take advantage of available funding opportunities.<sup>252</sup> In choosing between mission, and resource-accumulation, non-profit boards' decisions may become short-sighted and money-oriented.

Second, the diversity of those who provide resources to non-profits, together with the often obscure objectives of non-profits, can make RD theory difficult to operationalise in the non-profit sector. Anheier notes that the complexity of managing (or governing) a non-profit is partly due to the diversity of those on whom the organisation depends for its resources.<sup>253</sup> Therefore, the board's boundary-spanning role will entail coordinating with a broad array of constituents, in order to achieve consensus.<sup>254</sup>

### **3.4 Stakeholder theory**

#### **3.4.1 Stakeholder theory and the board's role**

*Stakeholder theory* focuses on the relationship between organisations and their so-called 'stakeholders' (defined below). It has spawned a huge literature, spanning many areas of organisational governance, business ethics, strategic decision-making, and so on.<sup>255</sup> It was developed initially with a particular focus on for-profits, where it strongly opposed the assumption of *shareholder dominated* governance mechanisms, instead demanding a broader view of corporate responsibility.<sup>256</sup> In doing so, it addressed

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<sup>250</sup> Malatesta and Smith, (n235)

<sup>251</sup> W A Rosenbaum and G M Kammerer, *Against Long Odds: The Theory and Practice of Successful Governmental Consolidation* (Sage Publications 1974)

<sup>252</sup> R T Blau and R G Harris, *Strategic Uses of Regulation: The Case of Line-of-Business Restrictions in the Us Communications Industry* (Center for Research in Management 1992)

<sup>253</sup> Rosenbaum and Kammerer, (n251); Anheier and Kendall, (n67)

<sup>254</sup> Since stakeholders are different interest groups each of which has its own interest to claim, their requirements can be different; see R Dart and others, 'Boards of Directors in Nonprofit Organizations Do They Follow a Life - Cycle Model?' (1996) 6 *Nonprofit Management and Leadership* 367

<sup>255</sup> The seminal contributions to stakeholder theory were made by Freeman. For an overview of current stakeholder theory, see R E Freeman and others, *Stakeholder Theory: The State of the Art* (Cambridge University Press 2010)

<sup>256</sup> This may cover parties participating in the governance and management process (this may include employees, suppliers, customers, communities governmental bodies, trade unions, etc.); see A L Friedman and S Miles, 'Developing Stakeholder Theory' (2002) 39 *Journal of Management Studies* 1



‘morals and values in managing an organisation in the traditional view of the firm’,<sup>257</sup> often with the explicit goal of seeking ‘... to achieve a more equitable distribution of the benefits of corporate activity for non-shareholders relative to shareholders’.<sup>258</sup>

We shall begin by noting the discussion around the very definition of ‘stakeholders’, before then turning to the heart of the debate around stakeholding itself. Here, we shall compare and contrast two competing conceptualisations of stakeholding: the instrumental, and the normative. Finally, we shall apply this thinking to non-profits.

### 3.4.2 A definition (and a typology) of stakeholders

Who counts as a ‘stakeholder’ of an organisation? This definitional question has long proved troublesome.<sup>259</sup> The most commonly quoted definition was given by Freeman.<sup>260</sup> It is broad and inclusive, and considers stakeholders as ‘any group or individual who can affect or is affected by the achievement of the organisation’s objectives’.<sup>261</sup> Theorists have then offered different accounts or typologies of those groups which may be considered to ‘affect’,<sup>262</sup> or to be affected by’, the achievement of the organisation’s objectives.<sup>263</sup> To be sure, neither of these groups are ‘self-defining’. Controversies exist over who should be included,<sup>264</sup> and this often results in a lack of consistency and clarity. Other theorists have held that this lack of consistency and clarity in the scope of stakeholders may eventually prevent the application of

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<sup>257</sup> Z Aycan, R N Kanungo and M Mendonca, *Organizations and Management in Cross-Cultural Context* (Sage 2014)

<sup>258</sup> I Maitland, 'Distributive Justice in Firms: Do the Rules of Corporate Governance Matter?' (2001) *Business Ethics Quarterly* 129

<sup>259</sup> R E Freeman, *Strategic Management: A Stakeholder Approach* (Cambridge University Press 2010)

<sup>260</sup> *ibid*

<sup>261</sup> The original version of this definition includes groups of shareholders, customers, suppliers and employees, as well as competitors, such as the government and communities per se. In order to improve this definition of stakeholders, Freeman further classifies them into two stakeholder groups according to the standard of ‘affect’ and ‘is affected by’; see 25; *ibid* ; Y Fassin, 'The Stakeholder Model Refined' (2009) 84 *Journal of Business Ethics* 113, 114; S Fernando and S Lawrence, 'A Theoretical Framework for CSR Practices: Integrating Legitimacy Theory, Stakeholder Theory and Institutional Theory' (2014) 10 *Journal of Theoretical Accounting Research* 149

<sup>262</sup> See e.g. K E Goodpaster, 'Business Ethics and Stakeholder Analysis' (1991) 1 *Business Ethics Quarterly* 53

<sup>263</sup> See e.g. S Miles, 'Stakeholder Theory Classification: A Theoretical and Empirical Evaluation of Definitions' (2015) *Journal of Business Ethics* 1

<sup>264</sup> Philips further distinguished it into three groups — ‘normative stakeholders’, ‘derivative stakeholders’ and ‘dangerous stakeholders’; R Phillips, 'Stakeholder Legitimacy' (2003) 13 *Business Ethics Quarterly* 25; Miles, (n14)

stakeholder theory in board governance,<sup>265</sup> since it fails to specify stakeholder identities and thus leaves a great deal of space for a dramatic expansion in the number of potential stakeholders.<sup>266</sup>

Beyond these definitional controversies, we might note a further point of interest in the distinction Freeman makes between, on the one hand, those who can affect and, on the other hand, those who may be affected by, an organisation. For this distinction suggests two rather different reasons why an organisation may be concerned with different stakeholder groups. Organisations may be concerned with those who can *affect* the organisation for essentially self-interested reasons; it may want to consider its impact on those groups because they, in turn, can impact the organisation, for better or worse.<sup>267</sup> By contrast, an organisation may be concerned with those groups which the organisation itself affects for essentially moral reasons; because the organisation may be responsible for the impacts, and especially any negative impacts, it inflicts upon them. This distinction is flagged up here because it corresponds to the division between what have been termed ‘instrumental’ and ‘normative’ stakeholding, to which we now turn.<sup>268</sup>

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<sup>265</sup> T M Jones and A C Wicks, 'Convergent Stakeholder Theory' (1999) 24 *Academy of Management Review* 206; R K Mitchell, B R Agle and D J Wood, 'Toward a Theory of Stakeholder Identification and Salience: Defining the Principle of Who and What Really Counts' (1997) 22 *Academy of Management Review* 853.; Orts and Strudler, (n18)

<sup>266</sup> Contributing to the internationalization as well as technological information networks, it is claimed that ‘virtually everyone and everything, everywhere, can ‘affect or ‘be affected by’ the decisions and actions of a business enterprise’. Consequently, anyone who satisfies the ‘affect or be affected’ criteria can theoretically be labelled as stakeholders in corporations, which obviously contributes little to the theory, which will eventually lose value in practice; see E Sternberg, 'Stakeholder Theory Exposed' (1996) 16 *Economic Affairs* 36.; Fassin, (n261).; Orts and Strudler, (n18); Fernando and Lawrence, (n261)

<sup>267</sup> T Donaldson and L E Preston, 'The Stakeholder Theory of the Corporation: Concepts, Evidence, and Implications' (1995) 20 *Academy of Management Review* 65

<sup>268</sup> Donaldson and Preston distinguish between three aspects of stakeholder theory: descriptive, instrumental and normative. This may be regarded as one of the typical typologies to approaches. The main difference between their approach, and mine, is their inclusion of the ‘descriptive’ version of stakeholding. This is mainly based on the Anglo-American legal system, has been mostly applied in the for-profit sector, and lends little to the discussion or research focus here; see *ibid* ; also see Kaler, (n17)

### 3.4.3 Two approaches to apply stakeholder theory

#### 3.4.3.1 Instrumental stakeholding

The instrumental stakeholder approach defines *real stakeholders* as those ‘whose relationship with the firm is economic or those that are able to yield power over firms’.<sup>269</sup> Taking care of the interests of these stakeholders can bring certain strategic and *commercial* benefits to an organisation.<sup>270</sup> Stakeholder theory in applying this approach thus attempts ‘to identify the connections between stakeholder management and the achievement of traditional corporate objectives’.<sup>271</sup> To be sure, the connection between stakeholders’ and organisations’ interests is unlikely to be straightforward.<sup>272</sup> Here, ‘[i]nstrumental uses usually stop short of exploring specific links between causes (i.e. stakeholder management) and effect (i.e., corporate performance) in detail, but such link is certainly implicit’.<sup>273</sup> But the implications for the role of the board are reasonably clear. The board must ensure good relationships with stakeholders, but only with those stakeholders it pays the organisation, instrumentally, to treat well. Another way of putting this is that, according to this instrumental approach, the board will treat some stakeholders well, but only as a ‘*means to some other end*’ – the end of achieving the organisation’s true goals.<sup>274</sup>

It might be noted that those organisations who adopt the instrumental application of stakeholder theory do not necessarily thereby adopt an immoral or irresponsible attitude to their stakeholders. Rather, they may be regarded as being merely ‘*morally neutral*’, putting ethical issues beyond their consideration.<sup>275</sup>

#### 3.4.3.2 Normative stakeholder approach

Compared to the instrumental approach, the normative stakeholder approach

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<sup>269</sup> M E Clarkson, 'A Stakeholder Framework for Analyzing and Evaluating Corporate Social Performance' (1995) 20 *Academy of Management Review* 92, 98; Freeman and others, (n141) 107

<sup>270</sup> Kaler, (n17) 74

<sup>271</sup> Donaldson and Preston, (n267) 69

<sup>272</sup> *ibid* 69

<sup>273</sup> *ibid* 71

<sup>274</sup> C Tantalo and R L Priem, 'Value Creation through Stakeholder Synergy' (2014) *Strategic Management Journal* 314

<sup>275</sup> Donaldson and Preston, (n267) 69

concentrates on “what the ‘function’ of companies should be and the ‘*moral or philosophical guidelines*’ they should follow with regard to their ‘operation and management’”.<sup>276</sup> It holds that, regardless of their instrumental value to the achievement of the organisation’s objectives, organisations must still protect stakeholders’ interests, but for moral (not instrumental) reasons.<sup>277</sup> When applying this approach to secure stakeholder’s interests, an organisations’ behaviour should, in general, reflect moral sentiments with respect to board governance, identifying the moral entitlements of each stakeholder, and protecting his/her rights from expropriation.<sup>278</sup>

This, again, has clear implications for the role of the board, a role that now differs from that envisaged by instrumental stakeholding. The board’s role is no longer restricted merely to identifying those groups that may affect the organisation, and working out how well or badly they should be treated in order to maximise the organisation’s achievements of its own objectives. Now, the board must engage in moral reasoning. It must work out what the morally responsible way is to treat the organisation’s stakeholders, and it must ensure they are treated accordingly. Another way of putting this is, the board’s role is to treat stakeholders’ interests as ‘*an end in itself*’.<sup>279</sup> They must protect stakeholders’ interests just because it’s the right thing to do, even if this means some reduction in their ability to achieve their organisation’s goals.<sup>280</sup> Research by Freeman employs the term ‘*stakeholder synthesis*’, in a six-step process that examines how the normative stakeholder approach affects a board’s decision-making performances.<sup>281</sup>

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<sup>276</sup> Kaler, (n17) 73

<sup>277</sup> J S Harrison, D A Bosse and R A Phillips, 'Managing for Stakeholders, Stakeholder Utility Functions, and Competitive Advantage' (2010) 31 Strategic Management Journal 58, 63; D Cumming, W Hou and E Lee, 'Business Ethics and Finance in Greater China: Synthesis and Future Directions in Sustainability, CSR, and Fraud' (2016) 138 Journal of Business Ethics 601

<sup>278</sup> Research here suggests stakeholders may be able to assess moral sentiments of the governance approach used with reasonable accuracy; see T M Jones, 'Instrumental Stakeholder Theory: A Synthesis of Ethics and Economics' (1995) 20 Academy of Management Review 404; Tantalo and Priem, (n274)

<sup>279</sup> Donaldson and Preston, (n267) 73

<sup>280</sup> Tantalo and Priem, (n274)

<sup>281</sup> Within a normative stakeholder approach, normative stakeholders are likely to continue to enforce step three of the aforementioned ‘synthesis’, following steps purely because the manager is supposed to ‘morally maintain fiduciary duty to every potential stakeholders’; see Freeman, (n255)

### 3.4.3.3 Choosing between these two approaches

Having set out the two theories of stakeholding, which is more appropriate for non-profits? This question is clearly a difficult one. There is no clear consensus in the literature favouring one or the other. And, before I develop my own answer, I want to complicate the issue a little further still. For the choice between instrumental and normative stakeholding is, in fact, related to an issue which we put ‘on hold’ earlier, when discussing ‘agency theory’, about the identity of the ‘principal’.

In that discussion about agency theory, and in the discussion just above about stakeholding, we have continuously referred to ‘the interests of the organisation’, or ‘the organisation’s objectives’. But what exactly are these? Whose interests count as those of the organisation? What are an organisation’s objectives?

Are the interests of the organisation simply the interests of donors? Some writers, such as Fama and Jensen, have argued just that; they see *donors*, who provide capital, as equivalent to the shareholders in the for-profit sector.<sup>282</sup> Their interests, therefore, become the interests of the organisation. Others, however, such as Puyvelde et al., take a broader view of non-profits’ organisational objectives, identifying them with a wider range of constituencies.<sup>283</sup> On that conception of the non-profit’s interests, the interests of some stakeholders may already become part of the very objectives of the organisation (leaving the interests of others to count only in either an instrumental, or a normative, way).

One way to make at least some progress in resolving these related controversies—about the objectives/interests of the organisation, and the choice between normative and instrumental stakeholding – is by reference to the theories of the non-profit that were developed in Chapter 2. We saw there that part of the role of the non-profit is to provide the reassurance to consumers, or to donors, that their interests will not be sacrificed by an organisation that exploits their comparative ignorance. On this view, then, the interests of consumers (in commercial non-profits), or of donors, in donative non-

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<sup>282</sup> This statement conforms with the definition of principal as shareholders in for-profit enterprises, who are also the contributor of capital; see Fama and Jensen, (n191) 313

<sup>283</sup> Van Puyvelde and others, (n199) 445

profits, form the core objective of the organisation. However, we also saw that non-profits cannot be understood *solely* in terms of their comparative superiority in meeting the demands of consumers or donors. That pays no regard to the *supply* of non-profits. Non-profits also function as participatory and expressive communities. This necessarily requires the objectives of non-profits to be conceived of more widely – more inclusively – than just the interests of consumers or donors. Part of the very objective of a non-profit is indeed to provide a means for some stakeholders to participate in the organisation and express their core values.

Acknowledging this means that *some* stakeholders' interests are already taken into account in thinking about the very objectives of the organisation. For others, however, I think the existing state of our knowledge simply precludes us from insisting that organisations must adopt either an instrumental, or a normative, version of stakeholding. There cannot be a one size fits all approach to this. It should, instead, be left to boards themselves, armed with more local knowledge about the circumstances of their own organisation, to determine which version of stakeholding they favour.<sup>284</sup>

### **3.5 Compatibility of different board roles**

#### **3.5.1 Roles of non-profit board under different theories**

Thus far, Chapter 3 has sought to capture the essence of different theories, and how each of these prescribes different board roles. To develop this in a more comprehensive manner, this section will now recapitulate three fundamental board roles (*control*, *service* and *strategic role*), following which their connection with relevant theories will be made clear. Thereafter, I shall argue that non-profits boards should not, and do not need to, *choose between* these different roles. Rather, as mentioned in the introduction to this chapter, our best understanding is achieved by combining elements of all these roles. As noted, I shall call this the 'integrated model for board governance'. Having done that, I shall finish, in sections 3.5.3 and 3.5.4 by addressing certain criticisms that might be made against the practicality of expecting boards to fulfil multiple roles simultaneously.

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<sup>284</sup> Without an appropriate or identifiable principal, then the agent in a non-profit context is more likely to find it difficult to determine who it is they should be accountable to; see Herman, (n190) 89

### 3.5.1.1 The control role

The control role of the board grew out of our analysis of agency theory and stewardship theory. It focuses on the need to control agency costs, through appropriate mechanisms to monitor the performance of the organisation's agents, and intervene where necessary. It has been fully explained already, and requires no more discussion here.

### 3.5.1.2 The service role

The *service role* refers to the board's institutional function, which includes representing an organisations' interest in society, linking organisations with their external environment, and securing critical resources.<sup>285</sup> Two theories (RD theory and stakeholder theory) have prescribed this service role. RD theory formulates this role in terms of boards reflecting their organisations' existing environment and directors securing the provision of important resources for their organisations.<sup>286</sup> Stakeholder theory travels a similar path, but focuses more clearly on the interests of stakeholders, either from an instrumental or a moral point of view.<sup>287</sup>

### 3.5.1.3 The strategic role

The board's 'strategic role', which is sometimes labelled visionary leadership, is essential to the organisation's effectiveness.<sup>288</sup> This *strategic role* focuses on the formulation, analysis, and ratification of corporate strategy.<sup>289</sup> Although Chapter 3 has not, so far, linked this role to any of the four considered theories, each of these theories have in fact implied the importance of the strategic role in an organisation's governance. Indeed, it is implicit in almost every aspect of an organisation's

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<sup>285</sup> Wheeler and Sillanpa, (n234)

<sup>286</sup> Klausner and Small, (n174)

<sup>287</sup> M Ezzamel and R Watson, 'Wearing Two Hats: The Conflicting Control and Management Roles of Non-Executive Directors' (1997) *Corporate Governance* 54 in Kevin Keasey, Steve Thompson and M Wright, 'Corporate Governance: Economic, Management, and Financial Issues' (1998) 13 *Managerial Auditing Journal* 390

<sup>288</sup> Renz, (n1)

<sup>289</sup> Babić, Nikolić and Erić, (n173) 143

governance. This may be reflected in the process of management control (the board's control role), and the fiduciary responsibility vested in directors, which requires attention to be paid to strategic concerns.<sup>290</sup> Executive performance cannot be evaluated reliably, without an appreciation of strategic issues as a whole.<sup>291</sup> Moreover, the boundary spanning role, which itself is linked to visionary leadership, can help broaden the board's strategic vision.<sup>292</sup> Directors who have access to information, vital to the diagnosis of opportunities and threats, can aid managers by mapping or reviewing strategic actions.<sup>293</sup> Instrumental stakeholder theory also posits that, protecting stakeholder's interests depends upon an organisation's strategic objective both in the short-term and long-term perspectives.<sup>294</sup>

### 3.5.2 Justifying the integration of different board functions

How, then, can we justify expecting boards to address, simultaneously, each of the three roles summarised above? The first point is that, if each of the four considered theories does indeed provide compelling arguments about what boards should be doing, there is no obvious reason to reject the prescriptions of any one of them. The fact that agency theory tells us something important about the (control) role of the board does not mean that, say, resource dependency theory must be telling us nothing useful.

Much of the evidence presented has proven that in highly institutionalized and management-based organisations, it is unrealistic to expect the board to perform just a single role. Indeed, the work of Hans *et.al.* has argued that '[n]o single theory

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<sup>290</sup> C M. Taylor, C J. Cornelius and K Colvin, 'Visionary Leadership and Its Relationship to Organizational Effectiveness' (2014) 35 *Leadership & Organization Development Journal* 566

<sup>291</sup> J Kreiken, 'The Board's Role in Strategic Planning and Resource Allocation' in P M B Edward Mattar (ed), *Handbook for Corporate Directors* (McGraw-Hill Book Company 1985) C N Waldo, *Boards of Directors: Their Changing Roles, Structure, and Information Needs* (Quorum 1985); S A Zahra and J A Pearce, 'Boards of Directors and Corporate Financial Performance: A Review and Integrative Model' (1989) 15 *Journal of Management* 291; B Gazley and K Kissman, *Transformational Governance: How Boards Achieve Extraordinary Change* (John Wiley & Sons 2015)

<sup>292</sup> Gazley and Kissman, (n291)

<sup>293</sup> *ibid*

<sup>294</sup> S Ayuso and A Argandoña, 'Responsible Corporate Governance: Towards a Stakeholder Board of Directors?' IESE Business School Working Paper, (2009) <[https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1349090](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1349090)> accessed 13 March 2016 L B Stearns and M S Mizruchi, 'Board Composition and Corporate Financing: The Impact of Financial Institution Representation on Borrowing' (1993) 36 *Academy of Management Journal* 603. Filatotchev and Nakajima, (n13); Chait, Ryan and Taylor, (n86)



adequately describes, encompasses, or explains the nature of consequences of strategically involved corporate boards'.<sup>295</sup> The assessment of board effectiveness will be more convincing if each of the board roles can be fully considered in a comprehensive point of view.<sup>296</sup>

Taking the board's controlling role as an example here, traditional corporate governance would suggest that the existence of a board is to fulfil its control role, in which to monitor the agent's (or managers') performance and reduce costs accordingly.<sup>297</sup> However, within modern corporate governance theory, this 'control role primacy' stance has been strongly challenged 'in respect of its scope, organisational view, moral implications and units of analysis'.<sup>298</sup> It fails to effectively appreciate the board's contribution, in many other aspects, such as co-opting the external environment and encouraging stakeholder interaction. Both empirical and theoretical evidence has indicated that board performance does not solely rely on an agent-principal paradigm, rather, many other elements may be at play and can thereby work as complements.<sup>299</sup>

This is by no means a rejection of the contribution of agency theory, rather just the fact 'each theory paints an incomplete picture of a highly complex phenomenon because it focuses on different sets of functions'.<sup>300</sup> Therefore, to achieve board effectiveness, it is of utmost importance to adopt an intensive overview through the synthesizing of these different theories.<sup>301</sup> In doing so, the following section will strive to explain how board performance is affected by the operation of multi-faceted roles when viewed in the frame of organisation governance. This reconceptualization is essential here, since it will enrich our understanding of the board's function, and help the non-profit board achieve its overall objective.<sup>302</sup>

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<sup>295</sup> H Van Ees, J Gabrielsson and M Huse, 'Toward a Behavioral Theory of Boards and Corporate Governance' (2009) 17 *Corporate Governance: An International Review* 307, 317

<sup>296</sup> *ibid* 582

<sup>297</sup> S B Bhandari, 'Ethical Dilemma of Nonprofits in the Agency Theory Framework' (2010) 8 *Journal of Leadership, Accountability and Ethics* 33

<sup>298</sup> P F Drucker, *Managing the Nonprofit Organization* (HarperCollins 1990) 157, 163; D C Hambrick, A v Werder and E J Zajac, 'New Directions in Corporate Governance Research' (2008) 19 *Organization Science* 381,394

<sup>299</sup> Weir, Laing and McKnight, (n18)

<sup>300</sup> Miller-Millesen, (n189) 533

<sup>301</sup> Weir, Laing and McKnight, (n18) 582

<sup>302</sup> Van Ees, Gabrielsson and Huse, (n295) 730

### 3.5.3 Challenges to establishing an integrative model

Whilst establishing an integrative model seems logically coherent, and demanded by the foregoing theoretical analysis, it does face some difficult practical challenges. Are these different board roles compatible with each other? Is there any conflict between those multiple tasks that directors are being asked to undertake? How could non-profit boards deal with the operation of *multi-tasking* in this context?

Multi-tasking has already become an essential part of modern society.<sup>303</sup> How efficiently we are able to deal with multi-tasking depends not only on an individual's capability, but also the approach we choose to take.<sup>304</sup> Perrow argued that multi-tasking could be managed if 'it involves things that you do routinely in your life'.<sup>305</sup> Nevertheless, when the issue to be dealt with involves 'deeper cognitive thinking', multi-tasking may reduce working efficiency.<sup>306</sup> However, theorists do not deny the possibility of multi-tasking.<sup>307</sup> What we really need is the *technique* in order to utilize it; for example, to avoid mistakes. The following part will explore whether directors in non-profit boards can effectively manage multi-tasking in the board context, and Table 3.2 will briefly summarize the potential difficulties when multi-tasking and solutions.

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<sup>303</sup> R W Masulis and S Mobbs, 'Independent Director Incentives: Where Do Talented Directors Spend Their Limited Time and Energy?' (2014) 111 *Journal of Financial Economics* 406

<sup>304</sup> *ibid*

<sup>305</sup> C Perrow, 'Economic Theories of Organization' (1986) 15 *Theory and Society* 11, 17; V Agarwal, L Ma and K Mullally, 'Managerial Multitasking in the Mutual Fund Industry' (2016) <[https://papers.ssrn.com/sol3/Papers.cfm?abstract\\_id=1910367](https://papers.ssrn.com/sol3/Papers.cfm?abstract_id=1910367)> accessed 26 March 2015

<sup>306</sup> A Chiarini, P Found and N Rich, *Understanding the Lean Enterprise* (Springer 2016) 119

<sup>307</sup> Agarwal, Ma and Mullally, (n305)

**Table 3.2 Multi-tasking and solutions**

Multi-tasking	Solutions
1, Directors time limit 2, Directors skill 3, Role conflict	1, Specialization through board mechanism 2, Improve directors' personal skills 3, Establishing connections between board's roles to boost its multi-tasking ability

### 3.5.3.1 Board challenges with multi-tasking

There are three principal difficulties here. We shall consider each briefly, then note why these difficulties are not, in fact, insurmountable.

#### 3.5.3.1.1 The director's time limit

In the non-profit context, there has always been a challenge to directors to deal with multiple tasks and manage their already limited time in a productive way. When compared to profit-based enterprises, the problem with non-profits has the potential to be more acute. Mechanisms facilitating profit-based board governance, such as capital investment, takeover markets and compensation packages are absent in non-profit organisations.<sup>308</sup> Without these incentives, non-profit directors have to take on much heavier workload within a certain length of time, usually in return for a less competitive package.<sup>309</sup> Studies have repeatedly found that overloading tasks was likely to reduce the working efficiency of company staff.<sup>310</sup> This is especially the case among part-time directors in non-profits as they may already serve on a number of

<sup>308</sup> A Ebrahim, J Battilana and J Mair, 'The Governance of Social Enterprises: Mission Drift and Accountability Challenges in Hybrid Organizations' (2014) 34 *Research in Organizational Behavior* 81

<sup>309</sup> *ibid*

<sup>310</sup> M Torchia, A Calabrò and M Morner, 'Board of Directors' Diversity, Creativity, and Cognitive Conflict: The Role of Board Members' Interaction' (2015) 45 *International Studies of Management & Organization* 6

boards or have their own careers alongside their directorship.

### 3.5.3.1.2 Skills requirements

To address multiple tasks, non-profit directors need to be equipped with a variety of skills given those three board's roles we addressed.<sup>311</sup> Whilst all those skills are crucial, it is unreasonable to expect every director to possess every required skill. Recruiting directors who possessed all required skills would be challenging, and perhaps only possible if accompanied by massively increased salaries. Yet, as a matter of fact, a majority of board members in non-profits receive token or little payment.<sup>312</sup> The earnings data company Research provided the comparison of payments between charities and enterprises from all sectors across the UK.<sup>313</sup> In 2015, the data indicate that CEOs in charities were paid '25 percent less than the total for all sectors', and charities pay their other directors about 17 percent less.<sup>314</sup>

### 3.5.3.1.3 Role conflicts

Multi-tasking may present a number of role conflicts to non-profit directors.<sup>315</sup> Role conflicts arise where there is a lack of consensus on a role between the role actor and others, or when there are incompatibilities among or within roles.<sup>316</sup> In the non-profit context, incompatibilities among various board roles may arise where directors attempt to fulfil all their different roles simultaneously.<sup>317</sup> The work of Belcher, for example, works out two 'syndromes' to characterize '... two sharply contrasting work patterns - referred to as *low-discretion* and *high-discretion syndromes*'.<sup>318</sup> The monitoring role of the board belongs to the low-discretion situation, because a director's task is following

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<sup>311</sup> For example, to be a good resource collector, directors need to learn how to quickly establish connections and have the capability to secure these resources for long-term and future endeavours. Malatesta and Smith, (n235)

<sup>312</sup> J Carver, *Boards That Make a Difference: A New Design for Leadership in Nonprofit and Public Organizations*, vol 6 (John Wiley & Sons 2011) 32

<sup>313</sup> ThirdSector, 'Charity Pay Study: Who Are the Highest Earners?' (*Third Sector*, 2015) <<http://www.thirdsector.co.uk/charity-pay-study-highest-earners/management/article/1335060>> accessed 25 April 2016

<sup>314</sup> *ibid*

<sup>315</sup> Ezzamel and Watson, (n287)

<sup>316</sup> A Belcher, *Directors' Decisions and the Law: Promoting Success* (Routledge 2014)

<sup>317</sup> A Belcher, 'Trust in the Boardroom' (2007) 16 *Griffith Law Review* 151

<sup>318</sup> *ibid* 162

the order of a supervising manager's performance, which is largely more a matter of conformity than performance.<sup>319</sup> Indeed, it is a feature of low discretion syndrome that the close supervision and bureaucratic rules that generate a mutually reinforcing cycle often leads to a situation of declining mutual trust.<sup>320</sup>

However, by contrast, *high-discretion syndrome* works in the opposite way.<sup>321</sup> This knowledge-based view of a corporation, which has increasingly gained support over the last decade or so, suggests that competitive advantage is to be found in organisations where employees have high discretion, and in which business knowledge can evolve.<sup>322</sup> The important point, for my argument and analysis in this section, is that the roles of resource collector and stakeholder representative tend to prefer the high-discretion context, as directors are required to be creative in solving relevant problems during the process of task performance.<sup>323</sup> Therefore, the evidence presented above would suggest that governance is best 'concentrated on those who are not encumbered by any other functions on the board'.<sup>324</sup> A particular consequence of role conflict means that undifferentiated roles fulfilled by several directors can often provide a relatively weaker incentive for board members to fully play their roles. As Riley has suggested, '[i]f a director is responsible for a series of roles [at any given point in time], then she [might] convince herself that her poor performance in one results from her devoting her attention to others'.<sup>325</sup>

### 3.5.3.2 Why multi-tasking is nevertheless feasible

As the evidence outlined above would appear to suggest, there are many factors that prohibit non-profit boards from adopting a multi-task approach in the integrative framework. Accordingly, this section attempts to identify strategies and mechanisms that non-profits could adopt to cope with multi-tasking. (This part is merely a brief overview of the relevant approaches, these points of view shall be further revisited in

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<sup>319</sup> *ibid* 163

<sup>320</sup> Belcher, (n316) 67

<sup>321</sup> *ibid*

<sup>322</sup> *ibid*

<sup>323</sup> Belcher, (n317) 164

<sup>324</sup> Riley, (n94) 134

<sup>325</sup> *ibid* 132

Chapter 4).

### **3.5.3.2.1 Division of labour and specialization**

The most obvious solution is to permit a division of labour amongst directors, allowing some directors to specialise on certain roles, whilst doing little in respect of others. Indeed, a recasting of a director's responsibilities will enable directors to assume liability for their own specific, delegated functions, and thus improve working efficiency. Accordingly, the problems caused by multi-tasking, such as role conflicts, time management and skill requirement, can be reduced considerably.

Directors' expertise will also be improved by an appropriate labour division, since they may then concentrate on one or two particular tasks, undertaking repetitive activities, which they may improve upon as already familiar with them.<sup>326</sup> This particular advantage proves to be even more prominent in non-profit organisations, because directors are in most cases unpaid 'amateurs' in the management of their boards.<sup>327</sup> Moreover, by allocating different tasks to particular directors, non-profits can broaden their scope in recruiting adequate directors.<sup>328</sup> Finally, specialization may have the effect of reducing conflicts that simultaneously arise between the performance of different roles, which may concern the potential incompatibility of board roles.<sup>329</sup> Once board roles are assigned to different directors, there may be a very small chance for a single director to be able fulfil various conflicting roles at the same time. As a result, a well-balanced board should ideally be built up, taking account of the requirement for the different roles of directors.<sup>330</sup>

### **3.5.3.2.2 Establishing connections between different board roles**

By reviewing multi-tasking in an overarching perspective, it is not difficult to identify that every board's role, task, and function can be influenced by each other. Rather than

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<sup>326</sup> *ibid* 133

<sup>327</sup> *ibid*

<sup>328</sup> *ibid* 134

<sup>329</sup> *ibid*

<sup>330</sup> Caers and others, (n185)

seeing multitasking as a burden to the non-profit board, the interaction between directors' tasks and the board's roles is likely to boost director's multi-tasking skills and thus enhance the working effectiveness of the entire board. Chapter 4 will demonstrate relevant strategies and approaches that could boost directors' multi-tasking skills.

### **3.5.3.2.3 Improving personal skills**

At the individual level, a director's ability can determine how well they could deal with multiple tasks. To accomplish a large job in a small amount of time, different people will choose different strategies.<sup>331</sup> This brings out the topic of *time management and selection of directors*. In time management theory, issues relevant to time consuming tasks can be solved by a set of major time management themes and strategies, which we will specify in 4.6 (board process). At the organisational level, time management has increasingly become an organisational issue embedded in the corporate structure and culture. For the best time usage, both managers and directors can help arrange directors' time more systematically. This matter is linked with the board culture that we shall address in 4.4.

## **3.6 Conclusion**

This chapter has focused on the role of the board in governing non-profits. Building on the foundations established in Chapter 2 about the role of non-profits themselves, it examined four essential theories (agency, stewardship, resource dependency and stakeholder theory). From those, it identified three fundamental roles (control role, service role, and strategic role) that a non-profit board should play. In doing so, it was careful to modify and tailored the four chosen theories to the distinctive qualities of non-profit organisations, and especially to the distinctive nature of the roles of non-profits, as elucidated in Chapter 2. Furthermore, the chapter also attempted to synthesize these different roles, and the theories which support them, into an 'integrated model for board governance'. In so doing, we acknowledged the difficulties and challenges such an integrated model presents, but argued also that, through careful board design, non-profit boards would be able to cope with these challenges. However,

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<sup>331</sup> D Mwenja and A Lewis, 'Exploring the Impact of the Board of Directors on the Performance of Not-for-Profit Organizations' (2009) 10 Business Strategy Series 359

this defence of the integrated model is clearly based on a fairly 'general' or 'undetailed' assessment of board design. On a case-by-case basis, there may be tensions between different board's elements: the perfect board membership to fulfil the control role may fail to collect resources, or to guarantee the interests of stakeholders, etc. There may well, in some situations, have to be compromises and trade-offs. Since, as is often said, 'the devil is in the detail', we must now examine much more carefully what a non-profit board should look like if it is to fulfil the demands of the integrated model. To this, Chapter 4 now turns.



## Chapter 4 | Designing a blueprint for non-profit boards

### 4.1 Introduction

Having identified the roles played by non-profits (Chapter 2), and the roles that should accordingly be played by their boards (Chapter 3), we are now, finally, in a position to develop the appropriate design of a board that might best fulfil these roles – what I referred to above as the ‘blueprint’ for non-profit boards. Zahra and Pearce identified four board attributes that are most relevant to determining a board’s likely success and effectiveness when attempting to achieve its prescribed role.<sup>332</sup> These were its *size*, its ‘*characteristics*’, its *structure*, and the *processes it follows*. Section 4.2 briefly introduces each of these four attributes. Thereafter, sections 4.3 to 4.6 examine each attribute in much greater detail, in the light of my integrated model for a non-profit board.

### 4.2 The four key board attributes introduced

#### 4.2.1 Board size

Board size refers to the number of directors who serve on the board.<sup>333</sup> This is fairly self-explanatory, and requires little further introductory explanation. However, one point might be made here. Whereas for-profits are often fairly constrained in the size of their boards (whether for legal or commercial reasons),<sup>334</sup> the same tends to be less true for non-profits. Thus, there tends to be more flexibility around the size of non-profit

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<sup>332</sup> Zahra and Pearce, (n291) 303

<sup>333</sup> Some authors have focused not just on ‘size’, but on a broader attribute of ‘composition’, which include both size and the ‘mix’ of ‘types’ of directors. The mix of different types of director concern the widely recognized dichotomy between internal and external directors. However, this issue of mix is less important in the non-profit sector. Although the internal and external split is important, debates about profit-based governance cite two reasons why it deserves less attention in the analysis of non-profits. First, there is less disagreement on this issue, as a majority of directors in non-profits are outsiders, who may work on a part-time basis and are not involved in day-to-day operations. Second, the proportion of internal and external members can vary significantly across non-profits, and so it is hardly possible to find a one-size-fits-all answer. Nevertheless, this matter is beyond the concern of our research; see *ibid* 306; Guest, (n16); Y Ning, W N Davidson and J Wang, 'Does Optimal Corporate Board Size Exist? An Empirical Analysis' (2010) 20 *Journal of Applied Finance* 1

<sup>334</sup> Ning, Davidson and Wang, (n333)

boards.<sup>335</sup>

#### 4.2.2 Characteristics

Second among the attributes is what I refer to as the board's *characteristics*. These will be examined from both an individual, and a collective perspective. By *individual perspective*, we shall mean the characteristics (such as the independence, or the skills) of individual directors.<sup>336</sup> The *collective perspective* looks at the nature of the board as a whole, as a separate organisational organ in its own right, and having its own features, distinct from those of its individual member directors.<sup>337</sup> These collective characteristics must therefore be 'enduring' – they are not merely a summary of the characteristics of the current membership, and they do not change just because one director happens to leave or a new one joins the board.<sup>338</sup> Rather, the board's own characteristics will change only when there is a 'significant quantum change in board composition and directors' background variables'.<sup>339</sup>

#### 4.2.3 Structure

Board *structure* concerns 'the dimensions of the board's organisation',<sup>340</sup> in terms of such factors as 'the number and types of committees, [sorts of] committee membership, the flow of information among these committees, board leadership, and patterns of committee membership'.<sup>341</sup> Non-profit directors typically come from a wide and diverse array of backgrounds, and with limited time the use of a committee structure will often be essential to improve board effectiveness.<sup>342</sup>

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<sup>335</sup> G Bai, 'How Do Board Size and Occupational Background of Directors Influence Social Performance in for-Profit and Non-Profit Organizations? Evidence from California Hospitals' (2013) 118 *Journal of Business Ethics* 171

<sup>336</sup> Zahra and Pearce, (n291) 307

<sup>337</sup> *ibid* 307

<sup>338</sup> Groysberg, Healy and Vijayaraghavan, (n28) 18

<sup>339</sup> Zahra and Pearce, (n291) 306

<sup>340</sup> *ibid* 307

<sup>341</sup> P Stiles, 'The Impact of the Board on Strategy: An Empirical Examination' (2001) 38 *Journal of Management Studies* 627. A D Upadhyay, R Bhargava and S D Faircloth, 'Board Structure and Role of Monitoring Committees' (2014) 67 *Journal of Business Research* 1486

<sup>342</sup> J Kohls, 'Corporate Board Structure, Social Reporting and Social Performance' (1985) 7 *Research in Corporate Social Performance and Policy* 165

#### 4.2.4 Process

The *process* concerns the manner – the procedures – by which the board operates. Zahra and Pearce summarized five elements of board process: ‘the frequency and length of meetings, CEO board interface, levels of consensus among directors on issues at hand, the formality of board proceedings, and the extent to which the board is involved in evaluating itself’.<sup>343</sup> On non-profit boards, decision-making processes are often less formal than those adopted by for-profits.<sup>344</sup> Thus, this part will concentrate only on the frequency and formality of board meetings.<sup>345</sup>

#### 4.3 Board size

Here we shall examine how board size can affect board performance in terms of each of the board roles identified in Chapter 3, namely the control role, service role and strategic role. Table 4.1 briefly summarizes the discussion we shall make about the pros and cons of the large/small board in non-profits. The overall argument goes as follows. Given that the boards of non-profits must play a larger number of roles than do for-profit boards, there are a number of advantages in non-profit boards, generally, being somewhat larger. However, the arguments do not go entirely in one direction: there are some counter-veiling concerns about the efficiency of larger boards, and some practical problems for non-profits, in particular, in being able to recruit sufficient, high-quality, directors to achieve the larger size that, generally, may be desirable.

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<sup>343</sup> *ibid* 178

<sup>344</sup> R B Tricker and R I Tricker, *Corporate Governance: Principles, Policies, and Practices* (Oxford University Press 2015)

<sup>345</sup> *ibid*

**Table 4.1 A summary of the arguments concerning the relationships between board role and board size**

<b>Board role</b>	<b>Large board</b>	<b>Small board</b>
Control role (monitoring directors and reduce agency costs)	Challenge manager's dominant position (spend more time monitoring) (increase specialization)	Reduce management cost (social loafing)
Service role (Resource collection and satisfy stakeholders' needs)	More opportunity to have external resources	
	Encourage stakeholders' participation	Stakeholders can have intensive involvement
Strategic role (long-term views and strategies)	Broaden the board's vision	Efficient decision-making Less distracted by overwhelming views
Practical problem	Non-profits have no ambition to expand Small non-profits are difficult to recruit directors	

#### **4.3.1 Board size: legal and empirical perspectives**

Many studies have considered the relationship between *board size* and *organisational performance* in *for-profit* enterprises. In one such study, Yermack found that 'smaller boards were more adept at monitoring the firm', whereas those with a large board size [have] a negative effect on the company's market value.<sup>346</sup> However, this connection seems to be more complex in the non-profit sector. Current studies fail to reach an agreement on the ideal size of a non-profit board.<sup>347</sup> The arguments around the idea board size in a non-profit seem less consistent, and more dependent on local variables concerning individual non-profits. It is worth noting, for example, that the UK Charity

<sup>346</sup> D Yermack, 'Higher Market Valuation of Companies with a Small Board of Directors' (1996) 40 *Journal of Financial Economics* 185, 197; Guest, (n16) 397

<sup>347</sup> De Andrés-Alonso, Azofra-Palenzuela and Romero-Merino, (n185)

Commission does not provide any particular requirement or suggestions on the number of directors in non-profits.<sup>348</sup>

### 4.3.2 Board size and board performances

The following part will explore some of the advantages and disadvantages that have been associated with either large, or small, boards.

#### 4.3.2.1 Control role

In this section, the relationship between board size and its control role will be evaluated by reference to the power balance between managers and board of directors. As Zahara and Pearce have stated, '[t]he number of directors frequently serves as an indicator of CEO domination of the board'.<sup>349</sup> That is to say, a large board can *challenge* its managers' *dominant position*, while the larger the board is the more easily the managers' misconduct can be identified and controlled.<sup>350</sup> However, it does seem to be the case that having a larger board may be especially advantageous in a non-profit context, given the larger number of roles that non-profit boards are, according to my account, to be expected to play.<sup>351</sup> A smaller non-profit board might likely find that too much of its time would be taken up with other, non-control, roles, and would accordingly have too little time to oversee managers.<sup>352</sup> Moreover, by increasing their board size, non-profit boards can also increase their *specialization*, through a further division of labour across different jobs,<sup>353</sup> again facilitating better monitoring of managers and thus a better power balance.<sup>354</sup>

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<sup>348</sup> They 'should have enough charity trustees so that they can carry out their duties effectively, but not so many that it becomes impractical to hold useful trustee meetings, where everyone can take part in the decision making'. Charity Commission, 'Good Governance: A Code for the Voluntary and Community Sector' (Code Steering Group, 2010)

<sup>349</sup> Zahra and Pearce, In A Levrau and L A Van den Berghe, 'Corporate Governance and Board Effectiveness: Beyond Formalism' (2007) 6 Journal of Corporate Governance 58, 67

<sup>350</sup> Zahra and Pearce, (n291); Guest, (n16); Ning, Davidson and Wang, (n333)

<sup>351</sup> For similar views, see K O'Regan and S M Oster, 'Does the Structure and Composition of the Board Matter? The Case of Nonprofit Organizations' (2005) 21 Journal of Law, Economics, and Organization 205

<sup>352</sup> Ning, Davidson and Wang, (n333)

<sup>353</sup> O'Regan and Oster, (n350) 209

<sup>354</sup> M A Desai and R J Yetman, 'Constraining Managers without Owners: Governance of the Not-for-Profit Enterprise' (2015) 4 Journal of Government & Nonprofit Accounting 53

Furthermore, as Cornforth notes, within small boards, managers, armed with an abundance of ‘knowledge, enthusiasm [and] time’ may outnumber, and will be more likely to ‘intimidate’, the few remaining directors.<sup>355</sup> Relatedly, he argues, a small board could be too ‘heavily dependent on the work and commitment of a small number of key individuals’.<sup>356</sup> In this situation, the loss of one or two key individuals may have far-reaching consequences for the stability of the board.<sup>357</sup>

#### 4.3.2.2 Service role

Turning now to the service role, again we can see how a larger board can bring about more opportunities to establish and secure external resources, and thus facilitate the board’s external, ‘boundary spanning’, activities.<sup>358</sup> Research by Callen, Klein and Tinkelman suggested that fund-raising was positively associated with an increase in board size.<sup>359</sup> Bai also supported this view, suggesting that a larger board can build more outside contacts, and thus operate more effectively at obtaining resources.<sup>360</sup> By contrast, smaller boards fail to span boundaries so well. Non-profits with smaller boards are often financially vulnerable, becoming over-dependent on a single and unstable financial source (usually the local government).<sup>361</sup> This is hardly surprising: given that establishing and maintaining external resources is particularly time-consuming, fulfilling the resource collection role is a significant challenge to already overloaded directors.<sup>362</sup>

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<sup>355</sup> Intimidation does not need to be physical or emotional coercion. See Cornforth, (n94) 118; B Corgnet, R Hernán-González and S Rassenti, 'Peer Pressure and Moral Hazard in Teams: Experimental Evidence' (2015) 2 *Review of Behavioral Economics* 379

<sup>356</sup> Cornforth, (n94) 117; Corgnet, Hernán-González and Rassenti, (n355) 387

<sup>357</sup> Corgnet, Hernán-González and Rassenti, (n355)

<sup>358</sup> J D Westphal, 'Collaboration in the Boardroom: Behavioral and Performance Consequences of CEO-Board Social Ties' (1999) 42 *Academy of Management Journal* 7

<sup>359</sup> J L Callen, A Klein and D Tinkelman, 'The Contextual Impact of Nonprofit Board Composition and Structure on Organizational Performance: Agency and Resource Dependence Perspectives' (2010) 21 *Voluntas* 101, 110

<sup>360</sup> Bai, (n335)

<sup>361</sup> They mostly rely on ‘short-term funding [which is] subject to an annual process review and renegotiation’, thus meaning this may be reduced or withdrawn at any time; see Zahra and Pearce, (n291) 118

<sup>362</sup> *ibid* 119

Similarly, the board's ability to provide a forum for stakeholder participation within non-profits also seems to be better served if the board is somewhat larger than might be the case in a for-profit. The expansion of non-profit boards could provide more space for stakeholders to participate in the governance of non-profits, with all the benefits which we noted above where stakeholder participation is facilitated.<sup>363</sup> Of course, merely increasing the number of stakeholder-representative directors does not guarantee their full participation in the organisation. Stakeholder-including boards will likely need more adept leadership to ensure the increased participation of each stakeholder, and this will be even more true the larger the board becomes.<sup>364</sup> Some of these challenges are addressed further below.

#### 4.3.2.3 Strategic role

Finally, large boards may also be more capable of performing the *strategic role*.<sup>365</sup> Golden and Zajac found that introducing more directors with different backgrounds and experiences is influential in shaping the orientation of a board toward strategic changes.<sup>366</sup> If a non-profit board is only constituted of one type of director (such as legal or financial professionals, for example), there is a likelihood it will become a 'homogenous group of experts who are cut from the same cloth'.<sup>367</sup> To be sure, merely having a larger board does not guarantee greater '*director heterogeneity*'.<sup>368</sup> Even a large board could be entirely composed only of very similar individuals. But a larger board seems to open up possibilities for diversification of directorial identities. For one thing, what has come to be called 'absorptive capacity theory' suggests that introducing stakeholder representatives may encourage boards to diversify the information sources and perspectives shared at board level, as to make for a more creative or innovative

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<sup>363</sup> L Wellens and M Jegers, 'Effective Governance in Nonprofit Organizations: A Literature Based Multiple Stakeholder Approach' (2014) 32 *European Management Journal* 223

<sup>364</sup> *ibid*

<sup>365</sup> D P Forbes and F J Milliken, 'Cognition and Corporate Governance: Understanding Boards of Directors as Strategic Decision-Making Groups' (1999) 24 *Academy of Management Review* 489; Wellens and Jegers, (n363)

<sup>366</sup> B R Golden and E J Zajac, 'When Will Boards Influence Strategy? Inclination× Power= Strategic Change' (2001) 22 *Strategic Management Journal* 1087, 1097

<sup>367</sup> Levrau and Van den Berghe, (n349) 67

<sup>368</sup> '*Director heterogeneity*' refers to director diversification with respect to background, gender, knowledge and experience, for example; see R C Anderson and others, 'The Economics of Director Heterogeneity' (2011) 40 *Financial Management* 5, 18

discussion.<sup>369</sup> And, as we have seen, facilitating stakeholder representatives is easier with larger boards.

#### 4.3.2.4 Some concerns about larger boards

So far, have suggested that larger boards may be better at performing both each individual role which non-profit boards must address, and the totality of those different roles. However, it must be conceded that there are some counterveiling arguments. First, even if a larger board is, overall, better able to perform the board's role, perhaps it does so much less efficiently than would a smaller-board. Its outputs might be greater, but at an even higher cost. Smaller boards are themselves cheaper to run. In this way, smaller boards may be better at *constraining management costs*.<sup>370</sup> Why would a smaller board tend to operate more efficiently? The thinking here is that '[t]he smaller the group, the better abled everyone is to really delve into issues and the less likely that anyone will be able to shirk his/her responsibility'.<sup>371</sup> A larger board is more likely to fall prey to the problem of '*social loafing*' – that that 'people exerting less effort to achieve a goal when they work in a group than when they work alone (e.g., pulling a rope), resulting in lower motivation levels'.<sup>372</sup> Furthermore, the *Ringelmann effect* demonstrates that the more people are involved in a task, the less efficient they often become.<sup>373</sup>

There are also some arguments that suggest a large board may have a 'limited effectiveness in directing strategic change during periods of environmental turbulence'.<sup>374</sup> It may be time-consuming for a large board to reach a consensus, for

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<sup>369</sup> M Harjoto, I Laksmana and R Lee, 'Board Diversity and Corporate Social Responsibility' (2015) 132 *Journal of Business Ethics* 641

<sup>370</sup> Desai and Yetman, (n354)

<sup>371</sup> D L Rhoades, P L Rechner and C Sundaramurthy, 'Board Composition and Financial Performance: A Meta-Analysis of the Influence of Outside Directors' (2000) *Journal of Managerial Issues* 76, 87

<sup>372</sup> E Sen and others, 'The Effects of Organizational Commitment on Social Loafing Behaviour at Higher Education Institutions I' (2016) 7 *IIB International Refereed Academic Social Sciences Journal* 96, 101; B Meyer, C C Schermuly and S Kauffeld, 'That's Not My Place: The Interacting Effects of Faultlines, Subgroup Size, and Social Competence on Social Loafing Behaviour in Work Groups' (2016) 25 *European Journal of Work and Organizational Psychology* 31, 43

<sup>373</sup> A Simms and T Nichols, 'Social Loafing: A Review of the Literature' (2014) 15 *Journal of Management Policy and Practice* 58

<sup>374</sup> J Goodstein, K Gautam and W Boeker, 'The Effects of Board Size and Diversity on Strategic Change' (1994) 15 *Strategic Management Journal* 241, 247



example, as more people will mean drawing upon a range of perspectives and diversified opinions, particularly with controversial/radical plans.<sup>375</sup>

Finally, there also exist some practical barriers which constrain the size and operation of a large non-profit board.<sup>376</sup> In practice, simply recruiting as many directors as the non-profit may need – of the right sort, expertise and involvement – may constitute a challenge in itself.<sup>377</sup> Recruitment problems may be especially intense for smaller non-profits. Empirical evidence suggests that most applicants to boards prefer to choose relatively larger non-profits, as large non-profits are more likely to have good reputations, a desirable work environment, and systematic governance.<sup>378</sup> Larger non-profits usually offer more specific job descriptions and better induction and training for new board members'.<sup>379</sup>

## 4.4 Board characteristics

### 4.4.1 Introduction

*Board characteristics* – as defined above – may positively or negatively affect a board's performance in a variety of ways.<sup>380</sup> This section examines board characteristics in two parts: collective (in 4.4.2) and individual (in 4.4.3). *Collective characteristics* concern 'the personality of the entire board'.<sup>381</sup> Thus, it encompasses the distinctive way that it operates, or what is sometimes referred to as the board's 'culture'.<sup>382</sup> Hence, in addressing collective characteristics, the aim is to identify a proper strategy to improve the board's own culture, and thus to enhance board effectiveness.<sup>383</sup>

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<sup>375</sup> Forbes and Milliken, (n365)

<sup>376</sup> K Jaskyte and T Holland, 'Nonprofit Boards: Challenges and Opportunities' (2015) 39 *Human Service Organizations: Management, Leadership & Governance* 163

<sup>377</sup> *ibid*

<sup>378</sup> Forbes and Milliken, (n365)

<sup>379</sup> Cornforth, (n94) 194

<sup>380</sup> Babić, Nikolić and Erić, (n173) 157

<sup>381</sup> J M Lynch, 'Activating the Board of Directors: A Study of the Process of Increasing Board Effectiveness' (Doctoral dissertation, Harvard University 1979)

<sup>382</sup> P Bolton, M K Brunnermeier and L Veldkamp, 'Leadership, Coordination, and Corporate Culture' (2013) 80 *The Review of Economic Studies* 512

<sup>383</sup> Torchia, Calabrò and Morner, (n310)

*Individual characteristics* focuses on individual directors, and such features as his/her age, educational background, values and experiences.<sup>384</sup> Naturally, these qualities will manifest themselves in the directors' choices.<sup>385</sup> Similarly they may act as a source of guidance on how to find the most appropriate directors and improve their skill set. Table 4.2 provides a snapshot of the various types of board characteristics, and the following section shall therefore investigate these types of characteristics that a non-profit board requires, from a normative perspective.

**Table 4.2 Board characteristics**

<b>Board Characteristics</b>	Collective Characteristics (Board Culture)	Openness and transparency Motivation and commitment Teamwork
	Individual Characteristics	Director's independence Professional knowledge and skills Types of stakeholder representatives Resource collection skills

#### **4.4.2 The collective characteristics: board culture**

##### **4.4.2.1 How can it affect board performance?**

To help facilitate our understanding as to how board culture is formed, and how it affects a director's performance, we shall introduce the concept of 'herd mentality' here. Herd mentality is, in short, a term used to describe 'how people are influenced by

<sup>384</sup> A Hough, M McGregor-Lowndes and C M Ryan, 'Theorizing About Board Governance of Nonprofit Organizations: Surveying the Landscape' (34th Annual Conference of the Association for Research on Nonprofit Organizations and Voluntary Action, Washington DC, 2005)

<sup>385</sup> D C Hambrick, 'The Top Management Team: Key to Strategic Success' (1987) 30 California Management Review 88

their peers to adopt certain behaviours, follow trends and purchase items’, among other things.<sup>386</sup> This understanding supposes that most people’s behaviour abides by one particular rule, and so following the group’s behaviour is likely to appear a sensible strategy in the relevant context.<sup>387</sup> Adopting this logic then, herd mentality theory insists that the more an individual stays in the same context, then the more likely they are to be influenced and follow similar trends.<sup>388</sup> Consequently, it follows that board members are usually more likely to share the same belief or organisational culture.<sup>389</sup>

Research carried out by Schein defines organisational culture as ‘a pattern of shared basic assumption that was learned by a group as it solved its problems of external adaptation and internal integration, that has worked well enough to be considered valid and, therefore, to be taught to new members as the correct way to perceive, think, and feel in relation to those problems.’<sup>390</sup> Schein further argues that although the concept of ‘culture’ appears to be abstract in this context, it has strong power to shape individual and group behaviour and therefore influence the effectiveness of the organisation as a whole.<sup>391</sup>

Board culture can also affect board performance in other ways, such as securing its stability. Lynch observes that ‘...board personality is believed to be more enduring than the characteristics of individual directors’ because it can shape different aspects of the board’.<sup>392</sup> Within the boardroom setting, directors’ performance follows the course of environmental changes/turbulence.<sup>393</sup> By contrast, a well-established culture tends to be long-lasting and cannot easily be changed.<sup>394</sup> However, once a board has properly set the ‘tone’ for its operation and conduct, its effectiveness it is likely to be enhanced accordingly.<sup>395</sup>

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<sup>386</sup> It heavily affects organisations’ governance in this approach: when things are uncertain/unpredictable, normally individuals’ first and best decision is to follow along; see J Surowiecki, *The Wisdom of Crowds* (Anchor 2005) 44-46

<sup>387</sup> Bolton, Brunnermeier and Veldkamp, (n382)

<sup>388</sup> See Surowiecki, (n386) 43

<sup>389</sup> Bolton, Brunnermeier and Veldkamp, (n382)

<sup>390</sup> E H Schein, *Organizational Culture and Leadership* (John Wiley & Sons 2006) 117

<sup>391</sup> *ibid* 119

<sup>392</sup> Lynch, (n381)

<sup>393</sup> K Desson and J Clouthier, 'Organizational Culture—Why Does It Matter' (Symposium on International Safeguards Vienna, November 2010) 3

<sup>394</sup> *ibid*

<sup>395</sup> *ibid*

#### 4.4.2.2 Factors influencing collective characteristics

Cultivating and maintaining board culture could prove to be more pressing than expected.<sup>396</sup> NICVA listed a range of problems that non-profits could commonly meet in the process of governance.<sup>397</sup> There are ‘mistrust between partners due to poor or weak relationships; lack of transparency—failing to share important information with each other; lack of strong agreements which clearly set out roles, responsibilities; and selecting the wrong partners in the first instance, and not recognizing it until it is too late’.<sup>398</sup> All of these governance pitfalls could be closely linked with a poor collaborative culture.

First, non-profit boards should, by virtue of their sector, encourage an open and genuine working environment by improving transparency.<sup>399</sup> Second, as our prior discussion of stewardship theory has emphasized (see section 3.3) a director’s motivation and commitment towards their duties or board tasks is likely to significantly affect board culture and vice versa.<sup>400</sup> Finally, a collaborative working environment is vital to the success of a non-profit board, as the vast majority of board members are geographically dispersed, part-time and unprofessional, insofar as this is not their job or specialism.<sup>401</sup>

#### 4.4.3 Individual characteristics

We now turn to consider some of the most essential elements that may relate to the individual characteristics that may affect board governance in non-profits. At the same time, this part shall explore approaches that can be adopted by non-profit boards to

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<sup>396</sup> L Guiso, P Sapienza and L Zingales, 'The Value of Corporate Culture' (2015) 117 *Journal of Financial Economics* 60

<sup>397</sup> NICVA, *Advice to Boards on Collaboration* (NICVA, 2014)

<[http://www.nicva.org/sites/default/files/d7content/attachments-resources/advice\\_to\\_boards9.pdf](http://www.nicva.org/sites/default/files/d7content/attachments-resources/advice_to_boards9.pdf)> accessed 12 March 2016

<sup>398</sup> *ibid*

<sup>399</sup> L T Christensen and others, 'Organizational Transparency as Myth and Metaphor' (2015) 18 *European journal of social theory* 132

<sup>400</sup> M Van Herpen, M Van Praag and K Cools, 'The Effects of Performance Measurement and Compensation on Motivation: An Empirical Study' (2005) 153 *De Economist* 303

<sup>401</sup> Guiso, Sapienza and Zingales, (n396)

improve their effectiveness. We shall follow the ‘integrative theoretical framework’ addressed in Chapter 3, and explore the connection between these individual characteristics and those three board roles (control, service and strategic role) that have been addressed already. Table 4.3 below will briefly summarize the structure of this section.

**Table 4.3 The structure of Chapter 4**

<b>Board role requirement</b>	<b>Individual characteristic</b>	<b>How could individual characteristics improve board governance</b>	<b>Concerns in the non-profit sector</b>	<b>Solutions</b>
Control role	Director's independence	Ability to challenge/monitor the manager	Independent thinking ability—Independent relationship	Independent thinking ability is more important than the independent relationship
	Professional knowledge and skills	Better challenge management	This essential attribute attracts less attention from legal regulations	Attract skilled candidates by approaches such as increasing salaries
Service and strategic role	Selecting stakeholder representative	1, Represent stakeholders 2, Improve resource collection 3, Adding strategic point of view	Too many stakeholders to sit in the boardroom	Stakeholders should be selected to the board by Salience Theory
	Resource collection	1, Fund raising 2, Attracting human resource		

#### 4.4.3.1 The control role requirement

A number of individual characteristics seem relevant to the directors' ability to perform their control role. We shall focus here on their *independence* and their *professional knowledge and skills*.

##### 4.4.3.1.1 Director independence

Increasing sensitivity towards a manager's misbehaviour, combined with a strict requirement on information disclosure, has indicated the importance of a director's independence.<sup>402</sup> Once directors risk losing their independence, then the controlling power of the director or the board per se can easily succumb to the dominance of professional managers. Directors will often end up as little more than a 'rubber-stamp' in a company's administration.<sup>403</sup> Independence in this context is commonly defined as the capability of 'exercising objective judgment', which encompasses both an *independent relationship* and *independent thinking ability*.<sup>404</sup> In other words, the director's independence requires both the exercise of *independent judgment* towards governing issues, and being *absent* or *unaffected by relationships or connections* which have the potential to influence his or her judgment.

In understanding the importance of a director's independence, we cannot consider their relational independence alone, and in isolation. Rather, it is vital to begin by examining the correlation between the *independent relationship* and *independent thinking ability*.<sup>405</sup> Although these concepts are interrelated, their relationship is *not necessarily positive*.<sup>406</sup> For relational independence can, in fact, have a negative impact on a director's ability to think independently. On the one hand, laws strictly require directors to keep an independent relationship with managers of the corporation, in order to

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<sup>402</sup> A Knyazeva, D Knyazeva and R W Masulis, 'The Supply of Corporate Directors and Board Independence' (2013) 26 *Review of Financial Studies* 1561

<sup>403</sup> Cornforth, (n94) 10

<sup>404</sup> *ibid* 11

<sup>405</sup> B W Goh and others, 'The Effect of Board Independence on the Information Environment and Information Asymmetry' (2014) <[http://ink.library.smu.edu.sg/soa\\_research/933/](http://ink.library.smu.edu.sg/soa_research/933/)> accessed 14 March 2016

<sup>406</sup> Even if a director's relationship satisfies the requirement for independence, it does not necessarily boost their independent thinking skills.

achieve a clear monitoring of operations.<sup>407</sup> On the other hand, a completely independent relationship is likely to lead to a lack of fluid or more informal communication and information exchanges between managers and directors, which will weaken a directors' independent thinking ability and eventually result in ineffective monitoring.<sup>408</sup> To demonstrate this further, one might note that directors have the power to hire and dismiss company managers, primarily through the use of information from managers themselves.<sup>409</sup> Yet the more arms-length and adversarial directors are, from the managers' point of view, the less readily may managers share information with directors. Research by Adams supports this by showing that directors who had a stronger monitoring role often perceived that they received less information from the manager.<sup>410</sup>

Thus, rather than concentrating the focus on the independent relationships of directors', this work argues more emphasis ought to be focused on directors' independent thinking. In the face of conflict between an independent relationship and one's own thinking ability, directors should be allowed to sacrifice one relationship in exchange for another, as long this improves board effectiveness.<sup>411</sup> For example, in order to share organisation-specific information, and to create a harmonious working environment, directors are encouraged to keep a good connection with managers. As this work has argued above, whether managers are willing to trade-off information with the board largely depends on an assessment of their relationship with directors: too independent a relationship may threaten the manager's position, and thus discourage collaboration.<sup>412</sup> This suggestion is consistent with an argument advanced in section 3.2; that is over-regulating the director's independent relationship, on the thinking of agency theory, would seem 'flawed', since it fails to 'capture social relations between directors and the CEO that may impair a director's independent judgment'.<sup>413</sup> By contrast, stewardship

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<sup>407</sup> Goh and others, (n405)

<sup>408</sup> R B Adams and D Ferreira, 'Strong Managers, Weak Boards?' (2009) 55 CESifo Economic Studies 482

<sup>409</sup> Their main responsibility is to hire and fire the CEO' to ensure the best possible leadership; see *ibid* 484;

J Lorsch and J Young, 'Pawns and Potentates: The Reality of American's Coprate Boards' (1990) 4 *The Executive* 85

<sup>410</sup> Adams and Ferreira, (n408)

<sup>411</sup> *ibid* 484

<sup>412</sup> *ibid*

<sup>413</sup> *ibid* 485



theory is more capable of facilitating a director's independence, as this places a much higher value on the benefits and achievement of cooperation.<sup>414</sup>

#### 4.4.3.1.2 Professional knowledge and skill

Board effectiveness also seems to require that directors possess appropriate knowledge and skills.<sup>415</sup> According to the work of Forbes and Milliken, the knowledge and skills most relevant to the governance of boards can be divided into two parts, as follows:<sup>416</sup>

- (1) *functional area knowledge and skills*;
- (2) *firm-specific knowledge and skills*

*Functional area knowledge and skills* span traditional domains of business, including accounting, finance, marketing and law, for example.<sup>417</sup> Clearly, it is impossible for directors to hold professional expertise in *every* field. Nevertheless, being equipped with sufficient relevant knowledge, particularly in the area of law and finance, is often essential to fulfilling the board's controlling role effectively. To the non-profit board, financial and legal experts have proven to be even more important than its for-profit counterpart. As noted in 4.3, because managers often have the time, skills, knowledge and resources to take control of the organisation as a whole, if directors, by contrast, lack such professional knowledge and skills, they may be unable to challenge the authority of their managers.<sup>418</sup>

Similarly, *firm-specific knowledge and skills* refer to detailed information directors or managers may know about the firm, and with this an intimate understanding of its operations and internal management.<sup>419</sup> Naturally, boards often require this type of 'tacit' knowledge in order to deal effectively with strategic issues.<sup>420</sup> For example, the board may require a deep understanding of how new and existing businesses within the

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<sup>414</sup> Goh and others, (n405)

<sup>415</sup> E L Valentine and G Stewart, 'The Emerging Role of the Board of Directors in Enterprise Business Technology Governance' (2013) 10 *International Journal of Disclosure and Governance* 346

<sup>416</sup> Forbes and Milliken, (n365)

<sup>417</sup> *ibid*

<sup>418</sup> P Dyer, *The Good Trustee Guide* (NCVO 2010) 65-68; Valentine and Stewart, (n415)

<sup>419</sup> R B Adams, A C Akyol and P Verwijmeren, 'Director Skill Sets' (2016)

<[https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2365748](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2365748)> accessed 13 April 2016 23

<sup>420</sup> I Nonaka, 'A Dynamic Theory of Organizational Knowledge Creation' (1994) 5 *Organization Science* 14

corporation would complement one another.<sup>421</sup>

#### **4.4.3.2 The service role and strategic role requirement**

This part shall be divided into two sections —RD theory requirement (examining director’s skills of boundary-spanning), and selecting stakeholder representatives (choosing the most appropriate stakeholder representatives to enhance board effectiveness).

##### **4.4.3.2.1 RD theory requirement**

Both sections 3.3 and 4.2.2 have demonstrated the importance of maintaining internal and external relationships. If directors are to serve effectively as the organisation’s ‘boundary spanners’, they need to possess a range of skills necessary for building successful partnerships.<sup>422</sup> In this context, this encompasses not only the personal qualities of ‘negotiation, mediation, assimilation, coaching and institutional engagement amongst others, but also imagination, empathy, optimism and modesty’.<sup>423</sup> Softer skills as part of this requirement also components of what is known as ‘*emotional intelligence*’ (*EI*), which is becoming increasingly more recognized as a key factor in management success stories.<sup>424</sup>

##### **4.4.3.2.2 Selecting stakeholder representatives**

As section 3.4 will have already outlined, stakeholders are crucial to the non-profit board, be this from an instrumental or ethical perspective.<sup>425</sup> However, as discussed in 4.3.2.3, involving too many types of stakeholder entities will inevitably impact upon

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<sup>421</sup> Adams, Akyol and Verwijmeren, (n419)

<sup>422</sup> Malatesta and Smith, (n235)

<sup>423</sup> R Tennyson, *The Partnering Toolbook* (Phoenix 2003)

<sup>424</sup> Z C Leung, 'Boundary Spanning in Interorganizational Collaboration' (2013) 37 *Administration in Social Work* 447

<sup>425</sup> They can be vital as a means to an end for achieving an organisation’s true goals, or instrumental in so far as justifying the organisation’s legitimacy and accountability; see L Ferkins and D Shilbury, 'The Stakeholder Dilemma in Sport Governance: Toward the Notion of “Stakeowner”' (2015) 29 *Journal of Sport Management* 93

the effectiveness of decision-making.<sup>426</sup> Accordingly, to better establish the blueprint with respect to the stakeholders, here we shall narrow the range of stakeholders, and define ‘who and what really counts in stakeholder management’ and which type of stakeholder representatives should sit on the non-profit board.

Before introducing a selective approach, we shall initially remind ourselves how stakeholder participation could add value to the effectiveness of non-profit board governance. From the instrumental stakeholder’s point of view, there are *two essential contributions*. First, an ostensible benefit arising from stakeholder participation and representation is that *resource collection* may be reinforced. Many stakeholders within the boardroom are either potential donors, or have sufficient external networks which may be able to bring about necessary resources for business or corporate development.<sup>427</sup> Second, as we have addressed in 4.3.2.3, introducing stakeholder representatives is likely to provide diversified opinions and creativity to the board, and thus add value to its long-term strategic leadership.<sup>428</sup>

Given the discussion above, this work shall discuss an attempt to provide a selective approach, based on *Stakeholder Identification and Saliency Theory* (herein *Stakeholder Saliency*).<sup>429</sup> The notion of *Saliency* in this theory may be defined as ‘the degree to which managers may give priority to competing stakeholder claims’.<sup>430</sup> *Three variables* were chosen by my research to be the criterion to prioritize stakeholder groups. The more the stakeholder is perceived to have, the higher their saliency is, and the better priority/opportunity they can get to sit in the boardroom. The three variables in this context are:

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<sup>426</sup> Suppose that a reasonable amount of representatives prepare to stand for their own interest groups/follow their individual preference/ideology, then they may propose different, even contradicting, opinions during the board meeting; see *ibid* 98

<sup>427</sup> Mwenja and Lewis, (n191)

<sup>428</sup> Cornforth and Brown, (n86)

<sup>429</sup> B R Agle, R K Mitchell and J A Sonnenfeld, 'Who Matters to CEOs? An Investigation of Stakeholder Attributes and Saliency, Corporate Performance, and CEO Values' (1999) 42 *Academy of Management Journal* 507, 508; T Thijssens, L Bollen and H Hassink, 'Secondary Stakeholder Influence on CSR Disclosure: An Application of Stakeholder Saliency Theory' (2015) 132 *Journal of Business Ethics* 873

<sup>430</sup> In other words, the greatest priority will be given to stakeholders who have power, legitimacy and urgency in this context; see Thijssens, Bollen and Hassink, (n429) 879

1. *Power*<sup>431</sup> (through which one may influence the firm);
2. *Legitimacy*<sup>432</sup> (of the stakeholders' relationships with the firm), and;
3. *Urgency*<sup>433</sup> (of the stakeholders claim to the firm).

Correspondingly, according to the three variables above, Table 4.4 lists particular groups of stakeholders satisfy this requirement and take priority in the boardroom:

**Table 4.4 stakeholder variables and selection**

Variables	Stakeholder entities	Reasons
Power	Donors/Funders <sup>434</sup> Customers/Service users <sup>435</sup> Government <sup>436</sup>	have the power to benefit, add interest to the board's performance
Legitimacy	Communities <sup>437</sup> Employees <sup>438</sup>	have the legitimacy to form part of the board, to ensure the decision-making process considers their own interests
Urgency	Other groups in case of Emergency	in any special/urgent situation, this group can respond to the need

<sup>431</sup> Power, in this context, means the extent to which a party has, or can 'gain access to coercive (physical means), utilitarian (material means) or normative (prestige, esteem and social) means to impose their will'; see *ibid* 880

<sup>432</sup> Legitimacy is taken as 'a generalized perception or assumption that the actions of an entity are desirable, proper, or appropriate within some socially constructed system of norms, values, beliefs, and definitions'; see M C Suchman, 'Managing Legitimacy: Strategic and Institutional Approaches' (1995) 20 *Academy of Management Review* 571, 580-581

<sup>433</sup> Urgency is defined as 'the degree to which stakeholder claims call for immediate attention'; see Mitchell, Agle and Wood, (n265)

<sup>434</sup> Securing donations is one of the most important tasks on the board.

<sup>435</sup> Customers/service users often directly access the products or services an organisation supplies. Hence, where they are able to, their participation can help supervise governance in order to control for service quality.

<sup>436</sup> Government naturally participates in the process of governance, however, this may be especially important to non-profits as political connections can often provide a variety of resources. At the same time, in many cases, government is also the stakeholder of non-profits.

<sup>437</sup> The participation of the community representatives could help non-profits to maintain a good relationship and gain trust with their community, and thus ensure non-profit's business operates well.

<sup>438</sup> Employees are influenced by the organisation's performance, but may also affect how the organisation operates.

## 4.5 Board structure

Turning now to the question of the board's structure, the main issue we shall address here is whether non-profit boards should adopt a '*committee structure*' to enable directors better to fulfil their role. Again, table 4.5 provides a snapshot of the arguments that we shall advance.

**Table 4.5 Board committees in non-profits**

<b>Committee types</b>	<b>Pros of committees in NPOs</b>	<b>Concerns in NPOs</b>
1, Executive 2, Audit 3, Fund-raising 4, Membership 5, Ad-hoc	1, Better multi-tasking through specialization 2, Avoid free-riding 3, Improve meeting efficiency 4, Relieve tension between conformance and performance role	1, Committee's task lack of certainty 2, Power balance and conflicting authorities

### 4.5.1 Value for the existence of sub-committees in the non-profit board

The advantage of the committee structure flows directly from the analysis of the role each director plays (and, especially those performing multiple-roles), which I have already argued not-for-profit boards should play.<sup>439</sup> By using sub-committees, different board members should enjoy more specific, narrowly defined and focused tasks.<sup>440</sup> To build on this, this section will identify a number of ways in which the committee structure approach may offer a number of advantages and improve upon board effectiveness.

Firstly, the advantage of a committee structure is that it enables the board to deliver upon a multiplicity of roles, some of which are core, legally defined roles, others of which I have suggested should supplement this but nevertheless need to be fulfilled by

<sup>439</sup> A Metzger, *Developing the Most Effective Committee Structure for Your Board* (Astric 2015)

<sup>440</sup> A Klein, 'Firm Performance and Board Committee Structure I' (1998) 41 *The Journal of Law and Economics* 275; Tan and Liu, (n18)

the board.<sup>441</sup> Committees may efficiently match the most appropriate board resources to the essential priorities of the organisation.<sup>442</sup> Indeed, committees provide opportunities to involve more people in the board's management, and may incorporate volunteers to use their specialized skills or interests to contribute to areas of importance or development.<sup>443</sup> Secondly, by delegating functions to subcommittees of the board, the free-rider problem discussed in previous chapters is less likely to occur and thus reduce.<sup>444</sup> Through the use of sub-committees, individual accountability is also more likely, since individual decisions are more likely to be identifiable by the public, which therefore makes it more difficult for directors to disguise incompetence or act behind colleagues.<sup>445</sup>

Thirdly, various meeting procedures can be improved through the use of committees. First, full board meetings can be held less frequently if committees are productive between board meetings and in dealing with issues of importance.<sup>446</sup> Second, an appropriate committee structure can help the board manage the flow of information, so directors are not over-burdened with unnecessary material that can hinder rather than facilitate good decision-making.<sup>447</sup> Naturally, this relates to the issue of *specialization* and *time-management*, discussed in Chapter 3. Given the context, the *confidentiality* of information can also be improved.<sup>448</sup> Directors may feel more comfortable and free to discuss sensitive issues (e.g. salary requirements) which they may otherwise be reluctant to propose were it aired at a full board meeting.<sup>449</sup> However, the issue relating to confidentiality may be more acute in non-profit organisations than in profit-based companies.<sup>450</sup> A profit-based board typically has more homogenous membership. A non-profit organisation, by contrast, may contain a more diverse membership, for reasons we have already explored.<sup>451</sup>

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<sup>441</sup> Tan and Liu, (n18)

<sup>442</sup> Callen, Klein and Tinkelman, (n231)

<sup>443</sup> R Kral, 'Crafting Board and Committee Agendas: What's on Your Agenda?' (2015) 51 The EDP Audit, Control, and Security Newsletter 16

<sup>444</sup> *ibid*

<sup>445</sup> *ibid*

<sup>446</sup> Callen, Klein and Tinkelman, (n231)

<sup>447</sup> O'Regan and Oster, (n351) 209

<sup>448</sup> *ibid* 210

<sup>449</sup> Metzger, (n439) 10

<sup>450</sup> *ibid*

<sup>451</sup> It may include stakeholder representatives, or those who contribute significant organisational resources to the corporation; see Mitchell, Agle and Wood, (n265)

Lastly, committees allow the board to relieve the tension between *conformance* and *performance* roles which are common issues for the non-profit board.<sup>452</sup> This work has argued that the board should not be tempted to interfere excessively in the management of the organisation, but should instead restrict itself to those roles which are its proper remit – controlling agency costs, representing stakeholders and building relationships with resource providers. Indeed, even where the board successfully avoids the temptation of ‘micro-managing’ the organisation, there remains the question as to whether it should dwell on ensuring conformance by management, or focus instead on the performance of the organisation. Research by Cornforth and others explains the distinction in the following terms: the board may sometimes over emphasize a conformance role, first, simply because as implied by agency theory would prescribe, directors distrust company staff and executives, and would rather closely monitor them, the company and every aspect of executive management.<sup>453</sup> Second, non-profit boards in the UK are externally accountability to the Government, which also tends to emphasize the conformance role over a performance one.<sup>454</sup>

Notwithstanding, there exists a growing tension between conformance and performance roles – with the conformance role often threatening to swamp boards’ focus on its strategic role.<sup>455</sup> If the Government wants boards of non-profits to play a greater role in strategy, then it may need to ensure that it does not over-burden boards with other requirements.<sup>456</sup> As the discussion has noted above, a single board cannot accomplish everything alone, and an increased focus on conformance would likely mean a reduced focus on performance issues. To mitigate the tendency of non-profit boards to focus on conformance matters at the expense of performance, greater use of the committee structure may offer one solution. Use of the committee structure will enable the board to reduce conformance to the committee, and eventually, the board will take back control of its performance role. For instance, the risk assessment committee is

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<sup>452</sup> We have seen already how there is a tension between the roles of management, one the one hand, and of the board on the other.

<sup>453</sup> Cornforth, (n94) 107

<sup>454</sup> The UK Government acts in multiple roles as the funder of non-profits and a regulatory authority in terms of how the agency delivers its services; see *ibid* 108

<sup>455</sup> Tricker and Tricker, (n344)

<sup>456</sup> The Comptroller and Auditor General, *Follow-up on the Charity Commission* (2015), paras 4.7-4.8, 4.10-4.19

responsible for accurate calculation and evaluation and should be cautious of every single risk, whilst the whole board should also remain open to change and risk rather than being tempted to maintain the status quo.<sup>457</sup>

#### 4.5.2 Committee types

We now turn to consider the types of committee that may prove appropriate for a non-profit. Naturally, the choice of committees should be driven by those roles set down by the board, that is: what tasks need to be assigned to committees and what committees are therefore required to fulfil those tasks.<sup>458</sup> Typically there exist set guidelines for non-profits, describing which committees are appropriate and ought to be adopted. By contrast, for profit-based companies, there is a long history and well-accepted list of committee types to perform board related tasks.<sup>459</sup> In terms of non-profit boards, the relevant code shall be referred to and discussed in Chapter 5. The chapter shall now consider each committee in turn.

*Executive committee:* dependent upon the size of the board, it may be advantageous for the board to form an executive committee, which may be authorized to meet and take action between board meetings when it is impractical to get the full board together for a special board meeting. The executive committee is usually charged with oversight of the organisation's manager. Moreover, it can also serve as an advisor to the manager and liaise between the manager and the full board.<sup>460</sup>

*Audit committee:* an audit committee's key function is liaison between the company accountant, auditor and its financial manager.<sup>461</sup> The mandate of the audit committee may be largely limited to matters pertaining quarterly reporting, annual financial reviews/reports, or closer supervision of accounting practices.<sup>462</sup> Similarly, the risk

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<sup>457</sup> Tricker and Tricker, (n344) 96

<sup>458</sup> *ibid*

<sup>459</sup> For example, the UK Corporate Governance Code (2016) recommends a corporate board has three committees: remuneration, audit and nomination.

<sup>460</sup> Tricker and Tricker, (n344)

<sup>461</sup> Ernst and Young, *Effective Board and Committee Leadership* (Tapestry Network 2013)

<sup>462</sup> P Broder and N McClintock, *Primer for Directors of Not-for-Profit Corporations* (Industry Canada 2002)



assessment and evaluation role of the board usually is the reserve of the audit committee.<sup>463</sup>

*Fundraising committee:* it is the job of the fundraising committee to create a plan that will guide the organisation in seeking out and securing funding from an array of outside sources. The committee must identify and communicate with potential donors to support the work of the organisation.<sup>464</sup>

*Membership committee:* the membership committee is often tasked with the developing criteria for membership, assessing prospective members for admission, overseeing election, as well as developing and delivering programs for the members.<sup>465</sup>

*Ad hoc committees and task forces:* ad hoc committees are formed when they are in need and often disbanded when their work is complete. One such example may be the development of bylaws, strategic planning or new program development.<sup>466</sup>

### **4.5.3 Potential difficulties and solutions**

As 4.5.1 has already demonstrated, a variety of benefits may be derived from the introduction and use of committees on non-profit boards. Although, overall, the advantages of committees in non-profits outweigh their deficiencies, in this sub-section we explore some of the potential difficulties when non-profits use the committee mechanism on their boards, and also offer some suggested solutions.<sup>467</sup>

#### **4.5.3.1 Committee tasks' lack of certainty**

One of the primary difficulties arising from a board committee may be that the role or 'remit' of each committee may be imprecise, causing a number of problems. First,

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<sup>463</sup> Ernst and Young, (n461) 5

<sup>464</sup> Callen, Klein and Tinkelman, (n231) 498

<sup>465</sup> E M Johnson, 'Board Committee Structure ', (2006)

<[http://www.guberna.be/sites/default/files/newsflash/nl\\_Readers/Board%20Committee%20Structure.pdf](http://www.guberna.be/sites/default/files/newsflash/nl_Readers/Board%20Committee%20Structure.pdf)>  
accessed 3 March 2015

<sup>466</sup> Metzger, (n439) 6

<sup>467</sup> ibid 10

committees can sometimes facilitate the very issue of ‘shirking’ that the committee structure itself was designed to overcome. The reality in the non-profit sector at present is that board members usually sit on more than one committee.<sup>468</sup> However, this can often mean directors are able to hide behind different tasks being undertaken in each committee, and thus claim that they are unable to fulfil the expectation of one committee because they are too busy with commitments to another. This problem may not be caused only by the imprecision in defining each committee’s role, but such imprecision makes it easier for directors to escape their duties or responsibilities through the multiplicity of memberships.<sup>469</sup> Second, the problem of *imprecise definition* within each committee goes beyond enabling committee members to ‘shirk’; even conscientious committee members may work less effectively if they fail to understand their tasks, owing to imprecision in the specification of their committee’s role.<sup>470</sup>

In order to address the issues discussed above, committee members should ideally receive more guidance, addressing specific aspects of their role. First, it is crucial the committee clarify each individual director’s role and tasks, as to enable them to understand their job and the committee on which they are sitting.<sup>471</sup> According to the Good Governance Code, an effective board should ensure that all board members ‘understand their relationship with and responsibilities towards committees’.<sup>472</sup> Moreover, non-profit boards can divide their committees into board and non-board levels. Board level committees may be responsible for governance matters and decision-making, while non-board level committees (e.g. advisory panels) merely work alongside the board, supplementing their role. This classification requires the board to clearly declare directors’ roles, particularly those *governing and non-governing roles*, within different committees.<sup>473</sup>

Building upon this, in order to help directors better comprehend their tasks, proper

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<sup>468</sup> *ibid* 11

<sup>469</sup> W W Powell and R Steinberg, *The Nonprofit Sector: A Research Handbook* (Yale University Press 2006) 135

<sup>470</sup> Ernst and Young, (n461) 8

<sup>471</sup> N Huberfeld, 'Tackling the Evils of Interlocking Directorates in Healthcare Nonprofits' (2006) 85 Nebraska Law Review 681

<sup>472</sup> Charity Commission, ‘Good Governance: A Code for the Voluntary and Community Sector’ (Code Steering Group, 2010)

<sup>473</sup> Riley, (n66)

training, education and feedback is essential. Board educational programs could be taken in a variety of forms and cover a range of topics, and should include updates on different occasions when necessary.<sup>474</sup> Moreover, self-evaluation can provide directors with measures by which to review existing practices and plan future approaches.<sup>475</sup> Second, to address the prospective issue of directors shirking from connected committees, the board may also opt to take care of those committees with conflicting interests, and avoid engaging the same individuals.<sup>476</sup> To this end, the development of company policy on each individual member's independence and diligence may prove an additional resource.

#### **4.5.3.2 Power balance and conflicting authorities**

The process of allocating tasks to different committees may result in a *power imbalance*. This imbalance may result in a relatively heavier workload for one committee than for others, which can sometimes become the source for governance-conflicts.<sup>477</sup> For instance, a power imbalance primarily exists between the executive committee and other committees.<sup>478</sup> Typically, the executive committee is responsible for a much heavier workload, such as planning board meeting agendas, coordination, and nomination, to name just a few. As such, this may lead some directors to refuse to serve on the executive committees, owing to commitments and liability exposure, which other committee members may not thereby face.<sup>479</sup>

In order to address the prospect of conflict, committee members should have a clearly prescribed understanding of their role and powers. It is recommended that once organisations have, or are considering, an executive committee, the board as a whole should formally decide how much power the committee has. Typically such a committee focuses on effective governance, and is therefore likely to take on the

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<sup>474</sup> Such as external training for directors or internal programs taken by directors themselves.

<sup>475</sup> Charity Commission, 'Good Governance: A Code for the Voluntary and Community Sector' (Code Steering Group, 2010) 18

<sup>476</sup> Charity Commission, 'Good Governance: A Code for the Voluntary and Community Sector' (Code Steering Group, 2010) 19

<sup>477</sup> Charity Commission, 'Good Governance: A Code for the Voluntary and Community Sector' (Code Steering Group, 2010)

<sup>478</sup> Sundaramurthy and Lewis, (n191)

<sup>479</sup> Ernst and Young, (n461)

leadership role.<sup>480</sup> By contrast to the executive committee, the advisory committee to a board has no power to act on behalf of organisations. Members of an advisory committee are expected to give professional or technical advice, as may be required.<sup>481</sup> In addition, it should be noted that each committee only has power over their committee tasks, and they must use their powers to further the interests of the board as a whole.<sup>482</sup>

## 4.6 The decision-making process of non-profit boards

### 4.6.1 Introduction

Of course, the *board meeting* remains the primary vehicle for decision making by directors.<sup>483</sup> It provides an opportunity to actively review the organisation's performance and build upon strategy for the future.<sup>484</sup> Among a variety of means available to directors today, 'physical' meetings remain one of the most effective means through which people share and exchange information and make decisions.<sup>485</sup> Accordingly, well-organized meetings will help directors' better use of working time and improve board effectiveness.<sup>486</sup> When compared to those in the profits-based sector, the need to ensure effective meetings is even more pressing in the non-profit sector, and for two main reasons. First, improving the effectiveness of a board meeting can help time-constrained directors save time for more important issues.<sup>487</sup> Second, inefficient meetings waste money and resources.<sup>488</sup>

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<sup>480</sup> E G MacDonald, *Should We Form a Board Committee?* (Dalhousie University College of Continuing Education 2012) 2

<sup>481</sup> Sundaramurthy and Lewis, (n191)

<sup>482</sup> *ibid*

<sup>483</sup> N Vafeas, 'Board Meeting Frequency and Firm Performance' (1999) 53 *Journal of Financial Economics* 113

<sup>484</sup> T McNulty and A Stewart, 'Developing the Governance Space: A Study of the Role and Potential of the Company Secretary in and around the Board of Directors' (2015) 36 *Organization studies* 513, 525

<sup>485</sup> *ibid* 526

<sup>486</sup> M Schwartz-Ziv and M S Weisbach, 'What Do Boards Really Do? Evidence from Minutes of Board Meetings' (2013) 108 *Journal of Financial Economics* 349, 356

<sup>487</sup> *ibid* 357

<sup>488</sup> M Lipton and J W Lorsch, 'A Modest Proposal for Improved Corporate Governance' (1992) *The Business Lawyer* 59

According to *Robert's Rules of Order*, a meeting will be 'productive, inclusive and participatory' when it follows a set of proper rules.<sup>489</sup> In the proceeding section, we therefore consider what type of rules non-profit boards should adopt in advance of their meeting process. Following discussion in section 4.2, I will narrow my scope to two attributes – the *frequency* and *format* of the board meeting.

#### 4.6.2 Frequency of the board meeting

Since the amount of business that has to be considered by a board is often extensive, over frequent board meetings can be a drain on board productivity.<sup>490</sup> However, research carried out by Conger et al. observed that increasing meeting frequency may prove to be a fairly inexpensive way to increase an organisation's value.<sup>491</sup> This has been furthered by Vafeas, whose research held that more frequent meetings could boost the board's control role, as it led managers to work in line with the interests of the board's decisions.<sup>492</sup> Since the core mechanism for informing and involving directors in a non-profit is the board meeting, reducing the frequency of board meetings may also prevent directors from seizing the most significant opportunities to becoming informed on governance information, exchanges of opinions, and challenges to the manager's authority.<sup>493</sup>

Nevertheless, some would argue that the result of the board meeting cannot always be as desirable as we imagined.<sup>494</sup> For instance, in many cases, managers set the agenda for board meetings, and routine tasks absorb much of the meetings. In turn, this limits opportunities for many directors to exercise meaningful control over management, and board meetings could fail to 'serve as a proactive measure for improved governance'.<sup>495</sup>

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<sup>489</sup> *ibid*

<sup>490</sup> P D Hahn and M Lasfer, 'Impact of Foreign Directors on Board Meeting Frequency' (2016) 46 *International Review of Financial Analysis* 295

<sup>491</sup> *ibid*

<sup>492</sup> Vafeas, (n483)

<sup>493</sup> K Jallow and B Al Najjar, 'The Determinants of Board Meetings: Evidence from Categorical Analysis' (2012) 13 *Journal of Applied Accounting Research* 178, 193

<sup>494</sup> V Sharma, V Naiker and B Lee, 'Determinants of Audit Committee Meeting Frequency: Evidence from a Voluntary Governance System' (2009) 23 *Accounting Horizons* 245; Jallow and Al Najjar, (n493) 194

<sup>495</sup> Jallow and Al Najjar, (n493) 194

### 4.6.3 Format of board meetings

Alongside the frequency with which board meetings take place, the degree of their formality can also affect the board's effectiveness.<sup>496</sup> The format of a meeting can vary largely depend on board characteristics. Generally, they can be divided into two types, *formal* and *informal board* meetings.<sup>497</sup> Formal meetings and votes can help to avoid legal challenges. However, it may not be appropriate for small organisations to follow this format, and organisations with fewer than a dozen members should consider adopting less formal rules to govern meetings.<sup>498</sup> Conversely, the *informal meeting* may be used to address daily operational and policy issues. Similarly, modern technology provides in person alternatives to the conventional face-to-face meeting, such as virtual meetings, which could save time and money but sacrifice the face-to-face communications.<sup>499</sup>

## 4.7 Conclusion

In summary, this chapter has critically analysed four attributes of the non-profit board (size, characteristics, structure and process) in an integrative framework. Each of these essential four attributes encompasses 'several pertinent elements that may contribute to non-profit performance'.<sup>500</sup> The blueprint I have built up has therefore been established through framing all different attributes into an integrative model. Nevertheless, we should always bear in mind that trade-offs have to be made when applying these attributes to the board and deciding which measures can facilitate its performance. Characteristics that help the board fulfil its control role may be associated with a weaker ability to raise resources.<sup>501</sup> We also found that no single attribute offers a complete explanation of the board roles, but rather the elements of each attribute can be applied in different circumstances; each board feature has a contribution to make to the

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<sup>496</sup> *ibid* 195

<sup>497</sup> *ibid* 196

<sup>498</sup> *ibid*

<sup>499</sup> This theory clearly indicates that face-to-face communication takes more advantages than many other indirect means, as it contains not only verbal expressions, but also many other non-verbal elements. J A Russell and A Mehrabian, 'Evidence for a Three-Factor Theory of Emotions' (1977) 11 *Journal of Research in Personality* 273, 285

<sup>500</sup> Zahra and Pearce, (n291) 306

<sup>501</sup> G C Kiel and G J Nicholson, 'Board Composition and Corporate Performance: How the Australian Experience Informs Contrasting Theories of Corporate Governance' (2003) 11 *Corporate Governance: An International Review* 189

governance debate. We could accept the fact that variables do influence board performances from different perspectives, either positively or negatively. It appears to be impossible for us to design an ideal blueprint suitable for every non-profit board. What we are trying to do is take account of every possible influencing factor to review every attribute of non-profit boards from a normative perspective, and synthesize them in a comprehensive approach.

## Chapter 5 The regulation of non-profit boards in the UK

### 5.1 Introduction

Having set out the proposed blueprint for the non-profit board, Chapter 6 will consider how this might be applied in the context of China. Before doing so, however, this Chapter 5 will consider the extent to which the principles that make up our blueprint are already reflected in the UK's legal/regulatory regime governing non-profits.

Since my primary focus in this thesis is non-profit board governance in China, this pause to consider the UK's regulatory framework requires a few words of justification. There exist three main, and interconnected, reasons for undertaking an analysis of the UK regulatory regime. Firstly, the UK benefits from a fairly well-developed legal/regulatory regime governing non-profits.<sup>502</sup> Such a regime includes provisions that specifically address matters pertaining to non-profit management, including how the governance of non-profits should operate through such boards. There is, then, a wealth of experience and 'institutional wisdom' in the UK's engagement with non-profits.<sup>503</sup> For anyone interested in non-profits, that knowledge is intrinsically interesting, in its own right.

However, and more to the point of this thesis, given the UK's longer experience in this area, it is also useful to consider how far the UK's regulatory regime does, specifically, conform to, or depart from, the blueprint I have put forward. Insofar as the UK regime includes regulations or laws that correspond with the thrust of my blueprint, then this supports the credibility of the proposals put forward. Conversely, the opposite is also true here: if the UK approach fails to accord with important aspects of my blueprint, this would at least give me cause for concern. It might not fatally undermine my argument, but it would require me to put forward reasons why the theoretical blueprint departs from practices adopted by the UK. Consequently, the approach within this chapter shall be to point out and discuss where such 'departures' are to be found.

Thirdly, and finally, there is widespread interest, in other countries, in the UK's

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<sup>502</sup> Worth, (n19) 35

<sup>503</sup> *ibid*



legal/regulatory approach towards the management of companies generally and non-profit companies in particular. China shares that interest.<sup>504</sup> Indeed, as China seeks to develop its own non-profit sector, including its regulation of the governance of such bodies and boards, then the UK is likely to be one country whose experience China will draw upon directly.<sup>505</sup> Since my own research hopes to influence the Chinese approach to regulation and practice, then showing the extent to which my proposals correspond to the UK model will likely add to the plausibility of my blueprint and might increase the likelihood of it being persuasive in future Chinese reforms.

It will be useful to begin by identifying the most commonly adopted corporate legal forms for non-profits in the UK. The UK's approach has largely been to ensure company structures act as 'appropriately constructed vehicles', specifically tailored to the different, distinctive, needs of different types of non-profit.<sup>506</sup> I shall focus on two such types of corporate legal form that a non-profit might choose to operate through. These are:

- Company Limited by Guarantee (CLG)
- Charitable Incorporated Organisation (CIO).

Additionally, two other types are available, but will not be considered here. A brief explanation as to why is necessary. First, non-profits can also operate through the legal form known as the Industrial and Provident Society ('IPS'). However, although this form is often adopted by 'co-operatives', it is much less often used by non-profits,<sup>507</sup> and therefore its treatment of boards is less significant for us. The other type of legal form I shall not consider here is the 'Community Interest Company' ('CIC').<sup>508</sup> In fact, although the CIC was only introduced in 2004, it is a little more widely used than the

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<sup>504</sup> Hasmath and Hsu, (n34)

<sup>505</sup> *ibid*

<sup>506</sup> A Dunn and C Riley, 'Supporting the Not - for - Profit Sector: The Government's Review of Charitable and Social Enterprise' (2004) 67 *The Modern Law Review* 632, 635

<sup>507</sup> According to Riley, 'the relatively small number of such Societies, compared to companies, presents a barrier of unfamiliarity to practitioners'; see *ibid*

<sup>508</sup> According to the Guidance of Community Interest Companies, 'CICs are limited companies which operate to provide a benefit to the community they serve. They are not strictly 'not for profit', and CICs can, and do, deliver returns to investors. However, the purpose of CIC is primarily one of community benefit rather than private profit'; see Office of the Regulator of Community Interest Companies, 'Community interest companies: guidance chapters' (Department for Business, Energy and Industrial Strategy, August 2013)

<[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/605411/cic-12-1333-community-interest-companies-guidance-chapter-1-introduction.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/605411/cic-12-1333-community-interest-companies-guidance-chapter-1-introduction.pdf)> accessed 27 November 2016

IPS. However, it is not truly a non-profit form. It is in fact aimed at ‘Social Enterprises’. It is not, for example, entirely precluded from distributing some part of its profits to its members. And a charity cannot constitute itself as a CIC (although some charities, constituted through a different legal form, can create a CIC as a separate trading arm if they so wish). Given all this, I shall not address the CIC here either.

The two forms we are considering – the CLG, and the CIO – are both ‘corporate entities’. A non-profit could, of course, choose to operate not through these two, or indeed any of the other, corporate forms. It could choose to operate as an unincorporated association, or alternatively as a ‘trust’. However, there are several reasons why very many non-profits, especially those of a medium size, do opt for incorporation in one of the above forms. An incorporated entity may enter into contracts and hold property in its own name, since the company itself forms an entity which is recognized as possessing a ‘special legal personality’.<sup>509</sup> Members of the company are not parties to the contracts the company makes, and are therefore not liable under those contracts. Rather they are only ever liable to contribute the amount they have committed to the company.<sup>510</sup> That is the ‘limit’ on their liability. An auxiliary benefit of being incorporated is that a corporation can create a ‘floating charge’ over its assets.<sup>511</sup> As such, this makes borrowing money easier when compared to unincorporated organisations.<sup>512</sup>

To be sure, these advantages do not always mean non-profit organisations are recommended to adopt incorporation. Indeed, many non-profits may opt to maintain their organisation’s unincorporated status, since incorporation entails meeting a wider range of legal obligations which, depending on the organisation’s size, may also entail cost, time and resources.<sup>513</sup>

Before turning to consider the two identified legal forms in turn, a final explanation of

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<sup>509</sup> M Mullen and J Lewison, *Companies Limited by Guarantee* (4th Ed edn, Jordan Publishing Limited 2014) 4

<sup>510</sup> In the case of a company limited by guarantee, this is equal to the amount of guarantee.

<sup>511</sup> Mullen and Lewison, (n509) 4

<sup>512</sup> Floating charges in corporations mean that ‘a creditor can secure a loan made to the company, without hindering the use of the assets on which the loan is secured. Unincorporated organisations can create floating charges, but they would require registration under the Bills of Sale Acts’; see *ibid* 63

<sup>513</sup> UK Government, ‘Set up a private limited company’ (GOV.UK) <<https://www.gov.uk/limited-company-formation/overview>> accessed 18 November 2016

the *sources* of UK regulation relevant to UK non-profit boards, in these two legal forms, is appropriate. Each legal form is governed by a particular statute, which prescribes many of the legal rules applicable to that legal form. For CLGs, that statute is the Companies Act 2006. It is supplemented by a number of ancillary statutes that deal with specific aspects of the company's affairs,<sup>514</sup> and with 'secondary legislation', in the form of 'statutory instruments', that deal with more technical aspects of the creation and operation of CLGs.<sup>515</sup> For CIOs, the relevant statute is the Charities Act 2011, which again is supplemented by statutory instruments dealing with more mundane or technical issues regarding the creation or operation of CLGs.<sup>516</sup>

The statutory rules that apply to, say, the CLG applies to any organisation which chooses to operate as a CLG. They are, in that sense, 'form specific': they apply only to those organisations that choose to operate through that legal form (the CLG). The same point applies to those statutory provisions, mentioned above, which apply to (but only to) the CIO.

However, there are also some provisions that we need to note in our discussion that are not 'legal form specific'. We shall note two such types of provision. The first relates to 'charities'. In the UK, the 'charity' is not a legal vehicle, in the way that, say, a company is. Rather, it describes a certain sub-set of organisations whose activities qualify as being 'charitable', and who wish to register as charities with the Charity Commission. All charities will be non-profits (an organisation could not register as a charity if it were not); but not all non-profits will be charities. And an organisation whose activities are charitable, and which registers as a charity, may operate under either of the two legal forms we are considering here (either as a CLG or as a CIO). Nevertheless, any organisation that chooses to register as a charity thereby becomes subject to another tier of regulation imposed by the Charity Commission as the 'price' for the advantages of securing that charitable status.

The other source of regulation that is relevant here is certain 'soft law' provisions that exist in the UK. In some instances, where the law itself makes no provision dealing

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<sup>514</sup> For example, the Company Directors Disqualification Act 1986 (hereafter 'CDDA 1986') and the Insolvency Act 1986

<sup>515</sup> The Companies (Model Articles) Regulations 2008 (SI 2008/3229)

<sup>516</sup> The Charitable Incorporated Organisations (General) Regulations 2012 (SI 2012/3012)

with some matter, these ‘gaps’ in the law may be filled by ‘voluntary’ codes of practice, encouraging those the code is aimed at to adopt examples of ‘best practice’. We shall consider one important example of such a code, applicable to non-profits, known as the Good Governance Code 2010.<sup>517</sup> With this sense of the different sources of rules in mind, we can now turn to consider each of the two legal forms in turn.

## **5.2 Company limited by guarantee (CLG)**

### **5.2.1 An overview of the CLG**

The CLG, a legal structure formed under the Companies Act 2006, is a private company in which the ‘liability of its members is limited by a nominal amount’.<sup>518</sup> The limit itself is set out in the constitution of the company, and essentially requires members to contribute the specified amount (usually, £1) ‘in the event of the company being wound up insolvent’.<sup>519</sup> Section 5 (3) of the Companies Act 2006 prevents a company being formed as a CLG with a share capital by stating that ‘any provision in the constitution of a company limited by guarantee purporting to divide the company’s undertaking into shares or interests is to be treated as a provision for share capital’.<sup>520</sup>

A CLG may be considered a desirable choice for non-profits, as it presents as a suitable vehicle for a broad range of purposes.<sup>521</sup> Firstly, unlike companies limited by shares, the admission and expulsion of members within CLGs is dealt with through provisions detailed in the memorandum or articles. No transfer of assets is required when ‘a person involved (either as a member of the company or director) decides to, or is made to, leave the company’.<sup>522</sup> This is important, especially where the company is likely to have its membership drawn from a wide pool of individuals. Secondly, the simplicity of those procedures employed to change the membership of the company means there are

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<sup>517</sup> Charity Commission, ‘Good Governance: A Code for the Voluntary and Community Sector’ (Code Steering Group, 2010)

<sup>518</sup> This nominal amount is usually £1, but it can be any amount that is thought fit. Mullen and Lewison, (n509) 64

<sup>519</sup> *ibid* 65

<sup>520</sup> Companies Act 2006, s 5 (3)

<sup>521</sup> For example, charities which are to have a corporate form can choose to be CLGs. Indeed, CLGs are also frequently used for the provision of social housing or for promoting the interests of a particular section of society.

<sup>522</sup> This is particularly crucial to non-profits which are not permitted to distribute their surplus income to the organisations’ directors and must reinvest this to support the organisation and its work.

considerable advantages for those corporations adopting a CLG where the members may have several other motives, other than mere investment.<sup>523</sup>

## **5.2.2 Reviewing the board of CLGs**

### **5.2.2.1 Board size**

As to the requirement of board size, the Companies Act 2006 stipulates no specific requirement as to the number of directors a CLG board should have.<sup>524</sup> Section 154 of the Act holds that ‘a private company must have at least one director’, but there is no upper limit.<sup>525</sup> Although, then, the Companies Act 2006 does not require non-profits to have the larger boards that we have suggested may often be more appropriate for non-profits, nor does it prevent them doing so. It leaves it up to each company CLG to determine for itself what its optimal board size may be.

### **5.2.2.2 Board characteristics**

Insofar as board characteristics are concerned, UK law has very little to say about board culture. Rather, the law’s focus is on individual characteristics, which are explored further below.

#### **5.2.2.2.1 Directors’ independence**

Concerning directors’ independence, two essential points were established in the blueprint developed in section 4.4. Firstly, the law should indeed insist upon directorial independence. That is to say, even if all directors are subject to a legal duty to act in the best interests of the company, this in and of itself does not guarantee *directors’ independence*.<sup>526</sup> Secondly, the blueprint (4.4) divided director’s independence into two separate aspects – relational independence and independent judgment skills – and then

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<sup>523</sup> Mullen and Lewison, (n509) 5

<sup>524</sup> W Byrnes, 'Pinpointing the Emergence of the Company Limited by Guarantee in Company Law: Historical Origins and Modern Day Review' (2013) Thomas Jefferson School of Law Research Paper 1

<sup>525</sup> Companies Act 2006, s154

<sup>526</sup> Byrnes, (n524) 5

argued that the law should lay greater emphasis on independent judgment skills than on relational independence.<sup>527</sup>

The Companies Act 2006 does address issues of directorial independence, but in a sense only indirectly. Thus, it does so through not through any substantive rules which require directors either to be relationally independent, or to have independent judgement skills. Rather, it imposes duties on directors which, indirectly, require them to act as if they were independent. In particular, s 172 Companies Act 2006 requires directors to act in good faith to promote the success of the company, whilst s 173 Companies Act 2006 holds that a director must exercise independent judgement.<sup>528</sup> Accordingly, a director may not ‘commit himself to defer to someone else’s opinion without exercising his judgment, or put the interests of another employer ahead of those of his company’.<sup>529</sup> Additionally, s 174 (1) Companies Act 2006 regulates the director’s independent judgment through stipulating a requirement detailing the director has a clear *duty to exercise reasonable care, skill and diligence*.<sup>530</sup> Indeed, directors who are found to fail in their exercise of reasonable care, skill and diligence in their management of companies and later become insolvent may find themselves subject to proceedings under the Company Directors Disqualification Act 1986.<sup>531</sup>

#### **5.2.2.2.2 Professional knowledge and skills**

We have seen, then, that UK law does not insist on directors actually having those characteristics which, it was argued above, are likely to ensure their independence. UK law merely requires a certain standard of behaviour which, indirectly, encourages a degree of independence in action. A similar picture emerges when we turn to consider what the law has to say about directors’ professional knowledge and skills. Again, the Companies Act 2006 does not impose any *pre-entry requirements* in terms of directors’

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<sup>527</sup> The OECD 2004 stated that ‘board independence...usually requires that a sufficient number of board member will need to be independent of management’; see OECD, *OECD Principles of Corporate Governance*, (Streering Group on Corporate, Paris 2004)

<sup>528</sup> Companies Act 2006, s173

<sup>529</sup> Mullen and Lewison, (n509) 7

<sup>530</sup> Companies Act 2006, s 174 (1)

<sup>531</sup> Mallin, (n14) 170

knowledge or skills.<sup>532</sup> Put differently, contrary to my blueprint, directors do not have to possess any particular qualification, knowledge and skills as a precondition to their being eligible to be appointed as such. Instead, the same general duties which apply to the behaviour of directors may, indirectly, encourage directors to obtain those skills in order to lessen the chances of their breaching their duties. Or those duties may encourage companies themselves to insist on their directors having such skills, either by setting standards within their constitution, or by selecting appropriate candidates during any given recruitment process. Of the general duties that apply to directors, s174 Companies Act 2006 (the director's duty of care, skill and diligence) is most likely to have this effect. Also relevant here is the threat of disqualification against those who have been directors of companies which have become insolvent, and who have proved themselves to be 'unfit' to manage a company.<sup>533</sup>

Set against this background of the law's reluctance to require particular knowledge or skills of company directors, soft law has stepped in and done a little to fill the gap. In particular, we might mention here the *Good Governance Code 2010*, which highlights the importance of professional knowledge/skill/experience to the board governance and lists relevant knowledge/skills that non-profits require.<sup>534</sup> But, to repeat the point made already, this Code is indeed merely 'soft law'. It carries no compulsion on CLGs, or their directors, to observe its terms. No sanction exists for non-compliance.

Compared, then, to the standard set out in the blueprint (section 4.4), the UK regulatory framework falls somewhat short of what is truly desirable here, with its primary reliance on the use of soft law (voluntary regulation).<sup>535</sup> This does too little to encourage a company or its directors achieving the professional knowledge and skills that may be required, and may therefore lead to directors shirking from their responsibilities in *three ways*. The first involves the *self-selection process* in which prospective directors may perceive themselves as competent to take on the role of director, even where they do not possess the professional knowledge/skills required.<sup>536</sup>

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<sup>532</sup> Byrnes, (n524) 6

<sup>533</sup> Company Directors Disqualification Act 1986, s6

<sup>534</sup> Charity Commission, 'Good Governance: A Code for the Voluntary and Community Sector' (Code Steering Group, 2010) 17

<sup>535</sup> Byrnes, (n524) 8

<sup>536</sup> *ibid* 9

The silence of relevant legal regulations, might well give a false impression to candidates and boards that professional knowledge/skill is less important than, as the blueprint argues, is in fact the case.<sup>537</sup>

Second, it may in fact enable directors to avoid liability for breaching their duty of care and skill (in section 174 Companies Act 2006), the very provision that was intended, indirectly to encourage directors to be more skilful or more highly qualified. Section 174 has both an ‘objective’ and a ‘subjective’ standard built into it.<sup>538</sup> In other words, all directors must be as competent as a ‘reasonable’ director (the objective test) but those who possess a richer array of skills or professional qualifications, that enable them to perform to a higher standard, are judged against that (subjective) higher standard. But in a sense this dulls the incentive on a director to acquire greater skills or qualifications, for that results in her being judged more strictly – against the higher, subjective, standard. And it allows those who could acquire those skills, but choose not to do so, to be judged only against the lower, reasonable, standard of an ‘average’ director.

Third, from a *recruiters’ perspective*, without reference to, and use of, a consistent benchmark, the selection of potential directors could become more dependent upon recruiter discretion (that is to say, their personal judgment and preference), which often proves to be inaccurate and a poor guide for recruiters to follow.<sup>539</sup>

### **5.2.2.2.3 Stakeholder representatives**

#### **5.2.2.2.3.1 Which type of stakeholders should sit in the boardroom?**

It would appear the law has clearly demonstrated a *supportive attitude* towards the involvement of *stakeholder representatives* on CLG’s boards, which is conforming with the blueprint addressed in section 4.4. For example, s 172 of the Companies Act 2006 enshrines the director’s duty within the decision-making process to consider the interests of their stakeholders.<sup>540</sup> However, on the question as to *which type of*

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<sup>537</sup> *ibid*

<sup>538</sup> Companies Act 2006, s174 (2)(a) and (b)

<sup>539</sup> Mullen and Lewison, (n509) 6

<sup>540</sup> *ibid* 7



*stakeholders should sit in the boardroom, if at all,*<sup>541</sup> then the law seems to *offer an answer which slightly departs from the blueprint.* The blueprint developed *two points* (see section 4.4) concerning the stakeholder identities of the non-profit board. *First*, there exists a conflict between encouraging greater stakeholder involvement in the board's governance, and securing the working effectiveness of the board itself.<sup>542</sup> This conflict may be explained with reference to the distinction between the 'instrumental stakeholder' and 'normative stakeholder'. *Second*, the instrumental stakeholder proposal would seem to be most desirable in this context, as it prioritises boards' effectiveness.<sup>543</sup>

#### **5.2.2.2.3.2 Stakeholders and board effectiveness**

Section 172 is clearly consistent with the blueprint's advocacy of instrumental stakeholding. Although, as noted, section 172 does require directors to have regard to the interests of a range of stakeholders, they must do this 'in good faith' and in order 'to promote the success of the company'. Thus, section 172 does not require directors to treat the interests of stakeholders as 'ends in themselves', or to give equal weight to each stakeholder's interests. Rather, boards must consider those interests instrumentally, as a means to better promoting the success of the company itself.

For for-profit companies, the 'success of the company' is usually to be understood in terms of the interests of its members (shareholders). This is captured in section 172(1) itself, which declares the duty to be 'to promote the success of the company for the benefit of its members'.<sup>544</sup> However, section 172(2) provides that:

'Where ... the purposes of the company consist of or include purposes other than the benefit of its members, subsection (1) has effect as if the reference to promoting the success of the company for the benefit of its members were

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<sup>541</sup> In other words, this would appear to express the tension between the instrumental and normative stakeholder division we have discussed in section 3.4. This suggests there are two attitudes toward the existence of stakeholders in the boardroom, which are moral stakeholders and instrumental stakeholders. The instrumental stakeholder value is supported by the concept that the focus of the board of directors is to improve its efficiency, and thus to generate maximum corporate value. However, the moral stakeholder value insists that 'a wider range of interests can be served as subordinate to the overall aim of maximizing corporate efficiency'. J Lowry and A Reisberg, *Pettet's Company Law* (Prentice Hall 2009) 70

<sup>542</sup> Discussed earlier in section 3.4 and 4.4.

<sup>543</sup> See section 4.4.

<sup>544</sup> Companies Act 2006, s172 (1)

to achieving those purposes'.<sup>545</sup>

Thus, section 172 does indeed require only an instrumental version of stakeholding. Including stakeholders is a means to an end, but in the case of non-profits, that end is the purpose of the organisation, not the wealth of its members.

Building upon this, as the blueprint (section 3.4 and 4.4) has already discussed, consistently requiring the board to assume responsibility for all stakeholders will inevitably have the effect of reducing its working efficiency and effectiveness. According to the blueprint outlined at sections 4.4 and 4.5 *the potential to improve board effectiveness* is that the board can follow the approach of Stakeholder Salience Theory; as to *prioritize and select* the most important stakeholder representatives sitting in the boardroom.<sup>546</sup> Section 172 is consistent with this approach.

#### **5.2.2.2.3.3 Conflicts of interests**

Involvement of stakeholder representatives also brings a separate concern, namely that of fulfilling the role of *nominee director*.<sup>547</sup> Nominee directors may find that the wishes of their nominating body conflict with their duties to the company.<sup>548</sup> UK regulation addresses this already. Thus, as we noted above, section 173 requires a director to exercise independent judgement. And section 175 Companies Act 2006 requires a director to avoid any situation 'in which he has, or can have, a direct or indirect interest that conflicts or may possibly conflict with the interests of the company'.<sup>549</sup> In *Boulting*, Lord Denning warned that:

'No one who has duties of a fiduciary nature to discharge can be allowed to enter into an engagement by which he binds himself to disregard those duties or to act inconsistently with them... take a nominee director... there is nothing wrong in it ... so long as the director is left free to exercise his best judgment in the interests of the company which he serves. But if he is put upon terms that he is bound to act in the

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<sup>545</sup> *ibid*

<sup>546</sup> Obviously, some of the resource collectors and stakeholder representatives should belong to the non-governing director group; see Mitchell, Agle and Wood, (n265) 861

<sup>547</sup> As such, some of the board members are nominated by another organisation/government / particular group of members, which attempt to involve themselves in a corporation's governance as a stakeholder entity; see D M Ahern, "Nominee Directors' Duty to Promote the Success of the Company: Commercial Pragmatism and Legal Orthodoxy" (2011) 127 Law Quarterly Review 118

<sup>548</sup> Riley, (n94) 108

<sup>549</sup> Companies Act 2006, s175 (5)

affairs of the company in accordance with the directions of his patron, it is beyond doubt unlawful'.<sup>550</sup>

### 5.2.2.3 Board committee

As the blueprint argued (section 4.5), the board committee acts as an effective vehicle for task allocations and specifications. However, UK law is subject to two difficulties – two ways in which it fails to fulfil the requirements of my blueprint. The first is that there is *no requirement in the Companies Act on companies to employ a committee structure in their boards*.<sup>551</sup> Equally, there does not appear to exist any regulation that prescribes a detailed board structure, which requires directors to act in or fulfil a number of different roles at board level.<sup>552</sup> Once again, the silence within the law itself has been filled by soft-law. For a more specific description regarding the use and function of board committees has been identified in a number of influential codes of practice.<sup>553</sup> For instance, the Good Governance Code declares that ‘in all but the smallest organisations, the board will need to delegate parts of its work to others in a clear, practical and legal manner. Delegation may be made to sub-committees...’.<sup>554</sup>

Second, not only does UK law not *require* companies to adopt a committee structure, it also makes it rather difficult for companies which choose to adopt a committee structure to then engage in the sort of delegation that such a structure logically requires. Admittedly, at first sight it can seem that UK company law does in fact permit and facilitate delegation by directors. The case of *Re City Equitable Fire Assurance Co Ltd*<sup>555</sup> is usually taken as authority for the rule that directors may delegate tasks to others, and are not ‘vicariously liable’ for the mistakes of the person to whom they have delegated. Moreover, directors do not seem to have ‘collective responsibility’: each director is judged by what he or she did or failed to do – not because they were part of a board that collectively made a mistake.

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<sup>550</sup> *Boulting v ACTT* [1963] 2 QB 606 at p.626 per Lord Denning

<sup>551</sup> *Mullen and Lewison*, (509) 5

<sup>552</sup> *ibid*

<sup>553</sup> Charity Commission, ‘Good Governance: A Code for the Voluntary and Community Sector’ (Code Steering Group, 2010); Riley, (n94) 131

<sup>554</sup> Charity Commission, ‘Good Governance: A Code for the Voluntary and Community Sector’ (Code Steering Group, 2010)

<sup>555</sup> *Re City Equitable Fire Assurance* [1925] Ch 407, 429

Nevertheless, whilst directors who delegate are not ‘vicariously liable’, ‘delegation does not absolve any director of a duty to supervise those to whom particular tasks have been delegated’.<sup>556</sup> Thus, the division of labour that delegating tasks to a committee is supposed to achieve can be undermined by the need to monitor the work of that committee. Moreover, it has been pointed out that ‘...neither the wrongful trading provision in s214 of the Insolvency Act 1986 nor the statutory duty of care and skill in s174 of the Companies Act 2006 expressly require the courts to take into account, when determining what a director ought to have done, the functions actually allocated to that director’.<sup>557</sup> These regulations fail to delegate the functions of the board to ‘individual directors in an efficient manner’.<sup>558</sup>

The uncertainties and deficiencies in the law itself are, on this point, compounded by the content of the Good Governance Code. It declares that ‘[a]ll trustees are equally responsible in law for the board’s actions and decisions, and have equal status as trustees’,<sup>559</sup> which implies that ‘a director to whom some activity is delegated has neither a greater nor a lesser responsibility than any other member of the board’.<sup>560</sup>

To sum up here, the inconsistency apparent within these regulations, combined with the unspecified requirement pertaining to the labour division appropriate for the board’s functioning, would seem likely to encourage or incentivize directors to ‘hide behind their colleagues’.<sup>561</sup> It would be far preferable if, in accordance with the blueprint (section 4.5) the law spelt out the directors’ duties with regard to delegation ‘with sufficient clarity and specificity so that those who take on these roles, or wish to enforce the duties of such directors, understand what they entail’.<sup>562</sup>

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<sup>556</sup> C Belcher, ‘The Unitary Board: Fact or Fiction?’ (2003) 1 *Corporate Ownership and Control* 147

<sup>557</sup> Companies Act 2006, s 174 (2); Insolvency Act 1986, s214 (4)(a); Riley, (n94)

<sup>558</sup> *ibid* 144

<sup>559</sup> Charity Commission, ‘Good Governance: A Code for the Voluntary and Community Sector’ (Code Steering Group, 2010) 19

<sup>560</sup> Indeed, the Code suggests that “not only do all board members owe the same duties, but that the board ‘is collectively responsible for the success of the company’”; see Riley, (n94) 145

<sup>561</sup> Belcher, (n556) 153

<sup>562</sup> Riley, (n94) 144

#### 5.2.2.4 Board process

UK law is generally permissive so far as board process goes. In other words, apart from a few general provisions in sections 248-249 Companies Act 2006 pertaining to the operation of the board and its meeting processes, the Act says little to mandate companies to adopt one board process or another.<sup>563</sup> Thus, the law largely leaves space for companies to develop their own approaches, say through constitutional provisions. This, again, is consistent with the terms of our blueprint.

### 5.3 Charitable Incorporated Organisations

#### 5.3.1 An overview of the CIO

Unlike CLGs, which may be used by both charitable and non-charitable organisations, CIOs are specifically designed for charitable use. They constitute a legal form that gives the benefits of incorporation, but for organisations that ‘do not want to fall within the legal regime applicable to companies registered under the Companies Act 2006’.<sup>564</sup>

The use of CIO status became available to charities in England and Wales on 4 March 2013.<sup>565</sup> The introduction of this relatively new legal form, designed specifically for charitable use, offers a number of benefits. First, the charity using a CIO is able to avoid the issue of *double-regulation*.<sup>566</sup> A charity operating as a CLG must comply with two bodies of rules: those contained in the Companies Act 2006, and which apply in virtue of being a CLG, and those imposed by the Charity Commission and which apply in virtue of being a registered charity. But this clearly causes duplication of regulation and associated costs.<sup>567</sup> For instance, ‘a charity operating through a CLG must submit

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<sup>563</sup> Companies Act 2006, s248-249

<sup>564</sup> Riley, (n94)

<sup>565</sup> In Scotland, the Office of the Scottish Charity Regulator began registering Scottish Charitable Incorporated Organisations (SCIOs) in April 2011. Corresponding to the three systems of charity law in the UK, there are three jurisdictions of CIOs in the UK, which are ‘CIOs established under the laws of England and Wales, CIOs established under the laws of Scotland, and CIOs established under the laws of Northern Ireland’. In this section, I will mainly focus on the legislation and codes of practices under the legal jurisdiction of England and Wales. If there is any serious conflicts or differences in their attitudes towards trustees in CIOs, I will mention specifically. G G Morgan, *Charitable Incorporated Organisations* (Directory of Social Change 2013) 5

<sup>566</sup> CLGs are subject to two sets of legal regulations, which are the UK company law and the charity law.

<sup>567</sup> Morgan, (n565)

accounts both to the Registrar of Companies at Companies House and to the Registrar at the Charity Commission'.<sup>568</sup> This duplication could lead to 'a confusing clash between the two bodies of rules'.<sup>569</sup> The CIO avoids this duplication: since it is available only for charities, all organisations operating as CIOs will, inevitably, be subject to the rules imposed by the Charity Commission: there is no need to have similar rules as part of the law of the CIO.

A second advantage for the CIO is that it is a more 'bespoke' legal form. A CLG may be used by many charities, but it was not designed specifically for charities. Its rules must therefore satisfy a wider range of organisational types that choose to use it. The CIO is a legal vehicle specifically designed for charitable organisations. Its rules, therefore, are tailored solely to the distinctive needs and circumstances of such organisations.<sup>570</sup>

The ability for non-profits to create this new form of corporate entity can now be found in the Charities Act 2011.<sup>571</sup> Part 11 of the Act sets out the bare structure of legal rules governing CIOs, whilst more detailed regulations may be found across a number of sources.<sup>572</sup> The first of these are the regulations that supplement the Charities Act 2011. The most important of these are the Charitable Incorporated Organisations (General) Regulations 2012 (hereafter the 'General CIO Regulations'); the Charitable Incorporated Organisations (the Insolvency and Dissolution Regulations) Regulations 2012 and the Charitable Incorporated Organisations (Consequential Amendments) Order 2012.<sup>573</sup> The Insolvency Act 1986 and Company Directors' Disqualification Act 1986 may also be applied to the CIO as well.<sup>574</sup> Each of these provide a considerable number of rules governing the regulation and administration of CIOs, and cover at least some of the ground covered by the Companies Act 2006 in respect of registered companies, such as CLGs.<sup>575</sup>

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<sup>568</sup> Dunn and Riley, (n506)

<sup>569</sup> 'The conflict between the duties imposed on directors and those imposed on charity trustees'; see *ibid* 656

<sup>570</sup> *ibid* 656

<sup>571</sup> It was first introduced by the Charities Act 2006, and relevant provisions were then replaced by provisions in the Charities Act 2011.

<sup>572</sup> Charities Act 2011, s11

<sup>573</sup> The Charitable Incorporated Organisations (General) Regulations 2012, (SI 2012/3012)

<sup>574</sup> Morgan, (n565) 34

<sup>575</sup> *ibid*

The second source of rules for CIOs are those to be found in the CIO's own constitution. Much like a registered company, a CIO must also register a constitution.<sup>576</sup> The Charities Act does not prescribe what the content of such a constitution must provide, so to this extent the constitution is not restricted by having to adopt a set of state-imposed, mandatory rules, governing the way in which the CIO should operate. Nevertheless, the Charities Act does specify certain areas the constitution must, at the very least, address, though the content of this is left to be determined.<sup>577</sup> The Act provides that the constitution must comply with any regulations made either under the Charities Act 2011, or by the Charity Commission. In practice, although the content is not prescribed by law, it will tend to closely follow one<sup>578</sup> of the two model constitutions (hereafter 'the Model CIO Constitutions') that have been prepared by the Charity Commission for CIOs. Following one of these ensures that the Commission is unlikely to object to, or delay, the incorporation of the CIO.<sup>579</sup> In what follows, then, as we consider whether the law governing CIO's respects the blueprint for the board developed in chapter 4, we will consider rules found not only in the Charities Act 2011 and the General CIO Regulations, but also those in the Model CIO Constitutions.

Before proceeding, we need to make a point in relation to terminology and charity law. Although company law uses the familiar concept of a director when, for example, imposing legal duties upon those controlling companies, charity law has never followed that approach. It could not target its obligations on 'directors' because not all charities would operate as companies, and therefore *not all charities would have directors*. Instead, then, charity law applies its rules to the so-called '*charitable trustee*'. They are defined in s177 of the Charities Act 2011 as 'the persons having the general control and management of the administration of a charity', and they are subject to a range of

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<sup>576</sup> Charities Act 2011, s 205 (2)

<sup>577</sup> Dunn and Riley, (n506)

<sup>578</sup> There are two model constitutions for CIOs issued by the Commission; they differ according to whether the CIO has voting members other than the CIO's charity trustees; see Morgan, (n565), 73

<sup>579</sup> The Commission's models can be found at the Charity Commission, 'Constitution of a Charitable Incorporated Organisation with voting members other than its charity trustees' (Charity Commission for England and Wales, October 2016)

<[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/562468/Association\\_Model\\_Constitution.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/562468/Association_Model_Constitution.pdf)> accessed 12 November 2016

duties and obligations which echo those applied by company law to directors.<sup>580</sup>

The CIO follows this charity law approach. It uses the label ‘charity trustee’ to refer to those running the CIO. Hence, in the following discussion, when describing or discussing the rules governing CIOs, many of these will be couched in terms of the requirements applying to ‘charity trustees’. But the reader should bear in mind that the ‘charity trustee’ of a CIO will be the equivalent to a director of a CLG.

### **5.3.2 Reviewing the board attributes of CIOs**

#### **5.3.2.1 Board size**

In terms of board size, the Charities Act 2011 merely states that a CIO must have ‘one or more’ trustees.<sup>581</sup> The Charities Act is, then, as non-prescriptive in relation to CIOs as was the Companies Act 2006 in relation to CLGs. And once again, the gap in the (charity) law is filled in, to some extent, by the Good Governance Code 2010, with its suggestion that the board should be ‘big enough to provide the skills and experience needed, but not so large that decision-making become unwieldy’.<sup>582</sup> However, the CIO Model Constitution is more prescriptive. It states that ‘there must be at least three charity trustees’,<sup>583</sup> and ‘the maximum number of charity trustee is 12’.<sup>584</sup> Indeed, the Charity Commission itself will not register a charity which applies for admission with fewer than two trustees.<sup>585</sup>

Overall, the legal approach to addressing matters concerning CIO’s board size has essentially been similar to the position outlined in the blueprint. Such an approach appreciates the potential value of a large board, but recognises there cannot be a ‘one size fits all approach’, and that sometimes smaller boards may be acceptable. The law then provides enough space and flexibility for CIOs to determine their size, as

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<sup>580</sup> Charities Act 2011, s177

<sup>581</sup> Charities Act 2011, s 206 (2)

<sup>582</sup> Charity Commission, ‘Good Governance: A Code for the Voluntary and Community Sector’ (Code Steering Group, 2010)

<sup>583</sup> ‘If the number falls below this minimum, the remaining trustee or trustees may act only to call a meeting of the charity trustees, or appoint a new trustee’. A CIO Model Constitution, art 12 (3) (a)

<sup>584</sup> ‘The charity trustees may not appoint any charity trustee is as a result the number of charity trustees would exceed the maximum’. A CIO Model Constitution, art12 (3)(b)

<sup>585</sup> Johnson, (n465)



preferred.<sup>586</sup>

### 5.3.2.2 Board characteristics

Discussion within section 4.4 divided board characteristics into matters pertaining to collective board culture and individual director' characteristics. This section continues that distinction.

#### 5.3.2.2.1 Board culture

Notwithstanding the essential role that board culture plays, the statutory provisions concerning CIOs have remained silent on this matter. By contrast, the Good Governance Code 2010 addressed board culture in some detail, outlining its importance in building-up 'synergistic team-production relationships' among trustees.<sup>587</sup> CIO boards are encouraged to invest 'sufficient time in developing positive working relationships amongst themselves and between the board and senior staff'.<sup>588</sup> Moreover, through providing a broad range of approaches,<sup>589</sup> the Good Governance Code 2010 emphasizes the importance for the board to be '*open and accountable* both internally and externally'.<sup>590</sup> According to such regulations, as discussed above, it can therefore be concluded that board culture is more greatly appreciated by CIOs and in keeping with the approach outlined above in relation to the blueprint.

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<sup>586</sup> Morgan, (n565) 89

<sup>587</sup> Charity Commission, 'Good Governance: A Code for the Voluntary and Community Sector' (Code Steering Group, 2010)

<sup>588</sup> Charity Commission, 'Good Governance: A Code for the Voluntary and Community Sector' (Code Steering Group, 2010) 22

<sup>589</sup> Relevant actions have been listed include 'open communications, informing people about the organisation and its work, listen and responding to the views of supporters, funders, beneficiaries, service users and others with an interest in the organisation's work'; see Charity Commission, 'Good Governance: A Code for the Voluntary and Community Sector' (Code Steering Group, 2010) 22

<sup>590</sup> Charity Commission, 'Good Governance: A Code for the Voluntary and Community Sector' (Code Steering Group, 2010) 22

### 5.3.2.2.2 Individual characteristics

#### 5.3.2.2.2.1 Management versus governance in CIOs

We have noted already that the Charities Act employs the term ‘charity trustee’, rather than director. What role does that Act envisage such trustees playing? Chapter 4 has already extensively explored the role of individual directors of non-profits, and thus the role of the board. Core to this was the idea that non-profits need some directors who will be there to monitor those managing the company, so that the board becomes, in part, a *monitoring body*.

However, charity law gives little acknowledgement to this distinction and separation between managing and monitoring the organisation. According to the Guidance of the Charity Commission, trustees include not only those who control/govern charities, but also those who are responsible for many other tasks such as the management and administration. In other words, the charity trustee, in many cases, is effectively the same as an *executive director*. The law has nothing to say about the need for a distinctive governance/monitoring role for charity trustees, separated out from the management of the CIO. It may develop the concept of a charity trustee as equivalent to the director, but it has no concept equivalent to, specifically, the *non-executive* director.

Although the Charity Commission and the Good Governance Code 2010<sup>591</sup> have distinguished between trustee’s governance and management in their guidance,<sup>592</sup> they do not develop the concept of a board which will monitor managers, because the Charities Act 2011 does not even think in terms of such directors or such a board in the first place. There are neither rules requiring some directors to act as monitors over

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<sup>591</sup> The Good Governance Code implies that: trustees should have the ability to distinguish between strategic matters and matters that are operational in relation to the oversight of the board. They should avoid ‘inappropriate involvement in operational matters but taking responsibility for challenging and holding to account senior managers (e.g. the chief executive, senior management team) or other persons, organisations or agencies to whom they have delegated implementation of their strategic decisions’; see Charity Commission, ‘Good Governance: A Code for the Voluntary and Community Sector’ (Code Steering Group, 2010)

<sup>592</sup> It is plausible that trustees may be asked not to interfere in day to day operations. Indeed, they may be obliged to ‘allow staff and volunteers to carry out any functions that have been delegated’. ‘Trustees and co-trustees must be able to ensure that delegated authority is being properly exercised, through appropriate monitoring and reporting procedures (and, where appropriate and possible, independent audit)’. *The essential trustee: what you need to know, what you need to do* (Charity Commission 2016, ref CC3) 30

others, nor regulations specifying the role of the board as monitoring rather than managing, representing stakeholders or being resource collectors, and so on. Thus, the CIO regulations fail to specify the role of CIO boards, and also fail to distinguish the organisation's governance from management.

#### **5.3.2.2.2 Trustee's independence**

Given that the CIO regulations do not develop a model of a monitoring board, it is unsurprising that those regulations also fail to mention anything about the trustee's *independence from management*. Instead, the law in question seeks to specify trustee's *independence from monetary related matters*, and stop trustees (or those connected with them) from receiving inappropriate benefits by virtue of their position in, or relation to, the CIO. For example, s 188 of the Charities Act 2011 attempts to ensure the charity's money goes to 'independent' people by defining '*connected persons*'.<sup>593</sup> Similarly, s178-180 of the Charities Act 2011,<sup>594</sup> the Charity Commission guidance discussed above,<sup>595</sup> and the CIO Model Constitution all outline examples of those situations in which trustees are most likely to get involved in payment matters.<sup>596</sup> Thus, the CIO legal framework does not require trustees to be independent of the management they are monitoring. Such rules do not grapple at all with the points made in the blueprint in 4.4, which is to ensure that some trustees/directors are sufficiently independent to be able to monitor management.

#### **5.3.2.2.3 Professional knowledge and expertise**

Turning to the regulations concerning trustees' knowledge and skill, none of the CIO relevant statutory provisions provide a specific standard pertaining to the professional

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<sup>593</sup> A statutory definition of who should be considered to be 'connected' to a trustee in the context of payments to trustees has been provided in the Charities Act 2011; see Charities Act 2011, s188

<sup>594</sup> As described in s 178 to 180 of the Charities Act 2011, a person is disqualified by law from acting as trustees if he 'has entered into a composition or arrangement with their creditors which includes an individual voluntary arrangement (IVA)'. Charities Act 2011, s 178 to 180

<sup>595</sup> *The essential trustee: what you need to know, what you need to do* (Charity Commission 2016, ref CC3) 8

<sup>596</sup> No charity trustee or connected person may: '

- (a) buy or receive any goods or services from the CIO on terms preferential to those applicable to members of the public;
- (b) sell goods, services, or any interest in land to the CIO;
- (c) be employed by, or receive any remuneration from, the CIO;
- (d) receive any other financial benefit from the CIO'. A CIO Model Constitution, art 6 (1)

knowledge, expertise and qualifications a trustees should have to hold office.<sup>597</sup>

Once again, addressing the knowledge and expertise of trustees is left to soft law. The Good Governance Code provides that ‘when charities recruit new trustees, they should think about the skills and experience the current trustees have, and whether there are any gaps’.<sup>598</sup> The Charity Commission proffers a number of recommendations, which include ‘building on the skills of your existing trustees’ training your existing trustees, working or sharing expertise with other charities, and recruiting new trustees to meet specific skills gaps’.<sup>599</sup> In addition to this, based upon the constraint with respect to the remuneration of trustees in this context, CIOs are advised to build on public confidence and that of their organisations, to attract more trustees.<sup>600</sup> For example, the *Private Action, Public Benefits* (PAPB)<sup>601</sup> report attempted to encourage public learning about non-profits as ‘the citizenship element of national curriculum’.<sup>602</sup>

#### **5.3.2.2.4 Board composition—stakeholder representatives**

Advancing upon the discussion in section 4.4, we shall investigate the law concerning stakeholder representatives in the CIO’s board. Indeed, it is a common practice for CIOs to *appoint stakeholders as trustees*, with a view to ensuring their increased involvement in facilitating governance/management of the company. According to the Charity Commission, a well-run charity will continuously attempt to encourage the involvement and participation of stakeholders in improving the organisation’s efficient management,<sup>603</sup> which has been considered among one of the best ways to obtain a wider selection of views and perspectives on a given topic.<sup>604</sup> However, similar to the argument we have advanced in relation to CLGs, the increasing inclusion of ‘stakeholder’ trustees in the administration of a CIOs also brings with it *two challenges*

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<sup>597</sup> Morgan, (n126)

<sup>598</sup> Charity Commission, ‘Good Governance: A Code for the Voluntary and Community Sector’ (Code Steering Group, 2010)

<sup>599</sup> The Charity Commission, ‘Trustee board: people and skills’ (Charity Commission for England and Wales, May 2014) <<https://www.gov.uk/guidance/trustee-board-people-and-skills>> accessed 12 November 2016

<sup>600</sup> Dunn and Riley, (n506) 642

<sup>601</sup> G Britain and T Blair, *Private Action, Public Benefit: A Review of Charities and the Wider Not-for-Profit Sector* (Cabinet Office Strategy Unit 2002)

<sup>602</sup> *ibid* 6.45-6.47

<sup>603</sup> *Users on Board: Beneficiaries Who Become Trustees* (Charity Commission 2012, ref CC24)

<sup>604</sup> *The essential trustee: what you need to know, what you need to do* (Charity Commission 2016, ref CC3) 8

– the conflict of interests between the stakeholder representing entity and the CIO,<sup>605</sup> and a likely reduction in the board’s working effectiveness.<sup>606</sup>

First, concerning the matter of *working effectiveness*, in addition to the legal regulations<sup>607</sup> we have discussed in section 5.2.2.2.3.2, to improve stakeholder’s working effectiveness, some of the more feasible solutions have been outlined by the Charity Commission to facilitate the application of the instrumental stakeholder approach in CIOs. For example, inductions and trainings come as highly recommended, where it is noted, ‘effective training for all trustees will help to consolidate a person’s strengths, to minimize weakness and to make up for any lack of knowledge and experience’.<sup>608</sup>

Second, in terms of conflicts of interests between the stakeholder representing entity and the CIO organisation itself, the statutory provisions governing CIOs often fail to address this conflict specifically, whilst some of the soft law provisions are relevant here. According to the CIO Model Constitution, a trustee must ‘declare the nature and extent of any interest, and absent himself or herself from any discussions of the charity trustees in which it is possible that a conflict of interest will arise between his or her duty to act solely in the interests of the CIO and any personal interest’.<sup>609</sup> Trustees must take all relevant factors into account, and be ready to explain their approach if asked.<sup>610</sup>

### 5.3.2.3 Board committee

Both the CIO Model Constitution and the Good Governance Code 2010 note the advantage of board committees in enabling a division of labour division and job specification for directors’ or trustees’ roles.<sup>611</sup> However, as we have argued in section

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<sup>605</sup> According to the Charity Commission, ‘a trustee’s duty to the charity may compete with a duty of loyalty they owe to another organisation or person’. The Charity Commission even lists a range of possible situations; see *Conflicts of interest: a guide for charity trustees* (Charity Commission 2014, ref CC29) 9

<sup>606</sup> As noted in section 4.4, stakeholder representatives and resource collectors (or fundraisers) may reduce the working efficiency of CIOs as they lack governance skills and knowledge.

<sup>607</sup> Companies Act 2006, s172

<sup>608</sup> *Users on board: beneficiaries who become trustees* (Charity Commission 2012, ref CC24) 4

<sup>609</sup> A CIO Model Constitution, art 7 (1) (2)

<sup>610</sup> *Conflicts of interest: a guide for charity trustees* (Charity Commission 2014, ref CC29) 10

<sup>611</sup> *ibid*

4.5, in spite of these benefits, there remains the possibility that trustees will attempt to shirk away from their responsibilities within the CIO, and free ride on others' efforts. Research also indicates that in a group situation (even a small group like a committee), in which 'either individual inputs are indistinguishable or monitoring costs are prohibitive', an individual is likely to have 'a negative incentive to free-riding and a positive incentive to supply less effort (shirking)'.<sup>612</sup> Accordingly, we shall now turn to consider how the CIO regulations deal with the issue of *trustees' free-riding within board committees*. The law essentially employs two approaches, which are the trustee's *duty of care, skill and diligence* and trustees' *use of delegated authority*.

First, the Trustee Act 2000 codified the trustee's *duty of care, skill and diligence*. Meanwhile, s 1 of the Trustee Act 2000 further indicates that trustees must consider getting external professional advice on all matters where there may be material risk to the charity or; where the trustees may be in breach of their duties.<sup>613</sup> In addition, the Model Constitution outlines a range of particular circumstances in which trustees must exercise their duty of care, skill and diligence.<sup>614</sup>

Second, the Good Governance Code 2010 clearly indicates that the voluntary sector, including CIOs should have 'clear written terms of reference for committees of the board ... which provide sufficient delegated authority and clear boundaries'.<sup>615</sup> It also stresses that trustees' use of delegated authority should be properly supervised to avoid the abuse of their power.<sup>616</sup> Furthermore, in order to assist each trustee in clearly understanding his or her role, the CIO Model Constitution declares that the CIO trustees 'shall from time to time review the arrangements which they have made for the

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<sup>612</sup> Upadhyay, Bhargava and Faircloth, (n341)

<sup>613</sup> Trustees Act 2000, Chapter 29, part1, s1

<sup>614</sup> 'These circumstances have regard in particular to: (i) any special knowledge or experience that he or she has or holds himself or herself out as having; and (ii) if he or she acts as a charity trustee of the CIO in the course of a business or profession, to any special knowledge or experience that it is reasonable to expect of a person acting in the course of that kind of business or profession'. A CIO Model Constitution, art12

<sup>615</sup> Furthermore, if a trustee does decide to delegate, they should set out the specific terms of the delegation in writing, for example 'in in the minutes of a trustees meeting. The following information should be recorded: •details of the powers delegated; •to whom the power is delegated; •procedures for reporting back to the trustees should be established; and •the trustees should keep the decision to delegate under constant review'; see Charity Commission, 'Good Governance: A Code for the Voluntary and Community Sector' (Code Steering Group, 2010) 19

<sup>616</sup> Charity Commission, 'Good Governance: A Code for the Voluntary and Community Sector' (Code Steering Group, 2010)

delegation of their powers'.<sup>617</sup> At the same time, the power of delegation could be made subject to a requirement that 'at least one member of each committee must be a charity trustee' in CIOs.<sup>618</sup> This is to ensure that the trustee-delegate can monitor what his or her co-delegates are doing, and 'take steps to prevent any acts or decisions that may, for example, be a breach of trust'.<sup>619</sup>

These regulations conform with our blueprint, attempting to list and avoid the potential situations leading to trustees' shirking behaviour. Compared with the CLG's regulations, they are more specific and can be more effective in preventing those trustees' deliberate misconduct. However, as argued in relation to section 5.2 above, it is important to appreciate the legal rules that permit a delegation of power do not also entail a delegation of responsibility.<sup>620</sup> Although all of the written rules referred to above are concerned with the clear delegation of tasks and power, they fail to define trustee responsibility according to individual powers or tasks. Indeed, according to research published by NCVO: '...while the court may in certain circumstances conclude that a delegate should be liable for any failure to exercise a delegated power properly in much the same way as the charity trustees by whom the power is delegated to him or her, the charity trustees will, as a general rule, remain personally responsible for the acts and defaults of the delegate'.<sup>621</sup>

#### **5.3.2.4 Meetings and proceedings of charity trustees**

In the CIO Model Constitution, the use of meetings is highly recommended.<sup>622</sup> Meanwhile, the use of electronic communications is included in the provision which discusses how to improve the meeting procedure.<sup>623</sup>

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<sup>617</sup> Furthermore, the constitution emphasizes that the power of delegation could be made subject to a requirement that 'at least one member of each committee must be a charity trustee' in CIOs; see A CIO Model Constitution, s18 (1) (2)

<sup>618</sup> A CIO Model Constitution, art 18 (1) (2)

<sup>619</sup> Morgan, (n565), 94

<sup>620</sup> The delegation of power does not involve the delegation of responsibility.

<sup>621</sup> A Moynihan, *The Good Trustee Guide* (NCVO 2015) 154

<sup>622</sup> A CIO Model Constitution, art 19

<sup>623</sup> A CIO Model Constitution, art 22

## 5.4 Conclusion

In this chapter, we have examined the rules governing the two principal corporate legal vehicles available for non-profits in the UK, namely the CLG and CIO. Whilst this examination has been interesting in its own right, we have also used it to explore how far the regulation applicable to these two legal forms corresponds with, or departs from, the blueprint developed in Chapter 4.

What have we learnt? We have seen that there is indeed a general correspondence between my blueprint, and UK regulation. However, this is more true in the sense that the UK rules permit the board design my blueprint has advocated. The UK rules rarely prevent companies from adopting that board design. However, less often do they actually compel companies to follow precisely the model I have described. In other words, the UK law is largely ‘permissive’ or ‘facilitative’: it allows, but does not mandate. But even this permissive approach is backed up by ‘soft law’ provisions – in the Good Governance Code for all non-profits, or in the publications of the Charity Commission for charitable non-profits – that recommend many of the board features my blueprint also favours.

The UK regime puts a heavy emphasis and value on retaining flexibility for non-profits. It acknowledges that there cannot be a ‘one size fits all’ approach, and that to legislate prescriptive rules on board size, directors’ characteristics, board structure, and so on, would restrict unnecessarily some non-profits. Again, my own blueprint has also emphasised the importance of retaining flexibility. However, the precise mix of hard and soft law must likely vary from country to country. What works well in one country may be less effective in another. It will depend, for example, on features of the legal system that determine how intrusive legal rules governing board size, character, structure and process become. It will depend on how widely mere ‘soft law’ is respected by those whom it addresses. Having reminded ourselves again that good board design will always be country specific, that leads neatly into our next chapter, which now turns our attention to China.



## Chapter 6 | The nature of non-profits in China

### 6.1 Introduction

The existence of a vibrant and reliable non-profit sector may be viewed ‘not as a luxury, but as a necessity, for [many] people throughout the world’.<sup>624</sup> The argument advanced in Chapter 2 suggested that non-profits may often successfully act as an intermediary, weaving the social, cultural, environmental and economic fabric of communities in most industrialized countries where state provision may not.<sup>625</sup> Similarly, China has witnessed a proliferation in the number of non-profits that have come into operation over the past two decades,<sup>626</sup> which has helped generate revenue for the Chinese Government, increase the number of jobs in this sector and deliver a wide variety of useful services.<sup>627</sup>

Indeed, the growing number of non-profits in China may be attributed to the increasing attention paid to social issues in various respects.<sup>628</sup> These social needs have become increasingly more prominent over recent years, since social and culture developments have often lagged behind the much faster economic development that has been witnessed in China.<sup>629</sup> Finally, there may be said to be several social issues that have arisen that are unique to the Chinese context, and which shall thereby form the focus of

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<sup>624</sup> L M Salamon and H K Anheier, 'Social Origins of Civil Society: Explaining the Nonprofit Sector Cross-Nationally' (1998) 9 *Voluntas* 213, 225

<sup>625</sup> NCVO, 'How big is the voluntary sector compared to the rest of the economy?' (UK Civil Society Almanac 2012) <[http://data.ncvo.org.uk/a/almanac12/how-big-is-the-voluntary-sector-compared-to-the-rest-of-the-economy/#Voluntary sector contribution to the economy](http://data.ncvo.org.uk/a/almanac12/how-big-is-the-voluntary-sector-compared-to-the-rest-of-the-economy/#Voluntary%20sector%20contribution%20to%20the%20economy)> accessed 19 March 2016

<sup>626</sup> Research indicated that the number of legitimately registered domestic non-profit organisations in China is over 520,000 in 2014, and there were 19,000 non-profits getting registered in 2013 alone. Anh Ton, 'Chinese NGOs Grow to Over 500,000 Thanks to New Reforms, But Strict Regulations Still Hamper Social Sector's Growth' (Asian Philanthropy Forum, 2 April 2014) <<http://www.asianphilanthropyforum.org/chinese-ngos-grow-500000-thanks-new-reforms-strict-regulations-still-hamper-social-sectors-growth/>> accessed 25 March 2016

<sup>627</sup> C Guo and others, 'Civil Society, Chinese Style: The Rise of the Nonprofit Sector in Post-Mao China' (2012) 19 *The Nonprofit Quarterly* 20 <<http://non-profitquarterly.org/2012/10/25/civil-society-chinese-style-the-rise-of-the-non-profit-sector-in-post-mao-chinaby/>> accessed 19 November 2015

<sup>628</sup> Owing to China's opening up and rapid economic transition, unique political structure, immense population, and the widespread minority ethnic groups, there has been a significant growth in the number of social issues. These issues could range from matters affecting gender inequality to child abuse and abandonment, to those relating to elderly nursing care and food safety; environmental damage and political injustice; see P Zabielskis, 'Environmental Problems in China: Issues and Prospects' in Zhidong Hao and S Chen (eds), *Social Issues in China* (Springer 2014) 42

<sup>629</sup> *ibid*

discussion in the following chapters.<sup>630</sup>

By contrast to the urgent social needs discussed, the development of the Chinese non-profit sector has only now begun to show signs of growth. Certainly research would suggest the potential social value of the Chinese non-profits sector has yet to be fully recognized.<sup>631</sup> Indeed non-profits in this context often have to confront various difficulties, which include establishing a place within the sector's overall identity, 'building its capacity', and 'earning the public trust', to name just a few.<sup>632</sup> Therefore, before investigating the non-profit governance in the Chinese context (Chapters 7-9), Chapter 6 deals with the nature/social functions of non-profits in China. The particular focus of our discussion will be to distinguish whether, and if so how, the nature and functions of non-profits in China differ from the account of Western non-profits developed in Chapter 2. Doing this is a precondition to tailoring our blueprint for non-profit governance to the peculiarities of China. As Chapter 2 demonstrated, without a comprehensive understanding of the nature of non-profits in the particular country in which they operate, we are unlikely to be able to formulate the most appropriate governance blueprint.

We have seen that the UK and USA benefit from an abundance of academic literature addressing non-profit governance. By contrast, the position remains very different for China, where even the term 'non-profit governance' is poorly defined, and was only effectively distinguished from the term 'government' in 2003 through the work of Yu.<sup>633</sup> Moreover, the non-profit governance literature in China is frequently dominated by a focus on the traditional patron-client model, 'involving respect and obedience' to the authority of their governance community.<sup>634</sup> The appropriateness and effectiveness

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<sup>630</sup> It includes regional elitism, discrimination against women, large protests against local government/businesses due to unfair treatment, etc. See P Wang, 'The Increasing Threat of Chinese Organised Crime: National, Regional and International Perspectives' (2013) 158 *The RUSI Journal* 6

<sup>631</sup> Han, (n37) 36

<sup>632</sup> L Feng, C P Advisors and Y Zhang, 2014 Observation Report on China's Third Sector (Huamin Research Center, 2014)

<<https://pdfs.semanticscholar.org/6893/05fdec33843102b78383ce809633e26eca6.pdf>> accessed 13 March 2016

<sup>633</sup> Yu firstly proposed and used the term in the mid-1990s. During that period of time, the term 'governance' was considered to be 'sensitive' to most people in China as it may be linked with democracy. Dr Yu distinguishes 'governance' from 'government' on two aspects—'public participation and control, and the location of decision-making'; see Hasan and Onyx, (n56) 6

<sup>634</sup> *ibid* 7

of this model has been doubted, however.<sup>635</sup> It fails to embrace the many fundamental functions of a governing board, which are identifiable within Western non-profits organisations, and may, as we have seen already, entail monitoring an agent's performance, providing strategic direction and encouraging a growth in public trust and credibility.<sup>636</sup> Indeed, to the majority of non-profits in China, the presence of a board is merely to satisfy the legal requirement of registration.<sup>637</sup>

In light of the discussion so far, Chapters 7-9 will address the functions of a non-profit in Chinese society, as well as the interplay between board governance and social determinants in the Chinese context, especially politically (i.e. Chinese Government), where through analysis of different legal regulations, we may then acquire a deeper understanding of non-profit board governance in China.<sup>638</sup> For the remaining chapters, Chapter 7 attempts to identify social determinants that may affect the operation of non-profit governance in China. Given the unique contextual elements, we shall then properly modify the blueprint we have developed in Chapter 4 to fit the Chinese context. Within this chapter, we shall then tailor the board's four attributes (size, characteristics, structure, and process) to fit with the factors (social determinants) affecting the Chinese context.

Chapter 8 builds on this to look at regulations in the three legal forms of non-profits in China (Foundations, Social Organisations and CNIs). During this process, the advantages and deficiencies apparent within these legal rules shall be investigated in light of our modified blueprint. Chapter 9 then supplements the discussion by addressing the recent enactment of the Chinese Charity Law 2016 (Charity Law 2016 hereafter) in March 2016. Within this chapter, we shall identify the differences between the Charity Law 2016 and the previous three sets of non-profit regulations in China. That will allow us to critically analyse the value of these reforms, predicting how this Act will likely be implemented and the impact this will have upon non-profits in China.

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<sup>635</sup> *ibid*

<sup>636</sup> Hasmath and Hsu, (n34) 82

<sup>637</sup> Hasan and Onyx, (n56) 84

<sup>638</sup> *ibid* 7

## 6.2 An overview of non-profit organisations in China

The existence of the non-profit sector in China is largely thought to have been triggered by a number of social gaps in the provision of state or private services.<sup>639</sup> As we saw in Chapter 2, viewed from the *'demand'* perspective, commercial markets may lack appropriate incentives to deal with activities in fields where they cannot predict a profitable return. Yet, even in the face of overwhelming social needs which commercial markets fail to fulfil, governments remain more likely to satisfy only the 'average' citizens' demand and the most pressing social needs through public services and goods. Often government-run agencies can prove to be bureaucratic, and incur high operating costs. Considering this from *the supplier's perspective*, then similar to its Western counterparts, non-profit organisations in China not only exist to fulfil a function that has been cast aside by government or the commercial market, but also to cater for a range of social benefits, such as individual self-fulfilment through participation in the non-profit.

Although the social value of non-profits in the industrialized world has already been discussed in Chapter 2, there remains a clear distinction to be made between the organisational nature of non-profits in China and of Western countries. The nature of non-profits in the Chinese context has not been well identified by the academic world and requires much further investigation.<sup>640</sup> Indeed, the less than satisfying performance of Chinese non-profits raises questions over the nature of non-profits in Chinese society. Does the non-profit sector merely grow to play the same function in China as their Western counterparts? Can non-profits in China effectively fill the gaps left by the failings of the commercial and governmental sectors? Table 6.1 summarises the discussion of these questions which this chapter will develop:

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<sup>639</sup> D Smith, 'Guanxi, Mianzi, and Business: The Impact of Culture on Corporate Governance in China' (2012) Private Sector Opinion 1

<sup>640</sup> *ibid*

**Table 6.1 Summary of Chapter 6**

<b>Nature of NPOs</b>	<b>Influencing Factors</b>	<b>Non-profits in the Chinese context</b>
Market Failure	Information Asymmetry	1, Information asymmetry is getting worse in the Chinese context 2, Non-profit sector is also facing trust crisis
Government Failure	Social pressure	1, Mounting social requirements 2, Limited resource
	Economic pressure	1. Slowing economic increase 2. China's 2020 plan
	Government Choose between GONGOs and Bottom-up NPOs	1, GONGOs: cannot effectively relief the government pressure; subordinate and listen to the government orders 2, Bottom-up NPOs: Independent from government support; behave more active and potentially anti-government; work more effectively and less bureaucracy
Individual Participation	Private entrepreneurs	1, Rural entrepreneurs 2, '90s generation
	Student volunteer	Actively involve in non-profit activities

### 6.2.1 Definition of non-profits

We begin by considering the definition and classification of non-profits in China. In contrast with the well-defined nature of non-profits in Western countries that we have discussed in Chapter 2, there remains no agreed definition of non-profit organisations in China.<sup>641</sup> However, regulations issued by the Ministry of Civil Affairs (MoCA), identify the three necessary and defining characteristics of a non-profit organisations (NPO) in China as follows:

<sup>641</sup> The NPOs generally refer to non-governmental, not-for-profit social organisations, NGOs, and civil organisations; see Huang and others, (n41) 64

‘NPOs are not for profit purposes; resource providers making investments in NPOs are not allowed to receive an economic return; resource providers do not enjoy ownership of NPOs’.<sup>642</sup>

Applying this description then, the non-distribution constraint would appear to be one of the defining features of a non-profit organisation in China. Indeed, academic literature on the Chinese context illustrates that the essence of a non-profit is ‘non-profit distribution rather than the prohibition of non-profits from making money’.<sup>643</sup> However, it was only in 2016 that Chinese law (the Charity Law 2016) finally addressed what particular activities non-profits could engage in.<sup>644</sup>

### 6.2.2 Classification of non-profits

Much like non-profits in the UK, Chinese non-profits come in many shapes and sizes, and therefore fall into several categories. For example, non-profits in China may be registered as social organisations, foundations, educational institutions or corporations. However, many of these, perhaps most, operate as unregistered bodies or associations.<sup>645</sup> To better inform this work’s understanding of such bodies, the different characters of non-profits are typically grouped according to the following classification, per the categories outlined on Table 6.2

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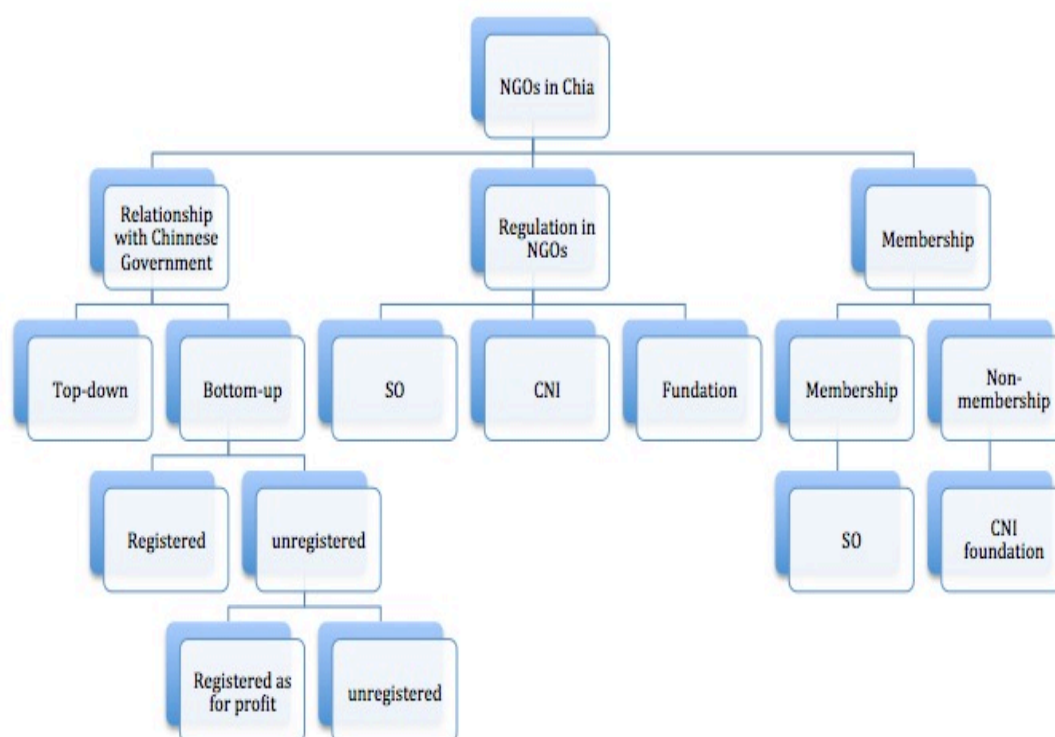
<sup>642</sup> NPO Accounting System, art 2 (2)

<sup>643</sup> Non-profit Organisation Bureau of the Ministry of Civil Affairs [民政部民间组织管理局]/Bureau for Politics and Law of the Legislative Affairs Office of the State Council [国务院法制办法政司] (eds.).

<sup>644</sup> ‘Charitable activities refers to the following public interest activities voluntarily carried out by natural persons, legal persons and other organisations through the donation of property’; see The Charity Law 2016, s3 (1)

<sup>645</sup> In the Chinese context, the terms ‘*non-profits*’ and ‘*NGOs*’ could be used interchangeably. E Beijing, ‘Chinese NGO’s--Carving a Niche within Constraints’ January 2003) < <http://beijing.usembassy-china.org.cn/report0103ngo.html>> accessed 15 April 2015

**Table 6.2 Non-profit classification in China**



### 6.2.2.1 Bottom up and top down non-profits

Drawing upon the two categories positioned at the third level of the table, according to the relationship between the Government and non-profits (different state-society orientations) in China, non-profits may be classified into two major types—*top-down non-profits* and *bottom up non-profits*.<sup>646</sup> Of the former category, top-down non-profits are officially registered under MoCA and are typically associated with the reform of the Chinese Government.<sup>647</sup> Quite often, they are the product of government reform itself, and are therefore often called Government Organized non-profits (commonly abbreviated to *GONGOs* in China). Bottom-up non-profits (which may also be defined as autonomous non-profits) are more people-centric, and often do not have a close association or connection with the Government.<sup>648</sup>

<sup>646</sup> L S Kaur, 'Third Sector: The Law in China and Non-Profit Organization, The' (2006) 4 International Journal of Civil Society Law 47

<sup>647</sup> *ibid*

<sup>648</sup> *ibid*

### 6.2.2.1.1 Autonomous non-profits (bottom up non-profits)

According to their legal status, bottom-up non-profits can be further sub-divided into *registered and unregistered (or 'grassroots')* non-profits. Organisations registered as bottom-up non-profits are entitled, by law, to operate under the supervision of the Chinese Government.<sup>649</sup> Although their relationship with the Government is less close than in the case of GONGOs, permission for registration by the local Government agency/department has largely been seen as a form of Governmental acceptance, and one which renders them a legitimate type of organisation, compared to 'Grassroots' non-profits.<sup>650</sup> 'Grassroots' non-profits, by contrast, often fail to register under the MoCA, and thereby fail to gain approval as legitimate or official non-profit, in keeping with Chinese law.<sup>651</sup> Some exist as unregistered organisations, whilst others operate under the guise of a registered, but profit-based, organisation.<sup>652</sup>

Those organisations that operate as unregistered grassroots bodies often attempt to keep out of the sight of, and control by, the Chinese Government.<sup>653</sup> In doing so, they have often attempted to avoid any connection with the Government, aware that their existence was illegal before the enactment of the Charity Law 2016.<sup>654</sup> Since such organisations cannot typically obtain official registration, they may encounter difficulties avoided by legally recognized bodies, since the latter enjoy a legal identity to undertake business activities, open bank accounts and holding public events in the organisation's own name. Unregistered grassroots organisations mostly exist on the periphery of Chinese society, and so in a form where the Government fails to, or opts not to, deliver public goods/services.<sup>655</sup>

Interestingly, the Government generally holds a suspicious and unsupportive attitude towards the activities of such organisations, which in turn contributes to a harsher environment for them and their operations.<sup>656</sup> Since the Chinese Government still

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<sup>649</sup> Hasmath and Hsu, (n34) 78

<sup>650</sup> Huang and others,(n41) 57

<sup>651</sup> *ibid*

<sup>652</sup> C Jie, 'The NGO Community in China. Expanding Linkages with Transnational Civil Society and Their Democratic Implications' (2006) *China Perspectives* 29

<sup>653</sup> Huang and others, (n41)

<sup>654</sup> *ibid*

<sup>655</sup> Jie, (n652) 35

<sup>656</sup> Jing, (n51)



remains a dominant force affecting the majority of society in China, the lack of support by the Chinese Government restricts the size, performance and the public credibility of grassroots non-profits.<sup>657</sup> Naturally, the otherwise ‘illegal’ status of grassroots non-profits in China is such that this often causes an added difficulty, as recording and obtaining empirical evidence is hard to achieve. For these reasons, we shall concentrate primarily on board governance in *GONGOs* and in *registered* bottom-up non-profits. However, having restricted our focus in that way, one interesting development that we might note here, which is found in the Charity Law 2016, is a degree of loosening of control by the Chinese Government over the Chinese non-profit sector generally, and traditional unrecognized grassroots non-profits in particular. Such non-profits have, for the first time, and since March 2016, become entitled to recognition and legal status to facilitate their activities. It is still too early to predict what impact this formal change will have, but we shall consider this latest development separately, in Chapter 9, when we turn to investigate the likely impact of the reforms contained in the Charity Law 2016.

#### **6.2.2.1.2 Government Organized NGOs (GONGOs) (Top down non-profits)**

By contrast to bottom up bodies, the Chinese Government empowers those top-down non-profit organisations (GONGOs) to deliver services to local communities in society, who thereby carry out a number of partly government-based functions and service provision.<sup>658</sup> Although they may claim to be independent from the Government, and therefore control their own administration, financial, employment, fund-raising and decision-making systems, many in fact do rely upon financial support and a range of other resources from the Government.<sup>659</sup> In ‘exchange’ for such resourcing, GONGOs must usually compromise part of their independence/self-governing autonomy and therefore undertake a number of government appointed tasks.<sup>660</sup> However, there has

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<sup>657</sup> For this reason, such NGOs could face challenges in resource collection and legal protections which I will evaluate further in Chapter 7. Y Li, 'The Role and Development of Grassroots NGOs in Eastern China' 2012) <<https://www.ntnu.no/documents/10443/21424885/Yuejin+Li.pdf/44323d8d-ae07-4d7d-8add-17e33f4e175a>> accessed 18 April 2016

<sup>658</sup> Jing, (n51) 562

<sup>659</sup> G Deng, 'The Influence of Elite Philanthropy on NGO Development in China' (2015) 39 Asian Studies Review 554, 560

<sup>660</sup> Jing, (n51) 591

been much controversy surrounding the issue of GONGO independence, which shall be explored in more detail, as relevant to this discussion in Chapters 7, 8 and 9.

### **6.2.2.2 Foundations, SOs and CNIs (by legal regulations)**

One of the ways one might classify non-profits in China is according to the *legal form* such organisations adopt. According to the ‘Accounting System of Non-profit Organisations’ (NPO Accounting System) of the Ministry of Finance in 2004,<sup>661</sup> officially registered non-profits can exist in one of three legal forms. These are social organisations (SO), civil non-business institutions (CNI), and foundations.<sup>662</sup>

These three forms bear a range of different legal features, and are therefore often bound by a number of different legal regulations.<sup>663</sup> This threefold classification according to legal form shall be employed frequently in Chapters 8-9 when we try to analyse the Chinese non-profit legal regime. Although this division of different types of non-profits is largely made on the basis of *legal form*, as discussed above, it would seem that such a classification of legal forms is also what is most commonly used within the academic analysis and by legal practitioners of non-profits in China.<sup>664</sup>

### **6.2.2.3 Membership and non-membership non-profits**

Non-profits in China can also identify themselves as either membership-based, or non-membership-based, organisations. Membership-based non-profits are considered to be ‘associations of individuals’, which include academic institutions and trade unions.<sup>665</sup>

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<sup>661</sup> 民间非营利组织会计制度 [Accounting System of Non-profit Organisations], promulgated by the Ministry of Finance on August 18, 2004, effective since January 1, 2005

<sup>662</sup> Social organisations (shehui tuanti), civil non-business institutions (minban feiqiye *danwei*), and foundations (jijinhui); see NPO Accounting System, art 2 (1)

<sup>663</sup> Except the newly enacted Charity Law 2016 that is regulating all non-profits in a general way, each of the remaining three sets of non-profit regulations is targeting on these three types of non-profits respectively.

<sup>664</sup> Through a search of the CNKI database, it is possible to identify that the term ‘non-profit organisation’ (NPO) is much less used both in the academic and practice context across in China. “A search through the database ‘China Academic Journals’ (www.cnki.net) during the years 1999 to 2010 for articles with the term “non-profit organisations” in their title provides more than 200 hits, but reveals only two articles published in journals which have a focus on law. In none of the articles is a definition of the term given.” T Von Hippel and K B Pissler, 'Nonprofit Organizations in the People's Republic of China' (2010) *Comparative Corporate Governance of Non-Profit Organizations* 428, 431

<sup>665</sup> *ibid*

Non-membership non-profits do not elect members; they could include schools, hospitals, and social welfare agencies.<sup>666</sup> According to empirical research, the Chinese Government seems to monitor and control more closely membership-based, rather than non-membership-based, non-profits.<sup>667</sup> We shall explore this issue further in Chapter 8.

### 6.3 Commercial market failure in China

To understand better the nature/social function of non-profits in China, we shall firstly investigate the relationship between non-profits and the commercial market in China. As the discussion in Chapter 2 has already detailed, one essential reason for the existence of non-profits is to fill gaps in the provision of goods and services left by commercial market failure. To recap, ‘*information asymmetry*’ is one of the most important factors that lead to the occurrence of this failure.<sup>668</sup> When compared with the commercial market, non-profits, because of the non-distribution constraint, are generally more able to *establish trustworthiness* and contract with their consumers, and then ensure their consumers’ interests can be well protected by this type of ‘trust-based contract’.

To understand what relevance this theory might have in explaining *Chinese* non-profits, we need to examine the prevalence of these two conditions (information asymmetry and trustworthiness) in the Chinese context. We might begin by noting that building trust with consumers in China has always been a challenge, and this is true both in the commercial setting and the non-profit sector.<sup>669</sup> However, it is at least arguable that the issue of information asymmetry is getting progressively worse, and especially in the commercial sector. In the Chinese commercial market, the vast majority of consumers harbour doubts over product quality, and distrust service suppliers owing to a series of commercial scandals and the inefficient implementation of any monitoring mechanism.<sup>670</sup> Enormous food-related scandals, involving a wide range of domestic manufacturers, have brought the reputation of the food industry to the lowest point in

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<sup>666</sup> Huang and others, (n41) 91

<sup>667</sup> Jing, (n51)

<sup>668</sup> E James and S Rose Ackerman, *The Non-Profit Enterprise in Market Economics* (Taylor & Francis 2013)

<sup>669</sup> Zabielskis, (n628) 38

<sup>670</sup> *ibid*

recent decades.<sup>671</sup> Apart from the issue of food safety, incidents exist in almost every corner of the commercial market, which has severely damaged market credibility.<sup>672</sup>

By contrast, with an ensuing crisis in trust apparent within the Chinese commercial context, the non-profit sector is indeed more likely to gain trust from its consumers. One such example of this may be healthcare and nursing homes, where in recent years the Chinese non-profit market has seen a soaring demand for elderly care services, matched by an ever more limited bed supply.<sup>673</sup> Of those nursing homes who claim to *be bound by a non-distributional constraint*, these have tended to enjoy significantly higher occupancy rates, presumably reflecting a more popular demand for such services, especially when compared to those in the commercial context.<sup>674</sup>

Indeed, empirical research indicates that this is mainly caused by lack of trust in the commercial market.<sup>675</sup> Even without investigating this possibility themselves, Chinese consumers assume a public run nursing home is likely to have more reliable employees and a greater integration with local communities than might be true of a commercial run service.<sup>676</sup> Interestingly, however, research has indicated many commercial nursing homes have a similar standard of living conditions (many even have better standards) as those which are run as non-profit organisations.<sup>677</sup>

This is not to say that Chinese non-profits have entirely escaped this crisis of mistrust. Scandals in a number of GONGOs, such as Guo Meimei in Red Cross,<sup>678</sup> the China-Africa Project Hope,<sup>679</sup> and the Henan Soong Ching Ling Foundation,<sup>680</sup> have harmed

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<sup>671</sup> *ibid*

<sup>672</sup> It covers from food safety to fake cosmetics, from online transaction and telephone fraud to children abuse in day care centre.

<sup>673</sup> A J Spires, L Tao and K M Chan, 'Societal Support for China's Grass-Roots NGOs: Evidence from Yunnan, Guangdong and Beijing' (2014) *China Journal* 65, 71

<sup>674</sup> Many elderly people would rather join the long waiting list to be offered a place in non-profit homes than turn to a commercial nursing home, which may have home ample availability; see C Liu, Z Feng and V Mor, 'Case - Mix and Quality Indicators in Chinese Elder Care Homes: Are There Differences between Government - Owned and Private - Sector Facilities?' (2014) 62 *Journal of the American Geriatrics Society* 371, 375

<sup>675</sup> Spires, Tao and Chan, (n673)

<sup>676</sup> Liu, Feng and Mor, (n674) 373

<sup>677</sup> Han, (n37)

<sup>678</sup> E Wong, 'An Online Scandal Underscores Chinese Distrust of State Charities' (*The New York Times*, 3 July 2011) <<http://www.nytimes.com/2011/07/04/world/asia/04china.html>> accessed 19 May 2016

<sup>679</sup> Huang and others, (n41) 91

<sup>680</sup> *ibid* 107

the reputation of non-profits' nationwide.<sup>681</sup> Other similar cases have indicated corruption on the part of GONGOs and quasi-governmental organisations, adding to the lowering of public trust towards such bodies and this sector as a whole.<sup>682</sup> As a result, there has been a sharp decline in both public donations and volunteers. Nevertheless, and as we noted in Chapter 2, the 'trust' argument does not depend on non-profits being entirely free of scandal, and enjoying complete public trust. It depends only on non-profits being comparatively more trustworthy than (or less untrustworthy than) for-profits. And, in China, the scale of mistrust in the commercial sector means that, comparatively, the non-profit sector is still more likely to gain consumer's trust.

#### **6.4 Government failure in China**

What relevance does the 'Government Failure' theory have in China? Recall that this theory suggests that non-profits will arise in order to address the failure or inability of the Government itself to provide those goods and services which the commercial market fails to deliver. In Chapter 2, we explored the main reason for Government failure which this theory has emphasised, namely that Government tends to supply only the type and quantity of goods and services demanded by the 'median voter'.<sup>683</sup> However, I also then sought to develop this theory, by pointing to a number of other difficulties that face the Government: its 'size', complexity and remoteness from the people consuming its goods and services; its tendency to suffer from bureaucracy; its difficulty in incentivising its employees.<sup>684</sup> Turning now to China, I shall argue here that these factors, and thus the problem of government failure, could be even worse in China than in Western countries. This is primarily because China is experiencing a *substantial increase in social need and extremely limited supply of government resources*.

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<sup>681</sup> *ibid* 167

<sup>682</sup> H Hong and J FlorCruz, 'Red Cross China in Credibility Crisis' (*CNN*, 7 July 2011) <<http://edition.cnn.com/2011/WORLD/asiapcf/07/06/china.redcross/>> accessed 23 March 2015

<sup>683</sup> As Chapter 2 explained, the extent of the 'shortfall' in Government provision will depend upon the heterogeneity of demands, which refers to different levels of demand triggered from variations in population characteristics (age, education, diversity of religion, or race, for example) and inequality of income.

<sup>684</sup> See section 2.4.2.

#### 6.4.1 Increasing social problems

China has a population of over 1.38 billion, across 31 regions, with a vast number of minority ethnic groups, and embracing a mix of religions. Its population is highly heterogeneous, and in consequence it is common to see different groups of people presenting very different, often competing, demands on the Government.<sup>685</sup> To this end, the Chinese Government has more recently had to confront social pressures to act on a range of matters, such as unemployment, an aging population, insufficient health insurance for many, along with matters pertaining to migration and environmental deterioration.<sup>686</sup> To take just one example, income inequality often counts among China's most urgent social ills.<sup>687</sup> The uniqueness of Chinese history, culture and the *model of fast economic transition* since the 1980s<sup>688</sup> also bring to bear a number of other social issues, which shall be further explored in Chapter 7.

However, as briefly mentioned above, the Chinese Government struggles to satisfy the enormous social demands placed upon it in the face of its relatively limited access to resources. The Government typically therefore opts to address only the most pressing, urgent or citizen-desired public issues.<sup>689</sup> With its recently proposed slogan of 'small government, big society', the Chinese Government has sought to make clear that it can no longer be the sole provider of public services or goods, supporting every person in need, and the most prominent and productive reaction to this and to alleviate such a burden is the creation of suitable non-profits.<sup>690</sup>

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<sup>685</sup> Hasmath and Hsu, (n34)

<sup>686</sup> Y Yang and others, 'The Abolition of Dual Administration of NGOs in China: Imperatives and Challenges' (2015) 5 *International Journal of Social Science and Humanity* 546, 548

<sup>687</sup> According to a 2012 survey by Peking University, 'families in Chinese cities and coastal provinces earn significantly more than their rural and inland counterparts. An average Shanghai household, for example, brings in £2,790 a year, while an average family in the inland province Gansu makes less than £1,200'; see J Kaiman, 'Bill Gates Urges China's Wealthiest to Give to Charity' (*The Guardian*, 28 April 2014) <<https://www.theguardian.com/world/2014/apr/28/bill-gates-china-peoples-daily-wealthy-charity>> accessed 28 March 2016

<sup>688</sup> It being distinct from the steady economic increase of Western countries, the *model of fast economic transition* in China has already led to mounting social challenges which will require action by the Chinese Government; see Jie, (n652) 31

<sup>689</sup> Huang and others, (n41) 25

<sup>690</sup> *ibid*

On the other hand, Chinese non-profits often take advantage of this social development. Changes in the overall labour market,<sup>691</sup> individual attainment of higher levels of social income,<sup>692</sup> together with an increasing adoption of a variety of ‘Western ideas of civil society’ have provided more space, opportunity and vitalities, which makes the non-profit sector in China indispensable forces, fulfilling functions left by the void and withdrawal of the Government.<sup>693</sup> A growing number of activists have thus established non-profit organisations, networking and expanding this sector.<sup>694</sup>

#### 6.4.2 Economic pressure on the Chinese Government

In addition to the analysis of *increasing social needs* in China, this section explores the second cause of Government failure—the *limited government expenditure*. The Chinese non-profit sector is increasing in importance as the high powered Chinese economy has begun to lose momentum and required assistance with development.<sup>695</sup> China’s economic growth in 2015 is the slowest for 25 years.<sup>696</sup> With ‘growing debt’ and ‘a housing and factory capacity’ stretched to its limits, economists predict that ‘Chinese officials project tougher years ahead’ for the Chinese economy.<sup>697</sup> Indeed, economists have suggested that ‘the tools the government has traditionally used to revive growth, infrastructure spending, easy credit and ramped-up exports appear increasingly ineffective, which raises the question of how could the government make a more sustainable economic policy?’<sup>698</sup>

In response, the Chinese Government has recently approved its next five-year plan, with the ultimate objective of significantly reducing poverty by 2020.<sup>699</sup> In doing so,

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<sup>691</sup> The economic reform in China is slowly making personnel available to non-profits independent of the government assignment system.

<sup>692</sup> With the development of the Chinese economy, people’s income improves their ability and willingness to support non-profits.

<sup>693</sup> Such as ‘citizen participation, volunteerism, a sense of social responsibility, pursuit of personal interests, and growing self confidence in controlling one’s life etc’; see Yang and others, (n686) 548

<sup>694</sup> Jie, (n652) 29

<sup>695</sup> Huang and others, (n41)

<sup>696</sup> M Magnier, 'China's Economic Growth in 2015 Is Slowest in 25 Years' (*The Wall Street Journal*, 2016) <<http://www.wsj.com/articles/china-economic-growth-slows-to-6-9-on-year-in-2015-1453169398>> accessed 19 March 2016

<sup>697</sup> *ibid*

<sup>698</sup> *ibid*

<sup>699</sup> J Kang and others, 'Review on Wind Power Development and Relevant Policies in China During the 11th Five-Year-Plan Period' (2012) 16 *Renewable and Sustainable Energy Reviews* 1907

officials have declared the essential role non-profits will play in achieving this goal. According to the official Chinese news agency, Xinhua, the primary objective of the Charity Law 2016 was not only to formalize law in this area, but also to ‘recruit help from good Samaritans in reaching the 2020 poverty alleviation target’.<sup>700</sup> Li Jianguo, a senior official in the National People’s Congress (NPC) supplemented this by declaring that all non-governmental sources, in particular charity programmes, are ‘an indispensable part of achieving poverty alleviation’.<sup>701</sup>

However, the truth behind the reality here may undermine this expectation, as the development of non-profits and the Chinese economy are significantly unbalanced. A study by the Charities Aid Foundation in 2015 indicated that the Chinese economy has grown to now be the world's second largest, while charitable giving has lagged far behind, with the country ranking 144th out of 145 countries for giving.<sup>702</sup> According to the research conducted by the China Charity Information Centre, people in China only donated an equivalent of just \$16 billion in 2014, which is even ‘less than 0.2 per cent of annual GDP’.<sup>703</sup>

#### **6.4.3 The Government’s need to choose between GONGOs and Grassroots**

The role of the Chinese non-profit sector in making up for limitations in Government supply seems very clear then. As noted in 6.2.2, there are two types of non-profits (GONGOs and Grassroots non-profits) which might fill this gap in Governmental provision, and the Government must determine which is the more appropriate one, a difficult decision to make. Accordingly, this section compares the advantages and pitfalls of GONGOs and Grassroots non-profits to the Chinese Government.

Over the past two decades, the strategy employed by the Chinese Government has been to tolerate the existence of many non-registered grassroots non-profits, allowing them

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<sup>700</sup> Nancy, 'Seven Recent Changes to the Draft Charity Law Fund Management Fee Set at 10' (*News Nub of Golden Bric*, 15 March 2015) <<http://www.hubgold.com/2016/03/15/seven-recent-changes-to-the-draft-charity-law-fund-management-fee-set-at-10/>> accessed 25 April 2016

<sup>701</sup> A France-Presse, 'China Aims to Increase Giving with First Charity Law' (*Global Post*, 9 March 2016) <<http://www.globalpost.com/article/6743856/2016/03/09/china-aims-increase-giving-first-charity-law>> accessed 25 April 2016

<sup>702</sup> *ibid*

<sup>703</sup> *ibid*



to ‘operate on a tight leash’, and thereby ensuring they remain ‘small and local’.<sup>704</sup> However, the economic transition and slow pace of social development in China has led the Government to accept that there remain too many social areas in which it has been ‘tentative and restrictive’.<sup>705</sup> From the Chinese Government’s perspective, both GONGOs and grassroots non-profits present a range of clear advantages and disadvantages. GONGOs are easy to control and monitor, which often make them more attractive to the Government. There are two major tasks which seem particularly suitable for GONGOs to fulfil. One is to take the lead on attracting philanthropic funding, particularly from international sources, which can include international non-governmental organisations (INGOs).<sup>706</sup> It is now common to see a great number of Government departments encourage the establishment of GONGOs with the obvious purpose of conducting resource exchanges/overseas study programmes with international organisations ‘in an unofficial capacity’.<sup>707</sup>

The second task for which GONGOs seem especially well suited is in areas where there exist less public concern or support from the Government, such as ‘contraceptive advice for unmarried couples’ or ‘HIV/AIDS prevention programmes for sex workers and drug addicts’.<sup>708</sup> In spite of the lack of public concern surrounding these issues, there remains an onus upon the Government to ensure these are dealt with and monitored effectively. However, interestingly, using non-profits to provide such services, in close collaboration with the Government, brings its own problems and controversy. It can be seen as threatening the social value/objective of non-profits. Non-profits, because they act as ‘agents of advocacy and contribute immensely to policy dialogue’,<sup>709</sup> should typically work independently. Having such close ties to Government sits at odds with these values. According to research carried out by Thomas, the existence and operation of non-profits allow the government to become ‘more of an enabler rather than a service provider’.<sup>710</sup> Additionally, non-profits are supposed to be able to represent the interest group of those who they are working with

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<sup>704</sup> Han, (n37)

<sup>705</sup> Yang and others, (n686) 548

<sup>706</sup> These resources and funding are difficult for the Government to get access to by themselves.

<sup>707</sup> N Steinberg, 'Background Paper on Gongos and Quangos and Wild NGOs', (2001)

<<https://www.globalpolicy.org/component/content/article/177/31600.html>> accessed 12 April 2016

<sup>708</sup> Jie, (n652) 29

<sup>709</sup> *ibid*

<sup>710</sup> J E Tropman and T J Harvey, *Nonprofit Governance: The Why, What, and How of Nonprofit Boardship* (University of Scranton Press 2009)

and ‘in this case ensure that such policies are adapted to aid real life situations’.<sup>711</sup> Finally, such bodies may play as ‘watchdogs’ and ensure, through the use of monitoring and research, that they could hold the Government accountable for their actions, thereby challenging the Government if necessary.<sup>712</sup> There are a variety of approaches to achieve this role/function, which may include lobbying or offering support to particular groups, which may otherwise be adversely affected by Government policies or decisions.<sup>713</sup> However, a difficulty here of course is that GONGOs tend to behave much like government-affiliated institutions. They in turn fail to effectively relieve the Government of any financial burden because GONGOs in most cases need the Government to provide funds to them rather than generate revenue by themselves.<sup>714</sup> Another side effect of this behaviour may be the reduction in public trust towards GONGOs as these non-profits are likely to give the impression to the public that they are following the Government’s order and representing the Government’s interests rather than working as an independent body for the benefit of their own stakeholders.

Turning now to grassroots non-profits, although they may very well provide social services that are independent from the Government, and so alleviate pressure for Government itself to act, to some degree the Chinese Government has not been prepared to loosen restrictions over grassroots organisations, for many of the reasons we shall outline in Chapters 8-9. The most significant of the concerns expressed by Government have been that, once control over grassroots non-profits is lost, particularly those operating in politically sensitive industries, then the political and social stability of China itself will be threatened.<sup>715</sup>

#### **6.4.4 The case of Guo Meimei**

GONGOs, particularly those with high profile charities, have suffered the most serious scandals occurred in the past few years, which shows the deficiencies of GONGOs.

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<sup>711</sup> *ibid*

<sup>712</sup> *ibid*

<sup>713</sup> B Thomas-Slayter, 'Implementing Effective Local Management of Natural Resources: New Roles for NGOs in Africa' (1992) 51 *Human Organization* 136

<sup>714</sup> Hasmath and Hsu, (n34)

<sup>715</sup> Hsu and Hasmath, (n54)

<sup>715-1</sup> E Wong, 'An Online Scandal Underscores Chinese Distrust of State Charities' (*The New York Times*, 3 July 2011) <<http://www.nytimes.com/2011/07/04/world/asia/04china.html>> accessed 19 May 2016

Among those scandals, the case of Guo Meimei in Red Cross has been at the center of public attention.<sup>715-1</sup> A young woman named Guo Meimei, claimed to be in the senior position at the Red Cross of China, which is the largest charitable GONGOs in China. She constantly posted photos in the social media website showing her lavish lifestyle. Her photos immediately sparked widespread doubts and outrage about corruptions occurred in non-profits in China.

Although both Guo and the Red Cross of China have denied having any ties to each other after this scandal, continuous disclosures of inside information and disputes over this incident attracted even more public attention. Guo and the Red Cross have been the most talked-about subjects throughout the society over the last several years. Furthermore, the scandal of Red Cross had a snowball effect. Not only the Red Cross Society of China, but also the whole non-profit sector in China had suffered an unprecedented crisis of trust and their reputation was seriously harmed nationwide. In addition to that, many other GONGOs such as the China-Africa Project Hope, the Henan Soong Ching Ling Foundation and the China Youth Development Foundation were repeatedly accused of corruption and misuse of funds, adding to the lowering of public trust towards this sector as a whole.<sup>716</sup>

As a result of the reducing public trust, there has been a sharp decline in donations to GONGOs in China. When the scandal of Guo Meimei occurred in June 2011, the Red Cross faced the biggest financial challenge in its history. The official statistics by the Chinese Government indicated that the total amount donating to the non-profit sector drop dramatically from 6.26 billion RMB in May 2011 to 0.84 billion RMB in August 2011.<sup>716-1</sup> Zhao, as the vice president of the Red Cross of China admitted to the media that the scandal of Guo meimei had made people suspicious and unwilling to make any donation the the society.<sup>716-2</sup>

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<sup>716</sup> For example, the China-Africa Project Hope, the Henan Soong Ching Ling Foundation and the China Youth Development Foundation have been sued for expending donations in a manner contrary to the intentions of donors and for falsifying financial records. H Hong and J FlorCruz, 'Red Cross China in Credibility Crisis' (*CNN*, 7 July 2011)

<<http://edition.cnn.com/2011/WORLD/asiapcf/07/06/china.redcross/>> accessed 23 March 2015

<sup>716-1</sup> Yang and others, (n686) 546

<sup>716-2</sup> *ibid* 548

<sup>716-3</sup> Jie (n652) 30

<sup>716-4</sup> *ibid* 32

<sup>716-5</sup> Wang (n630) 8

As a response to Guo's scandals, the Red Cross of China attempted to transform its public image and reputation by introducing a variety of strategic approaches. Wang, as the secretary general of the Red Cross of China, held that 'Guo Meimei incident makes us realize the problems and challenges in our project operation and fundraising. We sincerely welcome the public to oversee our work. If loopholes appear, we will spare no effort to probe and find the truth. However, we hope the public can treat the Guo Meimei incident in a more rational way'.<sup>716-3</sup> Unfortunately, in addition to the statement above, the Red Cross Society failed to make any other effort to control the organization's corruption, enhance its transparency of governance/donation procedures, and therefore improve its organization's public reputation. Scholars such as Jie claimed that 'the incident has triggered a collective outburst of long-time frustration about the Red Cross's murky bureaucracy and questionable governance. And faced with this crisis of trust, the Red Cross Society of China failed to give a reasonable explanation. It will lose its credibility completely if it does not learn lessons from the corruption scandals involving the overspending on meals and other spending irregularities'.<sup>716-4</sup>

In terms of the legal punishment, the judgment from Dongcheng court of Beijing clearly stated that Guo was convicted of operating a casino illegally and sentenced to five years in jail and fined 50,000 RMB. Unfortunately, the court failed to show any evidence indicating the central issue that the public concerned most—whether Guo has any relationship with the Red Cross, nor does the procurator explaining the investigating process. Sentencing Guo in the name of running a casino illegally could by no means give a sufficient explanation about the corruption scandals in the Red Cross. As a response to the legal sentence, there were increasing critics in China criticizing that there was little regulation over the misconducts, especially corruptions in the voluntary sector.

Wang, as the director of the most influential non-profit research institution at Tsinghua University, encouraged a better regulated environment for non-profits by stating that 'non-profits need to have a sense of crisis, to reform in an open and transparent environment where the public will question the credibility of these organizations all the time' There should be a law regulating fund-raising process and improving transparency of the governance process in non-profits in China.<sup>716-5</sup>

Despite the obscure legal judgement towards the case of Guo Meimei, fortunately, the new Charity Law 2016 came into effect shortly after those scandals occurred in the non-profit sector in China. The enactment of the Charity Law 2016 is believed to be stimulated by Guo's incident. As we shall demonstrate in Chapter 9, the law has made it clear that China had determined to amend regulations in relation to donations, transparency, and the registration of non-profits. There are basically three fundamental reforms of the non-profit sector in China, which are all rightly addressing issues in relevant to the public concern over GONGO's scandals. For instance, the Charity Law 2016 clearly indicates that those unregistered/grassroots non-profits have, for the first time, become entitled to recognition and legal status to facilitate their activities. As chapter 9 shall indicate, this reform clearly improves the independence of non-profits, and thus getting rid of the Government control. Furthermore, Article 60 of the law imposes a cap on annual management fees, with the purpose of restricting corruptions occurring in non-profits. There is a significant amount of emphasis within the law itself on the importance of transparency and information disclosure, with an entire Chapter of the act (Chapter 8, Article 69-76) devoted to this issue. Certainly, the Charity Law 2016 does much to improve public trust aspect. A great many of its provisions are designed to enhance public trust towards non-profits, and thus encourage donors to contribute their money or efforts. All of these can be regarded as a response to those scandals occurred among GONGOs, and are expected to be a great improvement to non-profits in China. Detailed provisions and impacts shall be further investigated in Chapter 9.

### **6.5 Participatory and expressive role of non-profits**

The third explanation for non-profits which we addressed in Chapter 2 focused on their participatory and expressive role. Recall, this looked at non-profits in terms of the reasons why people choose to *supply* them. It suggested that individuals – social entrepreneurs, volunteers, donors – do so because they satisfy participants' sense of self-fulfilment, and thereby encourage their development of confidence and move towards greater personal achievement. Does this theory have relevance in explaining Chinese non-profits? We shall argue, first, that indeed it does but that, second, participants in Chinese non-profits have distinctive and unique individual

characteristics. Understanding these individual characteristics will help our attempt to develop strategies to facilitate the non-profit governance in the following chapters.

There would appear to be two primary means by which individuals may get involved in the activities of a non-profit. The first, and most common, is to provide financial support through donations. The second is to work with the non-profit as a volunteer. This may involve any ‘altruistic activity where an individual or group provides services for no financial gain’.<sup>717</sup> Interestingly, in China there has been an emerging tendency over recent decades for two different groups to become increasingly involved in the activities of the non-profit, both as donors and as volunteers. These two groups are, first, private entrepreneurs and, second, specifically *young* volunteers. These two groups can significantly affect the performance of non-profits in China. More importantly, they are the stakeholders/suppliers of non-profits whose interests/requirements should be carefully served. As such, our analysis shall build upon the discussion so far by examining these two groups and exploring their significance and social function in relation to Chinese non-profits.

### 6.5.1 Private entrepreneurs

To most Chinese non-profits, private entrepreneurs are among the most important financial supporters, and may sometimes even be the founders of a given organisation. The ever-growing number of private entrepreneurs, and the formation and growth of the middle-class, have made the re-emergence of ‘philanthropy’ all the more possible. Indeed, a vast number of individuals have benefited from the rapid growth in China’s economy, particularly those who have been able to enter the upper and middle classes as a result of this.<sup>718</sup> Statistics from 2015 indicate that over 4.8 million new companies were registered in China in 10 months, ‘equalling to 10,600 new businesses per day or seven every minute’.<sup>719</sup>

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<sup>717</sup> Y Xu and N P Ngai, 'Moral Resources and Political Capital: Theorizing the Relationship between Voluntary Service Organizations and the Development of Civil Society in China' (2011) 40 *Nonprofit and Voluntary Sector Quarterly* 247

<sup>718</sup> This research was taken by the Chinese Academy of Social Sciences (CASS). B News, 'China's Middle Class Growing Fast' (*BBC News*, 30 March 2004) <<http://news.bbc.co.uk/1/hi/business/3582015.stm>> accessed 17 March 2016

<sup>719</sup> L Zhang, 'China's Startup Boom: 7 New Firms Every Minute' (*China.org.cn*, 9 June 2015) <[http://www.china.org.cn/business/2015-06/09/content\\_35775291.htm](http://www.china.org.cn/business/2015-06/09/content_35775291.htm)> accessed 17 March 2016

Building upon the rise in new companies registered in China, the new boom would appear to include a large number of private entrepreneurs. Among them, two groups of entrepreneurs would appear most likely to participate in non-profit activities, with a particular view to seeking self-fulfilment. The first of these are *rural* entrepreneurs. These are in a sense the first generation of entrepreneurs, who may have otherwise started their business by themselves during 1980s-1990s.<sup>720</sup> The second of these may be the post '90s generation of entrepreneurs, who are young, innovative and particularly interested in business with high technology.<sup>721</sup> These two groups of entrepreneurs usually feel obliged to respond to problems that typically arise in a Chinese transformation economy, and help with non-profit development in China. Forbes listed 115 billionaires in China in 2011, with a large number of these being interested in donating to the non-profit sector.<sup>722</sup> One example of this is the Sichuan earthquake in 2008, which led to a record \$8 billion in donations to the rescue and recovery effort, mainly from upper and middle class, 'a 380 per cent increase over the previous year'.<sup>723</sup>

I would argue that there are two principal reasons why these groups are interested in assisting non-profit beneficiaries. Firstly, through donating to non-profits, they expect to achieve self-fulfilment and enhance their personal reputation in society. Most of the rural entrepreneurs are likely to have spent their childhood living in extremely poor conditions, especially during 1960s-1980s, one of the hardest times in Chinese history.<sup>724</sup> This deprived childhood experience is likely to left them empathising with those who are living in poverty in modern Chinese society, and therefore render them more likely to donate to such a cause and to help those in need.<sup>725</sup> Owing to a lack of time, this category of donor would most prefer to donate money rather than participating in person.

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<sup>720</sup> K Yang, *Entrepreneurship in China* (Routledge 2016)  
<<http://www.worldfinancialreview.com/?p=2782>> accessed 13 March 2016

<sup>721</sup> Z Lu, 'What Are Our Young People Thinking Post-90s Generation' (*Church China* 10 March 2014)  
<<http://www.chinasource.org/blog/posts/what-are-our-young-people-thinking-post-90s-generation>>  
accessed 23 March 2016

<sup>722</sup> Wong, (n678)

<sup>723</sup> *ibid*

<sup>724</sup> Y Wang, 'Upstarts and Startups: China's Post-90s Entrepreneurs' (*ChinaDaily*, 8 May 2015)  
<<http://www.chinadaily.com.cn/china/entrepreneursinchina/>> accessed 16 March 2016

<sup>725</sup> Guo and Zhang, (n38) 328

Secondly, the post '90s generation, by contrast, usually tend to be 'doers'. They will more often act as 'social entrepreneurs', setting up their own non-profits, or supporting a range of non-profits in their specialized businesses, many of which are concerned with cutting edge knowledge, international issues, environment, women/minority group protection and technology.<sup>726</sup> Von Hippel and Pissler give the example of Zhang Meijuan, a private businesswoman, who enjoyed considerable financial success, but lacked a sense of personal fulfilment.<sup>727</sup> Establishing a non-profit foundation provided that. It did not bring material rewards, but did provide her with surprisingly high job satisfaction. Owing to the unique nature of non-profits that we addressed in 2.4.3, through collaborating with her colleagues with common interests and preferences, she could thus have a sense of belonging within a given community.<sup>728</sup>

In spite of the efforts made by many individuals in China, there still remains an apparent philanthropy gap, especially compared to the United States, for example. Research carried out in 2013 illustrated that those top 100 philanthropists in China only donated an equivalent of 890 million USD, which is less than what the CEO of Facebook and his family gave in 2012.<sup>729</sup> This big gap has obviously manifested itself by way of 'the number of philanthropic foundations' that exist in China. In 2012, China had only 2,961 foundations, less than 3 per cent of the number in the U.S.<sup>730</sup> Some of this has resulted in upper-middle class members of society facing criticism that their enthusiasm towards non-profit contributions is merely impulsive, spontaneous and reactive behaviours.<sup>731</sup> However, this cannot be explained only by the lack of the basic generosity among private entrepreneurs in China. The primary reason would appear to be that many of them still doubt the future and development of non-profits, due to over-regulation by the Chinese Government. At the same time, they may be reluctant to constantly donate their wealth to a cause, for the fear that the money will merely end up being used by a corrupt non-profit organisation.

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<sup>726</sup> Wang, (n724); Kaiman, (n687)

<sup>727</sup> Von Hippel and Pissler, (n664) 433

<sup>728</sup> *ibid*

<sup>729</sup> R Brandom, 'Mark Zuckerberg and Priscilla Chan to Donate 99 Percent of Their Facebook Fortune' (*The Verge*, 1 December 2015) <<http://www.theverge.com/2015/12/1/9831554/mark-zuckerberg-charity-45-billion>> accessed 29 March 2016

<sup>730</sup> *ibid*

<sup>731</sup> *ibid*



### 6.5.2 Student volunteers

Research suggests that university students and graduates of the 1980's and 1990's are an increasingly significant group of contributors to the funding of non-profits in China.<sup>732</sup> But unlike private entrepreneurs, this group tends to provide human resource support—as volunteers, even where there is no official government approval for their activities. Their extremely active involvement in non-profit activities can be attributed to their personal ideology, which may have been formed in the process of their unique life experiences during the Chinese Post-Reform Era.<sup>733</sup> These 'post '90s youth' are, on the one hand, often immersed in the monetary world, whilst on the other hand, are often more able to appreciate the non-monetary social value of sincere and pure connections between others, emotional communication and value spiritual self-fulfilment. A report by Guo and Saxton indicated that over 91.7 per cent of Chinese college students would like to take part in voluntary work taken in a variety of forms, and 83.1 per cent participant in volunteer work every year.<sup>734</sup> Indeed, it was noted that even in the absence of remuneration, a substantial number of students are encouraged and sustained by the virtue of non-profit missions and vision alone.

### 6.6 Conclusion

This chapter addressed the nature and role of non-profits in China. We saw many similarities with the Western non-profits. The same three explanations developed (in Chapter 2) to explain the role of non-profits also explained Chinese non-profits too. For instance, both the commercial market and the Chinese Government fail to act as the service provider due to a variety of reasons. Furthermore, the Chinese public, like their western counterparts, seek the rewards that come from participating in the life of non-profits. Nevertheless, each of these three explanations required modification to take account of a range of distinctive features of Chinese society, and the role of the market and the Government within it. Contextualising our theory of non-profits in this way

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<sup>732</sup> G C Chu, *The Great Wall in Ruins: Communication and Cultural Change in China* (SUNY Press 1993)

<sup>733</sup> 'Post 80s and 90s youth in China have grown up in the Post-Reform Era, when China's rapid economic growth has taken off and various institutions have gradually improved and come into line with international standards'; see Lu, (n721)

<sup>734</sup> C Guo and G D Saxton, 'Voice-in, Voice-Out: Constituent Participation and Nonprofit Advocacy' (2010) 1 Nonprofit Policy Forum 1

will prove essential as we turn to develop and contextualise the blueprint for board governance, now, in Chapter 7.

## Chapter 7 | The social determinants of non-profit governance and the impact on the blueprint

### 7.1 Introduction

A theme running through this thesis is that a ‘one size fits all’ approach to corporate governance cannot work. This is true when we consider the differences between different organisations – even those that are all non-profit. But it is also true when we consider differences between countries. What works in one country is unlikely to work perfectly in another.<sup>735</sup> As Caron and Richter argue, organisational governance reform in almost any market is ‘invariably an interplay between, on the one hand, the need for new international standards that facilitate transparency and trust, and on the other hand, an equally strong desire to maintain established customs and institutions’.<sup>736</sup> This is particularly true of emerging markets, typically in the East, which differ fundamentally from developed Western markets.<sup>737</sup> China, which is a widely applied example of the most recently developed and largest emerging market in the world, has endured a long battle between its unique contextual factors (such as collectivism, Confucianism, and *guanxi*) and the modern mode of corporate governance. As the discussion in Chapter 6 made clear, China’s quick transition from a planned economy to a market-oriented one started with an environment lacking the most crucial factors of institutional infrastructure, such as a ‘well-defined legal system, rigorous law enforcement, and well-functioned financial markets, etc’.<sup>738</sup>

In light of such a transition, a range of problems may arise, raising questions over how a culture might ‘change and adapt in the face of regional and international economic integration’.<sup>739</sup> What are the contextual determinants of Chinese non-profits, and how could these elements be adapted to promote better governance practices in the Chinese non-profit sector? However, as will be apparent from the analysis so far, such contextual factors may not be the only determinant of non-profit governance behaviour,

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<sup>735</sup> Smith, (n639) 4

<sup>736</sup> M I Caron, A Ficici and C L Richter, 'The Influence of Corruption on Corporate Governance Standards: Shared Characteristics of Rapidly Developing Economies' (2012) 2 Emerging Markets Journal 21

<sup>737</sup> *ibid*

<sup>738</sup> Q Liu, 'Corporate Governance in China: Current Practices, Economic Effects and Institutional Determinants' (2006) 52 CESifo Economic Studies 415, 421

<sup>739</sup> *ibid*

even though these play a crucial role. A more nuanced understanding of the objective, addressing individual behaviours based on their social, culture, political, economic, and ethical environmental context is essential for designing an improved governance blueprint as this might be applied to non-profit organisations.<sup>740</sup>

Recent research on the subject of corporate governance in China may broadly be divided into two streams. The first covers studies which analyse how to transplant Western governance practices to China by exploring a set of potential indicators of Chinese corporate practices.<sup>741</sup> The second concentrates on the potential contextual factors influencing governance mechanisms in China.<sup>742</sup> However, very little research has been undertaken to explore the issues surrounding governance mechanisms in the Chinese non-profit sector, and even less has sought to find a normative structure (blueprint) for non-profit governance in combination with its contextual factors.

Nevertheless, developing the blueprint in this way would appear particularly important for non-profits in China, given the unstable legal and political environment, as well as the less developed governance mechanism in the non-profit sector, which we shall address in the following sections.<sup>743</sup> More specifically, developing my blueprint for the Chinese non-profit sector could improve non-profit governance in China in two ways. Firstly, the blueprint itself essentially draws upon a variety of well-entrenched legal theories and practices, which can provide a wealth of experience to Chinese non-profits.<sup>744</sup> Second, given China is now seeking to develop its own non-profit sector, the blueprint attempts to provide viable solutions for non-profit governance, and thus influence the Chinese approach to regulation and practice. It is also a good opportunity for the Chinese Government and the legal system to self-reflect on the mechanisms

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<sup>740</sup> D Hay, S Adnan and C Staden, 'Culture, Governance Structure and Corporate Social Responsibility Reporting: Evidence from China, India, Malaysia and the United Kingdom' (AFAANZ Conference 2010, 2010)

<sup>741</sup> C-E Bai and others, 'Corporate Governance and Market Valuation in China' (2004) 32 *Journal of Comparative Economics* 599; H Matoussi and M K Jardak, 'International Corporate Governance and Finance: Legal, Cultural and Political Explanations' (2012) 47 *The International Journal of Accounting* 1; Liu, (n738)

<sup>742</sup> E T Hall, *Beyond Culture* (Anchor 1989) J Hooker, 'Cultural Differences in Business Communication' in S F K Christina Bratt Paulston, Elizabeth S. Range (ed), *The Handbook of Intercultural Discourse and Communication* (Wiley Blackwell 2008); Vanhonacker, (n35)

<sup>743</sup> Huang and others, (n41)

<sup>744</sup> Suchman, (n432)

taken to regulate non-profits. Given these benefits, this chapter will tailor and modify the UK-based blueprint appropriate to the Chinese context.

Chapter 7 begins (7.2) by considering the potential barriers to the process of ‘legal transplantation’ – of taking part of one country’s legal regime (such as its treatment of non-profits) and transplanting that into another country’s legal system. In addressing this, I will explain why it is essential to contextualize Western theories and approaches to the Chinese context. Thereafter, sections 7.3 to 7.6 look at the different attributes of non-profit board which the blueprint focuses upon. In doing so, we shall consider how to modify the attributes of such a governance blueprint in the Chinese context. Following this, the chapter then examines the relevant social determinants, as discussed in Chapter 4. Table 7.1 summarises the argument this chapter makes, by showing how the Chinese social determinants affect the modification of the UK-based blueprint.

**Table 7.1 Chinese social determinants and the blueprint modification**

Board attributes		Chinese Social Determinants	Consequences influenced by the determinants	
Board size		<i>guanxi</i> , <i>mianzi</i> , Group thinking	1, <i>guanxi</i> → improve resource collection → more members 2, <i>mianzi</i> → resource collectors stay on board → large board 3, Group thinking → less creativity	
Board characteristics	Director's independence	<i>guanxi</i> , Collectivism	1, Positive <i>guanxi</i> and negative <i>guanxi</i> 2, Director's independence relationship and independent judgment	
	Director's identity	Government representatives	Administrative and financial resource from the Government	1, Lacking of resources 2, Destroy non-profit independence and become government-affiliated organisations
		danwei system	Government-controlled work unit	1, Affect director's behaviors and ways of thinking 2, Improve <i>guanxi</i> net with the Government
		Professionals	Qualification vs Experience Adverse selection	1, Unfix criteria; 2, Biased decisions by directors/managers
Board structure		Black corruption in China	Anti-corruption committee in the non-profit board	
Board process		High Context Chinese Society ( <i>guanxi</i> , collectivism, <i>mianzi</i> , confucianism)	1, Ineffective meeting 2, Inactive performance; 3, Lack of frankness and creativity	

## 7.2 Contextual barriers in comparative research

The blueprint outlined in Chapter 4 was largely based on theories and empirical evidence drawn from Western countries. Although most Western systems have so far proven to be well suited to the functioning of industrialized countries, their overall suitability for China is yet to be determined.<sup>745</sup> China has in fact already borrowed, or ‘transplanted’, a number of different governance mechanisms – relating to for-profit companies – from the West. This borrowing has occurred during a period of rapid social change. As the evidence below demonstrates, the unsatisfactory consequences of a variety of legal transplantation attempts demonstrates how factors such as culture, legal systems, individual social and political histories and institutional dependence can often prevent the convergence between two legal systems from taking place.<sup>746</sup>

In consequence, it would appear to be irrational to attempt to apply the blueprint in Chapter 4 directly into the Chinese context, without first making modifications. Indeed, as research by Shi has argued ‘...every country is unique, and the effect of transplanting rules, systems is uncertain because it is all contingent on the history of the particular institutional structure, politics, economics and society. Stability, continuity and gradual evolution will continue to be the hallmarks of non-profit governance in China’.<sup>747</sup> Without appropriate assimilation of traditional knowledge and legal practices into the ‘imported regime’, it could be painful for the Chinese legal system to overcome ‘other traditional perceptions that stood in the way of legal transplantation’.<sup>748</sup>

Concerning the actual practices that take place in China, over the past two decades, it has made significant efforts to reform its implementation measures within the legal system. Intellectual property (‘IP’) law in China, for example, has been developed through the transplantation of the models from Western countries.<sup>749</sup> However, a

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<sup>745</sup> D Wang, *Development of Philanthropy in China: 2001-2011* (Beijing Normal University Press 2011) 25

<sup>746</sup> C Shi, *Political Determinants of Corporate Governance in China* (Routledge 2012) 190

<sup>747</sup> *ibid* 196

<sup>748</sup> M H Ng, *Legal Transplantation in Early Twentieth-Century China: Practicing Law in Republican Beijing (1910s-1930s)* (Routledge 2014)

<sup>749</sup> This reform is based both upon the German and Anglo-American legal models, for the purpose of improving Chinese corporate governance. L Zhang and N Bruun, ‘Legal Transplantation of Intellectual

variety of local Chinese social norms have been deeply shaped by many contextual factors, which may inherently conflict with the understanding of intellectual property rights in Western countries.<sup>750</sup> Therefore, ‘the resistance to legal transplantation of IP Regulations has led to a divergence between the formal IP rules in China and the actual IP norms as they are followed in practice, which has resulted in difficulty in the enforcement of IP laws’.<sup>751</sup>

In addition to the contextual barriers, irrational decisions made by Chinese legislators and the Government have resulted in transplantation failure on a variety of levels. Legislators and the Chinese Government have overused their discretionary power to transplant Western governance regimes, without applying the necessary critical judgment in respect of factors such as the legal infrastructure and supporting mechanisms of the source country, therefore undermining the overall effectiveness of these rules in the Chinese context.<sup>752</sup> Mechanisms such as directors’ fiduciary duties, duty of care and due diligence, and independent directors are all ideas that were transplanted from UK and US to improve the current Chinese corporate governance regime, which later did not turn out to be a success.<sup>753</sup>

The undesirable consequence of the transplantation has proven that ‘all these governance, regulatory and enforcement factors which originated within China’s distinct social, political and cultural contexts are likely to offset China’s convergence towards any particular international corporate governance mode’.<sup>754</sup>

With these potential barriers in mind, we shall examine and select the most important Chinese contextual factors that may require modification of the blueprint to make it

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Property Rights in China: Resistance, Adaptation and Reconciliation' (2017) 48 IIC-International Review of Intellectual Property and Competition Law 4

<sup>750</sup> Zabielskis, (n628)

<sup>751</sup> D Bosworth and D Yang, 'Intellectual Property Law, Technology Flow and Licensing Opportunities in the People's Republic of China' (2000) 9 International Business Review 453

<sup>752</sup> Ng, (n748)

<sup>753</sup> The Chinese Company Law adopted the board of supervisors which was modelled on the supervisory board in the German two-tier board system to exercise supervision over directors and managers. However, the law did not provide the board of supervisors with sufficient power to make directors and managers accountable, which turned out to be inefficient. The CSRC then introduced another supervision body, an independent director system for listed companies in 2001 which was borrowed from UK/US system. This strategy does not improve the governance efficiency in the Chinese context; see Shi, (n746)

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<sup>754</sup> *ibid*



appropriate for China. And, in so doing, we shall mainly focus on the impact of the Chinese Government (primarily addressing political factors). These political factors are, without doubt, the most essential matters influencing non-profit governance in China. Indeed, it is clear political factors cannot exist independently, and we must otherwise combine cultural, social, economic and legislative factors to undertake a comprehensive investigation. Accordingly, sections 7.2.2 and 7.2.3 will briefly examine the potential impact the Chinese Government may have upon the non-profit sector, alongside other influential factors, which shall be addressed in the frame of a blueprint modification later on (in sections 7.3 - 7.6).

### **7.3 The impact of the Chinese Government (political barrier)**

‘Corporate governance in China cannot be separated from political governance’.<sup>755</sup> Such a classic statement captures the persuasive dominance and influence the Chinese Government continues to have over the internal governance of corporations in China, be these found within the profit-based or non-profit sector. It cannot be denied that this type of intervention encumbers the operation of mechanisms that were otherwise transplanted from Western economies, where there exists no heavy form of government intervention.<sup>756</sup> Indeed, a majority of the social factors that are important here, such as economic development strategies, the enactment of legal rules, as well as a citizen’s ideology, which have been strictly controlled by the Chinese Government for centuries, all contribute to the well-established authority of the Government in China.

Indeed, the Chinese Government can influence non-profit governance in two respects in particular. These are the *internal governance* (7.3.1) and *external governance* (the legal regulations in 7.3.2 and other social determinants in 7.3.3). Having addressed these two matters, section 7.3.4 then explores the interplay between the Government and non-profit governance (both internal and external) in the Chinese setting.

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<sup>755</sup> See C J Milhaupt, 'Property Rights in Firms' (1998) Virginia Law Review 1145

<sup>756</sup> Guo, (n36)

### 7.3.1 Internal governance of non-profits

By ‘internal governance’, we mean those institutional control mechanisms which are developed and adopted by organisations themselves, and which are enforced by participants within the organisation. They include such mechanisms as internal transparency systems, internal monitoring and control by boards, mechanisms for disciplining management (such as remuneration rewards, or removal from the job) and so on.

Although these function as internal mechanisms, the Chinese Government has always attempted to control the non-profit governance through manipulating their *internal governance*. In China the governance of both large for-profit enterprises and non-profit organisations may be categorized as an ‘administrative model’, largely if not entirely coordinated by the Chinese Government.<sup>757</sup> The Government frequently attempts to enable their own representatives to occupy influential positions (i.e. directorships) in non-profits, as to maintain power and influence over their operation.<sup>758</sup> Such representatives are then often criticized to behave like ‘government officials in the hierarchy, and report their findings to Government agencies from which they are dispatched’.<sup>759</sup> Indeed, unlike in a Western market economy, the ‘unwritten rule’ in many Chinese non-profits is that the Government’s order is in a higher position of authority and priority, above any legal rule.

### 7.3.2 External governance of non-profits

*External governance* (or *external control mechanisms*)<sup>760</sup> includes laws and regulations, capital market, product market and labour market, external stakeholders and media, for example. Among these potential external control mechanisms, the Chinese Government has the most frequent interaction with the legal system. As discussed in section 7.2.1, a majority of corporate governance reforms in China were

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<sup>757</sup> Milhaupt, (n755) 189

<sup>758</sup> Shi, (n746) 188

<sup>759</sup> Q Ma, *Non-Governmental Organizations in Contemporary China: Paving the Way to Civil Society?* (Routledge 2005)

<sup>760</sup> It concerns those areas in which management or influence are external to the corporation’s functioning; see Weir, Laing and McKnight, (n18)

partly politically driven. Indeed, their overriding goal was to improve the interests of the Chinese Government and ‘maintain political, economic and social stability’.<sup>761</sup> Therefore, any form of legal transplantation has to take account of the intervention of the Government.

The Chinese legal system is highly centralized, and remains controlled by the Government as a means through which to influence non-profit governance. It has been argued that ‘[t]he control function of the legal system is mainly carried out by the government institutions with either political or bureaucratic or legal powers of control. Political factors have been the primary determinants of corporate ownership and regulation in China...’.<sup>762</sup> This is essentially due to the fact that Government bodies are often more powerful, higher in the hierarchy, than the legal department. The Ministry of Public Security and the Ministry of State Security, as the Government police agency, could ‘exercise far more influence over the criminal process than the Ministry of Justice, the prosecutors, and the courts’.<sup>763</sup> The Committee of Political and Legislative Affairs, as a central committee directly controlled by the Government, has the responsibility to control and oversee the performances of all the legal departments, including the Supreme Court of China.<sup>764</sup>

### 7.3.3 Social determinant—Confucianism

In addition to the interventions discussed above, there may also be an interaction between the Government and other social determinants. We shall take Confucianism as an example here. China has taken a unique path that is strongly affected by Confucianism, which emphasises order, balance and harmony. From a political dimension, the Communist Party could struggle to maintain its authority without an ideological underpinning.<sup>765</sup> Confucianism, emphasizing ‘*the central role of the state in the society*’, would seem to provide a ready-made ideology that teaches people to respect the authority of the Government, and does not challenge its rules.<sup>766</sup> Indeed,

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<sup>761</sup> Shi, (n746) 189

<sup>762</sup> *ibid* 192

<sup>763</sup> Jing, (n51)

<sup>764</sup> *ibid*

<sup>765</sup> C Li, 'The Confucian Ideal of Harmony' (2006) 56 *Philosophy East and West* 583, 588

<sup>766</sup> Shi, (n746) 190

Confucianism is the notion of ‘suppressing one’s desires and maintaining a high moral ground’, which has been advocated and used over generations by the Chinese Government to maintain its authority over social affairs and thus improve social unity.<sup>767</sup> Aside from the historical impact of Confucianism itself, the Government is making a great effort to reinforce the impact of Confucianism on individual political views. Relevant approaches include the proposed idea of *Harmonious Society* in 2004<sup>768</sup> and the Chinese Dream in 2013.<sup>769</sup>

Given the impact of Confucianism on society, the Chinese Government may naturally attempt to affect a director’s way of thinking by implementation of this way of working. Non-profit board governance could also be affected in two respects. First, from an individual level, directors, heavily affected by Confucianism, could acknowledge the importance of worshipping authority, and therefore fear to challenge others’ exercise of authority (especially by managers) in board meetings.<sup>770</sup> However, this would go against a director’s most essential task, which is to supervise and challenge managers’ decisions when necessary.<sup>771</sup> From another perspective, the non-profit, as an entity, may respect the power of the Government, and thus be more willing to accept orders in any given situation.<sup>772</sup> Consequently, this could weaken the independence of non-profits from the Government, which shall be further discussed in section 7.4.2.1.

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<sup>767</sup> Li, (n765)

<sup>768</sup> The idea of *Harmonious Society* originated from Confucius. ‘The Chinese Government preaching in favour of Confucian social harmony resonates with the Chinese people because Confucian values still inform Chinese ways of life’; see Shi, (n746) 191

<sup>769</sup> President Xi ‘has used the philosophy more sparingly, likely in favour of emphasizing his vision of the Chinese Dream’ in 2013. The Government attempts to ‘give Chinese a code of ethical value focused on social harmony and order’; see A E Cha, ‘Chasing the Chinese Dream’ (*Washington Post*, 21 October 2007) <<http://www.washingtonpost.com/wp-dyn/content/article/2007/10/20/AR2007102000530.html>> accessed 12 April 2015

<sup>770</sup> J F Paradise, ‘China and International Harmony: The Role of Confucius Institutes in Bolstering Beijing’s Soft Power’ (2009) 49 *Asian Survey* 647

<sup>771</sup> L Miles and S H Goo, ‘Corporate Governance in Asian Countries: Has Confucianism Anything to Offer?’ (2013) 118 *Business and Society Review* 23, 29

<sup>772</sup> Huang and others, (n41)

#### **7.3.4 Interplay between the Government and non-profit governance (internal and external governance)**

Based on the preceding analysis, I would argue that in the non-profit sector in China, the interaction of internal and external governance operates in a way that is quite unlike that in Western countries. In Western countries, it is readily accepted that external governance may well influence and guide the operation of internal mechanisms within an organisation. Most obviously, external legal rules can influence the way the board functions as an internal control mechanism. External capital markets can drive internal transparency arrangements or boardroom accountability, and so on. However, internal governance mechanisms are understood not to have any impact upon external ones.<sup>773</sup> The internal arrangement a particular company makes for, say, the operation of its own board, is assumed to make no difference to the external governance norms. Such external norms are general, applying universally, and will not be changed in relation to a particular company because of the local internal mechanism it has chosen to adopt. The influence, in other words, is ‘one directional’ – from the external to the internal, but not vice versa.

By contrast, in China there is a two way process of influence. As in the West, the external influences the internal. But, crucially, the internal can also influence the external. Internal and external governance are, in other words, interactive functions in China. The internal arrangements a particular company has chosen to adopt can indeed influence how external governance mechanisms are then applied against that particular company. Why does the Chinese system operate in this way? The primary reason leading to this difference between China and Western countries is because the Chinese Government is actively involved in the process of governance through its direct impact on the implementation of regulation. Compared to Western legal systems, which operate separately to the government, as section 7.3.2 has already started to detail, legal regulations and their implementation in China are heavily influenced by the Government policy. Moreover, as sections 8.3 and 8.4 will demonstrate, most non-profit regulations remain silent on the subject of governance issues, which therefore

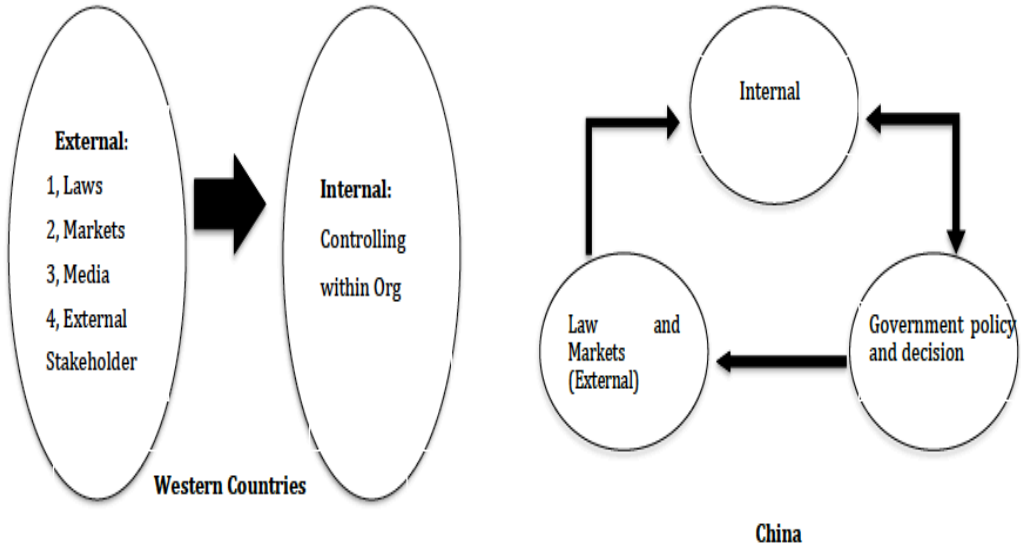
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<sup>773</sup> Weir, Laing and McKnight, (n18); E Schiehl, C Ahmadjian and I Filatotchev, 'National Governance Bundles Perspective: Understanding the Diversity of Corporate Governance Practices at the Firm and Country Levels' (2014) 22 *Corporate Governance: An International Review* 179, 183

leaves considerable space for the Government to make use of their discretionary powers during the implementation process.

This discussion will be supplemented by evidence in sections 7.4.2.1 and 8.4.4.2.2, demonstrating how the Government’s attitudes toward non-profits can vary greatly depending on whether the Government trusts the organisation and how close their relationship may be. But because of that, non-profits in China may in turn influence Government decisions by establishing and building up appropriate networks with the Government.<sup>774</sup> According to this logic, non-profits in China may also have an impact on the implementation of (external) regulations by maintaining connections with, and thus gaining trust from, the Government. Consequently, there exists a high possibility that the relationship between Government and non-profits will influence the way in which legal regulations are implemented. This relationship may be understood according to the following Table 7.2.

**Table 7.2 Interplay between internal and external governance**



<sup>774</sup> Social networks can be defined as *guanxi* in China. *guanxi* and how could it influence board governance and Government decisions shall be extensively examined in the following part and in Chapter 8.

## 7.4 Modifying the blueprint in light of the Chinese contextual factors

Following our analysis of transplantation barriers above, we can now consider how our blueprint for the non-profit board should be modified to make it appropriate for China. Recall the four basic attributes of non-profit board governance on which we focused: board size, characteristics, structure and process. Whilst these four attributes are as important in China as in the West,<sup>775</sup> there is less agreement on how these attributes might be affected by the contextual determinants identified above.<sup>776</sup> That is the task now before us.

### 7.4.1 Board size

Recall our earlier discussion regarding the most appropriate size for non-profit boards. We suggested that, overall, there seemed to be a good case, in general, for favouring larger boards for non-profits. In particular, larger boards seemed better able to fulfil the multiple roles that our ‘integrated model for board governance’ requires. They will be able to devote sufficient time and effort to the control role, whilst also attending to the strategic and service roles (including ensuring sufficient space for stakeholder representatives). Larger boards will be less likely to become dominated by more powerful, expert, full-time managerial insiders, and less dependent on a small number of key individuals whose departure could cause significant difficulties for the organisation.

However, we also noted that, set against these advantages, there were also a number of potential downsides in enlarging the board. There was an increased chance of ‘social loafing’ by some members, and a greater tendency towards ‘group think’. There was the risk that board meetings would become too long, too unfocused and inefficient as larger numbers of directors all competed to participate. And non-profits might simply struggle, practically, to find enough willing recruits to produce a board of a theoretically ideal size.

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<sup>775</sup> A Keay, *Board Accountability in Corporate Governance* (Routledge 2015); Jaskyte and Holland, (n376); Liu, (n738)

<sup>776</sup> Liu, (n738); Y Li, *The Structure and Evolution of Chinese Social Stratification* (University Press of Amer 2005)

Our task now is to see how this balance of advantages and disadvantages plays out in the specific context of China. In doing so, we focus on two key points. Firstly, as noted, larger board structures are assumed to be more capable of co-opting external influence and therefore being more effective at resource collection. Section 7.4.1.1 tests whether this assumption holds true for China, given the influence of contextual factors. Secondly, we shall examine whether the positive relationship between board size and group thinking noted above is likely to hold in the Chinese context. Here, two important Chinese social determinants – *guanxi* (network) and *Mianzi* (face saving) – shall be examined. We may infer from the argument below that these two social determinants, which widely occur throughout Chinese society, may also influence a director’s behaviour and the way that non-profits deal with business partners.

#### **7.4.1.1 *guanxi* and resource collection**

*guanxi* has been defined by Smith, Chua and Morris as ‘a Chinese version of networking’.<sup>777</sup> ‘It has more to do with the building and maintaining of deep, complex interpersonal relationships and bonds between individuals’<sup>778</sup> Within Chinese non-profits, a large board is considered desirable not only because of the enhanced resource collection ability organisations of this kind tend to be capable of achieving, but also due to the influence of *guanxi* (network) in Chinese society. The larger the board, the more directors, and the more individuals who can build and maintain *guanxi*, and thus facilitate the resource collection function of the board. *guanxi* ‘serves as a form of insurance in an otherwise risky business environment’.<sup>779</sup> Many observers have noted that lacking a sufficient *guanxi* or network can be a ‘fundamental barrier’ to attaining business entry in to some environments.<sup>780</sup> Meanwhile, *guanxi* facilitates not only access to financial support, but also to other resources such as information and

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<sup>777</sup> *guanxi* is essentially the influence of relatives, friends, and contacts; see R Y J Chua and M W Morris, 'Dynamics of Trust in Guanxi Networks' (2006) 9 Research on Managing Groups and Teams 95; Smith, (n639)

<sup>778</sup> Chua and Morris, (n777) 13

<sup>779</sup> T Casciaro and M J Piskorski, 'Power Imbalance, Mutual Dependence, and Constraint Absorption: A Closer Look at Resource Dependence Theory' (2005) 50 Administrative Science Quarterly 167 209; K K Xin and J L Pearce, 'Guanxi: Connections as Substitutes for Formal Institutional Support' (1996) 39 Academy of Management Journal 1641

<sup>780</sup> Xin and Pearce, (n779); Smith, (n639); C Ho and K A Redfern, 'Consideration of the Role of Guanxi in the Ethical Judgments of Chinese Managers' (2010) 96 Journal of Business Ethics 207



transaction priorities.<sup>781</sup> Accordingly, in order to fulfil their boundary-spanning role, the most important matter to Chinese non-profits is to establish *guanxi* in the markets through which they operate.

To see this more clearly, we need to understand better just how *guanxi* works in Chinese society. There are basically three layers of *guanxi*, based upon how close the relationships are between those involved. The most basic level is *shengren* (strangers).<sup>782</sup> The instinct of most Chinese people is to distrust and avoid doing business with *shengren* unless they are able to step up to the second category, *shuren*.<sup>783</sup> *Shuren* refers to ‘individuals with which commonalities exist’.<sup>784</sup> These commonalities originate from a variety of aspects of social life.<sup>785</sup> The third category, the closest relationship among individuals, is *jiaren*, namely, a ‘family member-like relationship’.<sup>786</sup> While kinship is undoubtedly regarded as the closest relationship, Chinese people also treat those extremely trustworthy people as their family members, even if they are not blood relatives.<sup>787</sup> Since establishing connections with the right people can provide tremendous benefits in business transactions, every individual and organisation in China seeks to ‘move beyond the *shengren* status’ and be taken as *shuren* or even *jiaren*.<sup>788</sup>

Although important to China, it can be argued that the social connection (*guanxi*) in Western business culture can be equally important to transactions too. The blueprint outlined in Chapter 4, as well as the later discussion of legal regulations (Chapter 5), have pointed to the fact that UK non-profits equally appreciate the importance of building and maintaining good relationships with their partners, be these individuals or

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<sup>781</sup> T W Dunfee and D E Warren, 'Is Guanxi Ethical? A Normative Analysis of Doing Business in China' (2001) 32 *Journal of Business Ethics* 191

<sup>782</sup> *shuren* refers to those individuals who have met for the first time.

<sup>783</sup> P P Fu, A S Tsui and G G Dess, 'The Dynamics of Guanxi in Chinese Hightech Firms: Implications for Knowledge Management and Decision Making' (2006) 46 *Management International Review* 277

<sup>784</sup> U C Braendle, T Gasser and J Noll, 'Corporate Governance in China—Is Economic Growth Potential Hindered by Guanxi?' (2005) 110 *Business and Society Review* 389, 393

<sup>785</sup> Such as ‘having lived in the same village, former school classmates, and people who frequently eat together, at the same table’; see *ibid* 72

<sup>786</sup> Fu, Tsui and Dess, (n783)

<sup>787</sup> H Davies and others, 'The Benefits of “Guanxi”: The Value of Relationships in Developing the Chinese Market' (1995) 24 *Industrial Marketing Management* 207, 211

<sup>788</sup> Fu, Tsui and Dess, (n783)

organisations.<sup>789</sup> Accordingly, it might be argued, the prevalence of *guanxi* in China will not make any significant difference to the decisions or board size of Chinese non-profits, compared to, say, those in the UK. But this understates the significance of *guanxi* in Chinese business relationships. For ‘in China, business is driven to a much greater extent by relationships and connections than is business in many other economies’.<sup>790</sup> This relationship-based approach to business, as Alston calls it, has numerous ramifications for non-profit organisations involved in any business transactions.<sup>791</sup> The range of different approaches there are to building connections indicate a range of differences between China and Western countries.

Firstly, there are differences between the social understandings of *guanxi*. *guanxi*, as the core social value in China, would appear to be more fundamental to business in Chinese society than those in Western countries. Vanhonacker summarizes this when arguing, ‘...in the West, relationships grow out of deals; in China, deals grow out of relationships’.<sup>792</sup> As such, *guanxi* has become ‘a carefully calculated science’ that is an ‘unwritten law’ that has emerged from Chinese society.<sup>793</sup> As research by Garten states, people in Western countries consider wealth as the symbol of a successful businessman, whereas the greatest business achievement in China is the establishment of *guanxi*.<sup>794</sup>

Secondly, the approach taken to establishing *guanxi* tends to vary from country to country. *guanxi* in China has been defined by Levin as a long-term deep and complex connection that is ‘*developed and nurtured over time*, in many cases, without a specific need for that relationship’.<sup>795</sup> Indeed, “[b]y ‘using’ the individual with whom one has *guanxi*, the moral code of reciprocity means that the user is likely to be called upon at a

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<sup>789</sup> For instance, the rise of business associations in Western countries have partly been to provide opportunities for organisations to establish networks and thus conduct business on the basis of well-formed relationships; see Y Fan, 'Ganxi's Consequences: Personal Gains at Social Cost' (2002) 38 *Journal of Business Ethics* 371, 380

<sup>790</sup> Smith, (n639) 7; J P Alston, 'Wa, Guanxi, and Inhwa: Managerial Principles in Japan, China, and Korea' (1989) 32 *Business Horizons* 26, 28

<sup>791</sup> Alston, (n790) 34

<sup>792</sup> Vanhonacker, (n35) 28

<sup>793</sup> D Z Levin and R Cross, 'The Strength of Weak Ties You Can Trust: The Mediating Role of Trust in Effective Knowledge Transfer' (2004) 50 *Management Science* 1477

<sup>794</sup> This can be explained as follow: ‘to those in the West, where you can secure a deal through formal meetings even if you don't know someone’, while without the assistance of *guanxi*, it is especially challenging to make a deal; see *ibid* 1487

<sup>795</sup> *ibid*

later, unspecified date, to assist the other party [in] solving unpredictable issues”.<sup>796</sup> As Smith further explains, *guanxi* cannot be developed until ‘you have a problem’ and, instead, people should take a long-term view.<sup>797</sup> However, Western culture is not accustomed to the slow building of relationships, especially those with unpredictable short-term returns or gains. From the perspective of Western non-profits, only those relationships likely to bring benefits to the organisation in the relatively near future are likely to be selected and developed by the board.<sup>798</sup>

According to the discussion so far, it could be assumed that non-profit boards in China do not necessarily identify directors as being responsible for any specific kind of task. Instead, the expanding membership of an organisation’s board may be merely to show an attempt by the non-profit to establish *guanxi* with particular institutions or individuals.<sup>799</sup> This behaviour of the non-profit board could be understood as a gesture of goodwill. Excluding these people from non-profit boards would signal the non-profit’s intention to cut off this particular *guanxi*, which may then put the non-profit at a disadvantage.<sup>800</sup>

#### **7.4.1.2 *mianzi* and social status**

Although the oversized nature of non-profit boards in China may have the effect of improving *guanxi*, and thus lend itself to the facilitation of fund-raising or resource collection, by contrast, as we have argued in 4.3, this is likely to result in an increase of agency costs and unnecessary administrative expenses. Indeed, in order to reduce the agency cost without deterring the non-profit’s resource collection function, research by Vandenbroucke, Knockaert and Ucbasaran suggested that resource collectors may consider working outside the non-profit board, a practice that has already found success in many other European countries.<sup>801</sup>

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<sup>796</sup> *ibid* 1488

<sup>797</sup> Smith, (n639)

<sup>798</sup> Y Luo, 'Guanxi: Principles, Philosophies, and Implications' (1997) 16 *Human Systems Management* 43 48

<sup>799</sup> *ibid* 49

<sup>800</sup> Alston, (n790) 29

<sup>801</sup> E Vandenbroucke, M Knockaert and D Ucbasaran, 'Outside Board Human Capital and Early Stage High - Tech Firm Performance' (2016) 40 *Entrepreneurship Theory and Practice* 759

This practice would appear to be efficient at first glance. However, it is unlikely to work well in Chinese non-profits. In China, those who fulfil the position of boundary spanners in non-profits always prefer to have a position on the board, since the title of director, according to the traditional Chinese class hierarchies,<sup>802</sup> is regarded as a much higher social class than that of employee.<sup>803</sup> Such social hierarchy matters are of the utmost importance to Chinese people, owing to the traditional understanding of *mianzi* (saving face).<sup>804</sup> Saving face may be understood as ‘...the lengths that an individual may go to in order to preserve their established position in society, taking action to ensure that one is not thought badly of by his or her peers’.<sup>805</sup> With its root in Confucianism, *mianzi* is ‘a sociological manifestation of the respect, pride, and dignity of an individual or business’.<sup>806</sup> Ting-Toomey noted that *mianzi* is one of the most precious social tools of the Chinese people, and a strategy that protects self-respect and individual identity.<sup>807</sup>

Admittedly, face saving is essential in many cultures throughout the world, and people in Western countries may also prefer to be members of a board with the title of director rather than work as a normal employee. However, Chinese culture would appear to place greater emphasis on face-saving.<sup>808</sup> For example, Chinese culture strictly adheres to a hierarchical regimentation, where people may be strictly classified according to a different hierarchy, primarily based on their working positions.<sup>809</sup> Accordingly, ‘treating name cards with respect is a central element of face—looking at the name

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<sup>802</sup> The Chinese class hierarchies are based on the classification of the four traditional occupations: ‘in descending order, these were the shi (gentry scholars), the nong (peasant farmers), the gong (artisans and craftsmen), and the shang (merchants and traders)’; see S McQuaide and A J Barbieri-Low, *Artisans in Early Imperial China* (University of Washington Press 2009)

<sup>803</sup> Accordingly, to improve resource collection ability, non-profits have to cater to the demands from these boundary-spanners and allow them to sit in the boardroom.

<sup>804</sup> *mianzi*, or face, is regarded as another core value within the Chinese social setting and therefore of significance in the context of non-profit governance.

<sup>805</sup> Smith, (n639)

<sup>806</sup> P J Buckley, J Clegg and H Tan, ‘Cultural Awareness in Knowledge Transfer to China—the Role of Guanxi and Mianzi’ (2006) 41 *Journal of World Business* 275

<sup>807</sup> S Ting-Toomey, ‘Intercultural Conflict Styles: A Face Negotiation Theory’ in YY Kim and WB Gudykunst (eds) *Theories in Intercultural Communication* (Sage, 1988)

<sup>808</sup> This distinctive attitude towards face may primarily be due to the fact that Western countries emphasize the value of individualism, whilst China has a collective culture. People in the West are almost expected to ‘protect oneself from narcissistic injury, irrespective of social context’, whereas, in China, ‘they are concomitantly intended to preserve and maintain strong social relationships’, in what is referred to as ‘face-giving’; see Smith, (n639)

<sup>809</sup> Li, (n765)

card, commenting on the individual's job, and treating the item with respect all save face to the individual'.<sup>810</sup>

### **7.4.1.3 Group thinking**

A further concern in respect of large boards is likely to be the issue of effective group thinking, which may also be referred to as herding-type behaviours. Research carried out in relation to Western organisations would appear to suggest that herding behaviours within the board can have the effect of destroying director creativity.<sup>811</sup> Indeed, this can have the effect of undermining the argument in favour of a large board in Chinese non-profits, since without a director's creativity, the strategic role of the board could be ruined. Whilst this view is addressed in more detail below, it would seem the herding behaviour mentioned is thought to have little impact on board efficiency in China. Indeed, given the evident pros and cons of board size noted above, we may conclude that, unlike non-profit organisations in the UK, the size of non-profit board in China is heavily influenced by contextual factors.<sup>812</sup> Non-profits, especially those with financial difficulties, are likely to do well by expanding on their board in order to improve their boundary-spanning role.

## **7.4.2 Board characteristics**

We now turn to address 'board characteristics' in the Chinese context, focusing on a director's *independence* and her *background*.

### **7.4.2.1 Directors' independence**

As the blueprint outlined in section 4.4 has made clear, director's independence is linked to a variety of benefits. Nevertheless, in China, the independence of non-profit directors may be heavily influenced by social determinants. Indeed, compared to the UK, directorial independence is far more complex in China, owing to two contextual

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<sup>810</sup> Smith, (n639), 9

<sup>811</sup> 'Group members try to minimize conflict and reach a consensus decision without critical evaluation of alternative viewpoints, by actively suppressing dissenting viewpoints, and by isolating themselves from outside influences'; see Guiso, Sapienza and Zingales, (n396)

<sup>812</sup> Brown and Guo, (n179)

factors (*guanxi*, and Chinese collectivism). Section 7.4.2.1.1 will explore how a director's independence could be affected by external *guanxi* (directors' social network with their business partners). Section 7.4.2.1.2 will then investigate the interaction between director's independence and internal *guanxi* (director's connection with their colleagues/other directors). During this process, Chinese collectivism shall be taken into account. Finally, section 7.4.2.1.3 shall modify the blueprint to reflect the reality of directors' independence in the Chinese context.

#### **7.4.2.1.1 External *guanxi* (director's network with business partners)**

We have seen how external *guanxi*, between a board and its business partners, can compromise a director's independence. And yet, failing to develop *guanxi* could be a fundamental barrier to business in China. In reality, then, non-profits in China frequently have to compromise board independence in exchange for a better *guanxi*.<sup>813</sup> Put differently, directors are encouraged to enable their friends and relatives to be involved in transactions, so as to secure resources and thus facilitate the boundary spanning role of non-profits. In spite of the advantage that *guanxi* could bring to non-profits, the board should be aware of the negative *guanxi* that may result in a wide range of misconduct, such as corruption, which shall be examined in 7.4.2.1.3.

#### **7.4.2.1.2 Internal *guanxi* (director's relationship with colleague)**

In addition to the external *guanxi*, the internal *guanxi*, referring to the individual director's connection with their colleagues, could also significantly affect a director's independence. In the Chinese context, the internal *guanxi* is closely linked with *Chinese collectivism*. Concerning non-profit governance, the notion of Chinese collectivism is one that promotes the idea of better director connections, which is to say greater interdependence rather than their independence.<sup>814</sup> Collectivism as a concept is closely associated with other 'positive' concepts such as teamwork, unified

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<sup>813</sup> Since the concept of *guanxi* is deeply rooted in Chinese ideology, business is often conducted between individuals who share a close relationship; see Smith, (n639)

<sup>814</sup> Shi, (n746)

management, and working efficiency.<sup>815</sup> Consequently, in light of collectivism, directors in the Chinese context treat connections as a human resource net to improve working efficiency, rather than something that infringes upon independence.<sup>816</sup> As such, to encourage and facilitate the establishment of collectivism within non-profit boards in China, directors are more likely to select people with whom they are already familiar, preferably with close *guanxi*. As a result, they will favour family members, such as *jiaren*, rather than those who offer a solely commercial advantage.

As Collier has argued, it is vital to recognize the importance of collectivism, which has developed for a long time as a social rule within the Chinese context. Indeed, the concept of *individualism*, which was introduced to China from the West over the recent two decades, strongly counters the traditional collectivism of ancient China,<sup>817</sup> where reliance upon collective behaviours and interdependence had become engrained among modern day Chinese citizens.<sup>818</sup> Research by Braendle and others noted that ‘social and economic transactions in collectivist cultures are organized around small groups defined by familial, tribal, ethnic, religious, or other social relationships’.<sup>819</sup>

In essence, this is thought to be based on the mutual trust environment in the Chinese society, which has gradually diminished as people refuse to communicate with strangers and are more reliant on *guanxi* they have already built by themselves.<sup>820</sup> Interestingly here, a social attitude survey in 2013 indicated a dramatic decline in social trust in China. Results revealed over 70% of respondents did not trust strangers, and their trust in business operators in particular was extremely low.<sup>821</sup> As such, *guanxi* contacts that begin with personal relationships founded on trust and prospects of mutual benefit between individuals can often create a relatively harmonious and trusted work environment.<sup>822</sup>

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<sup>815</sup> *ibid*

<sup>816</sup> *ibid*

<sup>817</sup> Braendle, Gasser and Noll, (n784) 393

<sup>818</sup> *ibid* 391

<sup>819</sup> *ibid* 390

<sup>820</sup> China’s transformational economy and diversified social values have accelerated the trust crisis to a stage where it is almost past the point of no return; see Chu, (n732) 332

<sup>821</sup> H Gao and others, ‘Spillover of Distrust from Domestic to Imported Brands in a Crisis-Sensitized Market’ (2015) 23 *Journal of International Marketing* 91

<sup>822</sup> Vanhonacker, (n35) 52

#### 7.4.2.1.3 Directors' independence and *guanxi*

Based upon such work, and in order to secure directors' independence, without affecting resource collection and positive interpersonal relationship, we intend to distinguish positive *guanxi* from negative *guanxi*, and treat them differently. In spite of people's frequent usage of *guanxi*, Chinese people are often prone to treat it as a negative activity, inextricably linked to the existence of corrupt practices (perhaps due to social pressures and custom), rather than trustworthy ones.<sup>823</sup> However, *guanxi* need not necessarily destroy directors' independence. In fact, *guanxi*, according to many theorists, can be understood as a 'neutral' word.<sup>824</sup> Indeed, '[w]hen used for legal purposes that do not infringe on public interests, *guanxi* can be an extremely useful way for members of a relationship network to take care of legitimate personal or business affairs'.<sup>825</sup>

Both positive and negative features of the practice of *guanxi* have been reflected through the earlier research conducted in to the use of *guanxi* in the Chinese business world. Positive *guanxi*, commonly being associated with power and authority and the extension of resources in society, has been considered a major source of business success within Chinese society.<sup>826</sup> To non-profit boards, positive *guanxi* can improve board efficiency, and create a better working environment, without necessarily affecting directors' independence of judgment.<sup>827</sup> Conversely, in this context, negative *guanxi*<sup>828</sup> will occur only on the condition that 'the exchange or transaction taking place within *guanxi* involves corrupt activities or one or more of the parties operate outside the law'.<sup>829</sup>

Given the discussion so far, it would appear irrational to ask or expect non-profit directors in China to be as independent as those in the UK, as this will destroy the

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<sup>823</sup> *ibid*

<sup>824</sup> Luo, (n798); Vanhonacker, (n35); Smith, (n639)

<sup>825</sup> Braendle, Gasser and Noll, (n784) 391

<sup>826</sup> Ho and Redfern, (n780)

<sup>827</sup> *ibid*

<sup>828</sup> A typical negative *guanxi* example is the recent scandal in Chinese non-profits involving Guo Meimei, a young woman who posted numerous pictures of her lavish lifestyle on the Internet. She claimed to have a close connection with the Red Cross Society of China (RCSC) and her luxury expenditures were allegedly evidence of corrupt behaviour involving public donations to the RCSC for the Wenchuan earthquake; see Hong and FlorCruz, (n682)

<sup>829</sup> Ho and Redfern, (n780)



positive *guanxi*, which is particularly important to non-profit governance. Research by Tamanaha, which has sought to build upon this, noted that positive *guanxi* has been relied upon as a mechanism for organisational governance when legal and institutional mechanisms fail to resolve problem in a reliable manner.<sup>830</sup> He further divided social rules into two categories – ‘the rule of man’ (Chinese *guanxi* mechanisms) and ‘the rule of law’ (international standards and use of legal norms).<sup>831</sup> In China, people are more likely to handle their conflicts by the rule of man (*guanxi*) than they are to adopt the apparently ‘Western’ approach.<sup>832</sup> Based upon the argument above, it can be concluded that positive *guanxi* will not destroy a director’s independence, which is an acceptable/welcomed matter in the Chinese context.<sup>833</sup> Non-profits are therefore recommended to establish a threshold (but one that is more permissive than in the UK standard) based on the contextual factors mentioned above, in order to restrict directors’ connections with the relevant organisations and individuals.

#### **7.4.2.2 Directors’ background**

What type of people should sit on Chinese non-profit boards? Three types of directors shall be discussed here: Government-appointed directors (7.4.2.2.1), directors affected by *danwei* system (7.4.2.2.2) and directors with professional knowledge (7.4.2.2.3).

##### **7.4.2.2.1 Government-appointed directors**

The Government can influence non-profits ‘externally’, from outside, without actually becoming a director. However, is it better, or worse, for Chinese non-profits to the Government inside the organisation, giving them an external role in governance, through appointing one or more government representatives as directors? What are *the*

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<sup>830</sup> In many areas, and in many ways, *guanxi* serves as a positive force of order in modern China; where incomplete reforms and the relatively new legal mechanisms accompanying them are not yet uniformly adopted by Chinese society, as much as these are not enforced by Chinese authorities; see B Z Tamanaha, *On the Rule of Law: History, Politics, Theory* (Cambridge University Press 2004)

<sup>831</sup> *ibid*

<sup>832</sup> In the Western world, people tend to rely on the rule of law to resolve their conflicts, while in China, these two coexisting and usually contradictory systems work together to determine the outcome of social conflicts. ‘S Lane, 'Does the Chinese Practice of Guanxi Lead to Corruption in Business?' (*Ethic Intelligence*, March 2012) <[www.redflaggroup.com/resource/Compliance-Insider-02-SEP-NOV-2012.pdf](http://www.redflaggroup.com/resource/Compliance-Insider-02-SEP-NOV-2012.pdf)> accessed 7 September 2014

<sup>833</sup> *ibid*

*advantages and disadvantages*, for the non-profit itself, of taking that step? The following sections will provide a further investigation.

#### **7.4.2.2.1.1 Advantages (financial and administrative resource)**

Consistent with stakeholder salience theory in Chapter 4, theorists believe that the Chinese Government, as one of the most powerful and influential stakeholders in China, often takes priority when getting to sit in the boardroom.<sup>834</sup> Guo identified that there are two advantages to having government representatives—*provide funding* and *facilitate administrative resources*.<sup>835</sup> Firstly, the Government serves as a major funding source for most registered non-profits in China. Over 56% of non-profits surveyed in 2014 relied heavily on government funds.<sup>836</sup> Between 2012 and 2013, the Chinese Central Government provided about \$200 million each year for social services, provided by non-profits which have a close relationship with the Government.<sup>837</sup> Directors themselves have noted that adding several government employees does not harm the board, rather such people can bring in money that other directors may find difficult to obtain through public support.<sup>838</sup>

Secondly, having government officials on the board of a non-profit may help non-profits to overcome administrative barriers, such as registration difficulties.<sup>839</sup> As we shall see in Chapter 8, in China neither the national constitution, acts of law nor other regulations confer a positive right to establish a non-profit. Indeed, law had provided for the set-up of a dual management system, ‘whereby so-called sponsor organisations are involved, alongside the Government body’, to take charge of the registration, management and monitoring of non-profits.<sup>840</sup> In practice, these sponsor organisations are actually affiliated to and controlled by Government departments.<sup>841</sup>

As Li and Zhang note, ‘the dual management system gives almost all of important power to business supervision units of government in charge, and the government

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<sup>834</sup> Agle, Mitchell and Sonnenfeld, (n429)

<sup>835</sup> Guo, (n36)

<sup>836</sup> Hsu and Hasmath, (n54) 522

<sup>837</sup> Feng, Advisors and Zhang, (n632)

<sup>838</sup> *ibid*

<sup>839</sup> M W Collier, 'Explaining Corruption: An Institutional Choice Approach' (2002) 38 *Crime, Law and Social Change* 1 3

<sup>840</sup> Yang and others, (n686)

<sup>841</sup> Foundation Regulations 2004, reg 6 and reg 9

stipulates that only the agencies authorized by government and the Communist Party can serve as business units in charge'.<sup>842</sup> This situation obviously leaves non-profits with no choice but to welcome government representatives to join the board. Although no legal rule requires this, theorists believe that it has already become the unspoken rule that non-profits are better to include government officials in their boardroom.<sup>843</sup>

#### **7.4.2.2.1.2 Deficiencies (loss of independence)**

There is little doubt that establishing a close connection with government authorities often may bring short-term benefits to a non-profit. Once a non-profit permits a government representative to sit on the board in exchange for an amicable relationship with the Government, then it will often gradually lose its independence. Guo noted within his research that over-depending on the Government is likely to 'push nonprofit boards away from the making of important decisions and even further away from the community'.<sup>844</sup> Firstly, the Government, as the primary (and perhaps the only) funding-provider, could take advantage of this and use its control over funding as a source of discretionary power.

Moreover, the Chinese Government may interfere with the daily-operation and governance of non-profits. For example, research has indicated that 'the Government has always attempted to prevent non-profits taking those sensitive activities that uphold citizens' political and other rights which could politically challenge government'.<sup>845</sup> Li then uses the term 'government offside' to describe the common phenomenon in the non-profit sector, which refers to "governmental actions 'without legal basis', which mainly reflect in the fact that government is directly involved in non-profit fundraising, the usage of charity funds, and that the government intervenes in the internal management of social organisations".<sup>846</sup>

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<sup>842</sup> Guo, (n36) 463; Feng, Advisors and Zhang, (n632)

<sup>843</sup> For example, 'the CCP's Central Bureau and MoCA issued a joint document requiring every NGO that has three or more CCP members to establish a party branch to supervise its political behavior' since 1998; see Guo and others, (n627)

<sup>844</sup> Guo, (n36) 13

<sup>845</sup> Feng, Advisors and Zhang, (n632)

<sup>846</sup> 2014 Observation Report on China's Third Sector – The Field of Philanthropy: The Duo-Variation of Administration and De-Administration; see *ibid*

However, as we have consistently argued so far, non-profits, no matter in China or in Western countries, serve as the third sector, supposedly independent from the commercial market and the government. Salamon and Anheier have argued, ‘non-profits are not only formal, private, and non-profit distributing, they are also self-governing and voluntary’.<sup>847</sup> However, it is largely assumed, once non-profits in China rely upon Government support, then sooner or later, they will end up as government-affiliated organisations, catering for Government preferences alone.<sup>848</sup> Meanwhile, by virtue of their interaction with the state, often such non-profits will then lose the public’s confidence.

At present, when compared to the practices in the UK, the number of non-profits supported by the Chinese Government is extremely high. Somewhat expectedly, perhaps, the Government is believed to carry significant weight in the governance and management of these non-profits. Although having *guanxi* with the Government is not by itself sufficient to enable non-profits to achieve their organisational goals, more often than not it is a significant factor in smoothing out the delivery of their day-to-day functions.<sup>849</sup> Accordingly, the non-profit sector could build a proper relationship of trust with the Government as an independent organisation, rather than being government affiliated institutions.

#### **7.4.2.2.2 Board members influenced by ‘*danwei*’ system**

In spite of the changing policy towards non-profits, board governance in China remains government-denominated through a variety of unique Chinese mechanisms. The *danwei* system is one such mechanism, which has existed in Chinese society since before the year 2003.<sup>850</sup> Notably, no researcher has attempted to link the *danwei* system with non-profit governance to date, so far as I am aware. This is perhaps surprising, since *danwei* could significantly affect the performance of non-profit directors and with it their way of thinking. The *danwei* system itself, and its relationship with non-profits,

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<sup>847</sup> Salamon and Anheier, (n82)

<sup>848</sup> S Cho and D F Gillespie, 'A Conceptual Model Exploring the Dynamics of Government–Nonprofit Service Delivery' (2006) 35 *Nonprofit and Voluntary Sector Quarterly* 493, 498

<sup>849</sup> Guo, (n36)

<sup>850</sup> D Bray, *Social Space and Governance in Urban China: The Danwei System from Origins to Reform* (Stanford University Press 2005)

is introduced in section 7.4.2.2.1, and section 7.4.2.2.2 then investigates how the *danwei* system could affect director's performance and thus influence non-profit governance.

#### **7.4.2.2.2.1 Relationship between *danwei* system and non-profits**

The *danwei system* was a government-controlled work unit tied to almost every urban resident in China during the Maoist period.<sup>851</sup> It provided 'employment and welfare benefits such as free housing, schooling and health care'.<sup>852</sup> Most urban residents were also required to ask for permission from the system if they intended to undertake events such as travel and marriage.<sup>853</sup> It was 'the first step of a multi-tiered hierarchy linking each individual with the central Communist Party infrastructure', and ensuring that citizens obeyed the Communist Party's rules.<sup>854</sup>

Broadly speaking, the *danwei* system was the old version of non-profits, though as an operation its social function was far more than that. Almost all the social welfare services in China at the time were provided by local Government in the form of a *danwei* system.<sup>855</sup> *danwei*, in both cities and rural areas, was considered to be "self-sufficient entities [provided] 'cradle-to-grave welfare' filling the space that non-profits often inhabit" today in the Chinese society.<sup>856</sup> With the implementation of reforms, the traditional structure of *danwei* was profoundly changed, and then replaced either by official/private non-profit organisations, or by state-owned enterprises (SOEs).<sup>857</sup> Although the *danwei* system has gradually lost its dominant role since the launch of these reforms, it continues to affect the governing mechanism of the newly established communities in its own way, particular in respect of administrative and procedural traditions, for example.<sup>858</sup> This shall be further addressed below.

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<sup>851</sup> *ibid*

<sup>852</sup> *ibid* 19

<sup>853</sup> *ibid*

<sup>854</sup> It monitored employees for signs of political waywardness. Any disagreements about the Communist Party would be recorded on a file, where a black mark could have a host of repercussions, from denial of promotion or better housing to imprisonment. Beijing, 'Danwei people become citizens' (*The Economist*, 2003) <<http://www.economist.com/node/2043197>> accessed 23 March 2016

<sup>855</sup> Y Xie, Q Lai and X Wu, 'Danwei and Social Inequality in Contemporary Urban China' (2009) 19 *Research in the Sociology of Work* 283

<sup>856</sup> Yang and others, (n686) 553

<sup>857</sup> *ibid*

<sup>858</sup> *ibid*

#### 7.4.2.2.2 The impact of *danwei* system on directors

Naturally, the effect of removing the *danwei* system has also had an impact on the governance of non-profits as these exist today. In spite of this, it might be said the *danwei* system was rather a double-edged sword. On the one hand, it can be said to have improved *guanxi* between non-profits and local Government, primarily because a majority of today's non-profit employers were in the *danwei* system, which itself belonged to the Government.<sup>859</sup> Therefore, directors may still take advantage of this to facilitate their fund-raising for non-profits. Conversely, on the other hand, the old tradition inherited from *danwei* might be said to prohibit the application of the modern way of thinking – or Western mode of governance – within Chinese non-profits.<sup>860</sup>

To the system itself, there were basically two typical characteristics recognized in China as the *danwei* system – *strong political control* and *traditional bureaucratic mechanism*, and research has suggested these two features may influence a non-profit director's way of thinking and behaviour in two specific ways.<sup>861</sup> First, those non-profit directors who experienced working under the *danwei* system would have been required to attend mandatory weekly meetings to study the Chinese Party's documents, for the purpose of cultivating their personal respect and worship of the Chinese Government.<sup>862</sup> As a result, those non-profit directors would likely voluntarily follow Government policy, and would not go against government representatives in the decision-making process.

Second, the *danwei* system has been applied to the Chinese society for decades, which could have significant impact on individual's performance and ideology. It is highly likely that non-profit directors who were 'brought up with' or operated within the frame of the *danwei* system will be heavily influenced by the traditional mode of thinking, and the bureaucratic mechanisms that are associated with this.<sup>863</sup> Moreover, non-profit directors who were part of the *danwei* system could have a sense of spiritual attachment and belonging to this system.<sup>864</sup> Accordingly, many may refuse to adapt to,

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<sup>859</sup> Bray, (n850)

<sup>860</sup> *ibid*

<sup>861</sup> *ibid*

<sup>862</sup> Xie, Lai and Wu, (n855) 288

<sup>863</sup> *ibid*

<sup>864</sup> Yang and others, (n686)

or accept, a new mechanism, particularly based upon Western governance. The *danwei* system therefore has the effect of impacting upon a director's independent thinking ability, creativity and decision-making skills.

#### 7.4.2.2.3 Professionalism and expertise

Professional knowledge and expertise, as we argued in 4.4, may be equally, if not more, important to non-profits in China than to organisations in the UK. Research indicates that without the assistance of professional directors, a non-profit board in China could be more likely to shift its governance towards Government control, owing to some of the historic factors addressed above.<sup>865</sup> However, compared to what may be expected of a UK-based blueprint, the Chinese non-profit would appear to show a contrasting attitude towards professionals on the board. The directors of Chinese non-profits are frequently inactive in their role, insofar as many know very little about their organisations and their duties or functions.<sup>866</sup> Evidence would appear to suggest that directors do not understand the importance of governance in the non-profit sector, primarily because the majority of Chinese non-profits do not believe they are part of the 'epistemic community' or community of experts.<sup>867</sup> Fieldwork statistics equally suggest that the majority of non-profits do not consider professional knowledge as an important tactic to improving board effectiveness.<sup>868</sup>

In spite of this complex understanding of professional knowledge that exists throughout China, non-profits have recently attempted to improve on matters pertaining to board professionalism. Research indicated that there has been a noted change in the recruitment policy of many Chinese non-profits over the past few years —more emphasis was placed upon candidates' professional knowledge.<sup>869</sup> Applicants are

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<sup>865</sup> This may include, but is not limited to, the overreliance on the Government's fund, a multitude of government representatives on the board, and the impact of *danwei* system.

<sup>866</sup> Huang and others, (n41)

<sup>867</sup> A Li, 'Critical Examination of the Legal Environment for Social Organisations in China', in Y Li (ed), *Freedom of Association in China and Europe* (Brill, 2005)

<sup>868</sup> Rather, building up long-lasting *guanxi* with government authorities is often perceived as being the primary tactic to influencing the Government's decision making; see K W Simon, 'Regulation of Civil Society in China: Necessary Changes after the Olympic Games and the Sichuan Earthquake' (2009) 32 *Fordham International Law Journal* 943

<sup>869</sup> G Peterson, 'Overseas Chinese and Merchant Philanthropy in China: From Culturalism to Nationalism' (2005) 1 *Journal of Chinese Overseas* 87, 88

usually now required to have higher educational qualifications in order to perform their role.<sup>870</sup> Despite the efforts made by many non-profits, cultural factors may get in the way of recruiting professional directors in China.<sup>871</sup> To be specific, the Chinese people tend to seek to create a harmonious working environment, and avoid conflict and disagreement.<sup>872</sup> As such, directors and managers do not like their opinions to be challenged, particularly by those fully-qualified professionals, who they may perceive as threatening their authority.<sup>873</sup> And so, empirical evidence indicates that when selecting from candidate directors, features such as personality, flexibility and their attitude toward authority and senior directors may outweigh an individual's professional knowledge and experiences.<sup>874</sup>

### **7.5 Board structure (anti-corruption committee)**

We have already been able to note some of the advantages that having a committee structure can bring to an organisation. However, in the context of China, this work argues there is a practical need for a specialist committee absent from the blueprint so far. This is, specifically, an anti-corruption committee. A wealth of recent literature in this area would appear to indicate that in countries with a high level of corruption, organisations do not normally have good corporate governance practices.<sup>875</sup> As a result, this work argues that the blueprint proposed should be adapted to include a requirement that boards create an *anti-corruption committee* as a primary part of the sub-committee structure.

Of course, many might argue that almost every country, including the most advanced democratic one, with well-developed institutions, may and often do encounter corruption scandals. Corruption, it has been said, is 'the humiliation of agents due to

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<sup>870</sup> Interestingly, non-profit boards, particularly those of a reasonable size and reputation, are typically interested in the recruitment of retired professionals, prominent researchers, and famous entrepreneurs.

<sup>871</sup> Hay, Adnan and Staden, (n740)

<sup>872</sup> *ibid*

<sup>873</sup> Huang and others, (n41)

<sup>874</sup> *ibid*

<sup>875</sup> F Modigliani and E Perotti, 'Security Markets Versus Bank Finance: Legal Enforcement and Investors' Protection' (2000) 1 *International Review of Finance* 81; J S Hellman, G Jones and D Kaufmann, 'Are Foreign Investors and Multinationals Engaging in Corrupt Practices in Transition Economies?' (2000) 11 *Transition* 4; X Wu, 'Corporate Governance and Corruption: A Cross - Country Analysis' (2005) 18 *Governance* 151; S Rose-Ackerman, 'The Political Economy of Corruption' (1997) 31 *Corruption and The Global Economy* 60, 67



the deficiency of moral principles'.<sup>876</sup> This may be, and often is, multifaceted and can be categorized on different scales, based on varied criteria. Nevertheless, as the research below will indicate, the corruption in China is currently much more serious compared to that in most Western countries, which indicates the importance of the anti-corruption committee to the non-profit governance.

To distinguish between corruption in China and Western countries, Friedrich classifies corruption into three levels depending on the types of exchange between partners, and the number of people involved. These are *petty corruption*, *grand corruption*, and *systemic corruption*.<sup>877</sup> Based on this classification, theorists insist that, within recent years, China has experienced a wave of systemic corruption, most of which has been of a very serious kind, whereas Western countries such as UK experience typically only petty corruption.<sup>878</sup>

Moreover, Rothstein claims corruption is more prominent in countries with weak anti-corruption laws, and particularly within emerging markets, such as China.<sup>879</sup> And, corruption is more common and accepted by society with a collectivist culture (such as China) since 'people in collectivist culture cannot recognize and reveal corrupt behaviours'.<sup>880</sup> The level of corruption in China could be further established by the result of the most recent anti-corruption campaign.<sup>881</sup> According to the Central Commission for Discipline Inspection in 2017, the campaign, launched in 2012, had

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<sup>876</sup> Braendle, Gasser and Noll, (n784)

<sup>877</sup> 'Petty corruption occurs at a smaller scale and takes place at the implementation end of public services when public officials meet the public. Examples include the exchange of small improper gifts or use of personal connections to obtain favours...Grand corruption is defined as corruption occurring at the highest levels of government in a way that requires significant subversion of the political, legal and economic systems. Such corruption is commonly found in countries with authoritarian or dictatorial governments but also in those without adequate policing of corruption...[S]ystemic corruption (or endemic corruption) is corruption which is primarily due to the weaknesses of an organisation or process. Factors which encourage systemic corruption include conflicting incentives, discretionary powers; monopolistic powers; and a culture of impunity'; see C J Friedrich, 'Corruption Concepts in Historical Perspective' in A J H M Johnston (ed), *Political Corruption: Concepts and Contexts*, vol 3 (Transaction Publishers 2002) 17

<sup>878</sup> S Yuen, 'Disciplining the Party: Xi Jinping's Anti-Corruption Campaign and Its Limits' (2014) *China Perspectives* 41

<sup>879</sup> B Rothstein, 'What Is the Opposite of Corruption?' (2014) 35 *Third World Quarterly* 737, 740

<sup>880</sup> This society's perception has been classified as white corruption. Concerning the society's perceptions, corruption can be classified as white, gray, and black. According to Collier, 'white corruption means that the majority of society, including its elite and the masses, would not punish the particular behaviour'; see Collier, (n839)

<sup>881</sup> Most of the officials investigated so far in the campaign were removed from office, facing accusations of bribery and abuse of power.

resulted in more than 100,000 individuals being indicted for corruption.<sup>882</sup> Nearly 2,600 fugitives have been extradited or repatriated, and 8.6 billion yuan in assets were recovered.<sup>883</sup>

Given the extensive corruption in the Chinese society and the argument towards *guanxi* above, the anti-corruption committee should be aware that any such anti-corruption process should be able to distinguish clearly a genuine *guanxi* from corrupt behaviour, and this distinction needs to be clearly specified by non-profits. Research carried out by Braendle, Gasser and Noll found that ‘*guanxi* can in many cases be interpreted as a borderline case of corruption’.<sup>884</sup> Indeed, as we have argued, although there have been a number of incidences in which *guanxi* have been abused, naturally it would be irrational to consider every *guanxi* as the prospective source of corruption per se.

## 7.6 Board meeting

In the Chinese context, the decision-making process of non-profits could be shaped by contextual factors such as collectivism, *guanxi*, *mianzi* and *Confucianism* in the following ways. Firstly, the Confucianism, which places emphasis upon a ‘rigid social hierarchy’ and ‘deference towards leaders’, encourages top–down control.<sup>885</sup> This top-down control leadership model may also be understood as paternalism, with leaders telling people what to do and those people tend to do as they are told, unquestioningly.<sup>886</sup> At the same time, seniors/leaders in an organisation do not expect or appreciate being challenged by their junior colleagues.<sup>887</sup> As a result, this model in non-profit boards is likely to create strong barriers to communication between senior directors (such as the chair of the board) and juniors within the boardroom, and thus reduce information flow in the decision-making process.<sup>888</sup>

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<sup>882</sup> C Wang, 'The Establishment of a Legal System in Anti-Corruption Campaigns in the Early Days of the New China' (2014) 7 *Tsinghua China Law Review* 101

<sup>883</sup> Yuen, (n878)

<sup>884</sup> Braendle, Gasser and Noll, (n784) 393

<sup>885</sup> Li, (n765) 587

<sup>886</sup> J-L Farh and B-S Cheng, 'A Cultural Analysis of Paternalistic Leadership in Chinese Organizations', *Management and Organizations in the Chinese Context* (Springer 2000)

<sup>887</sup> *ibid*

<sup>888</sup> *ibid*

Secondly, frankness, arguments and conflicts are not appreciated during the board meeting. And so many do not want to give their opinions in public. Li *et al* recount how one corporate manager in China complained, with regard to board meetings, that ‘no matter how much fellow colleagues may attempt to encourage others to participate in the meeting, they will sit there, smiling politely...Board members will not tell you when they do not understand’.<sup>889</sup> Fear of losing face and damaging *guanxi* are often cited as reasons for Chinese unwillingness to deal with problems openly and directly. As Warner noted, directors always attempt to ensure that they can retain ‘face’ (or *mianzi*) in the presence of people of greater or similar seniority.<sup>890</sup> However, this passive reaction of directors tends to lead to real discussion happening outside of the meeting, which could significantly reduce the information flow and creativity within the boardroom.

Hall, a pioneer cross-culture researcher, explains all these typical individual performances in the Chinese context as follows.<sup>891</sup> Individuals could be heavily affected by the context of the society they are living in.<sup>892</sup> For example, Western countries belong to low-context societies, which are typified by high levels of forthright and explicit communication and the verbal and written communication of rules and norms.<sup>893</sup> China belongs to the high-context societies, in which the most important principal ‘when dealing with business associates with who one must maintain working relationships’ is to ‘preserve harmony through deference, courtesy, and indirection’.<sup>894</sup>

To deal with it, Warner suggested that the board meeting be held within a small group involving only the most relevant directors.<sup>895</sup> This can help to create a relatively relaxed environment to avoid directors’ pressure of proposing difficult questions and arguments. Through this approach, *guanxi* could be preserved, as well as *mianzi*. In

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<sup>889</sup> K Goodall, N Li and M Warner, 'Expatriate Managers in China: The Influence of Chinese Culture on Cross-Cultural Management' (2006) 32 *Journal of General Management* 57, 60

<sup>890</sup> *ibid*

<sup>891</sup> M Warner, 'Human Resource Management in China Revisited: Introduction' (2004) 15 *The International Journal of Human Resource Management* 617, 622

<sup>892</sup> Hall, (n742)

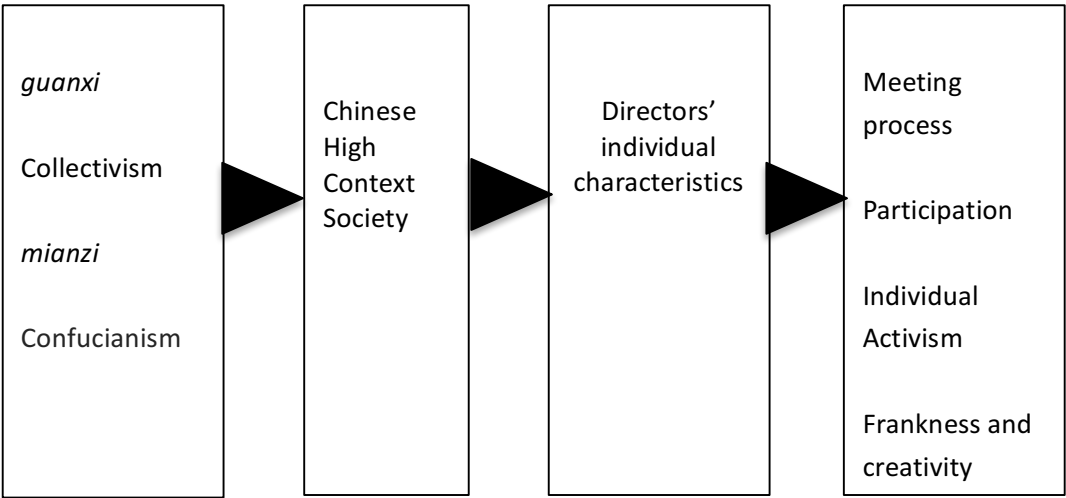
<sup>893</sup> *ibid*

<sup>894</sup> N Pacek and D Thorniley, *Emerging Markets: Lessons for Business Success Andthe Outlook for Different Markets*, vol 18 (John Wiley & Sons 2007) 158, 163

<sup>895</sup> Warner, (n891) 620

addition, small group discussions are an alternative approach that can encourage individuals to voice their opinions without the fear of embarrassment. To better understand the interaction between these Chinese social determinants and board meeting processes, relevant factors can be identified in Table 7.3 as follows.

**Table 7.3 Board meeting process and social factors**



**7.7 Conclusion**

Contextual factors could affect the performances, choices and behaviours of individuals in the Chinese society. Values such as *guanxi*, corruption, face and collectivism embedded in the China have proven to have significant impacts on the governance regime in non-profit organisations. This chapter presents solid evidence on the influence of contextual factors in shaping the governance mechanism in the Chinese non-profits. In Chapter 7, we attempt to challenge the conventional wisdom on the influence of social factors and its relationship to the performance of non-profit governance. During the process, we are able to establish a tailored governance blueprint for Chinese non-profits to follow.

## Chapter 8 | Reviewing non-profit regulations in the Chinese context

### 8.1 Introduction

As the discussion in Chapter 6 has demonstrated, the last two decades have witnessed a significant rise in Chinese non-profits, particularly insofar as the scale and scope of their work in China is concerned. In spite of the great efforts made by non-profit practitioners, the legal framework governing the Chinese non-profit sector has long been criticized as being extremely vague, lacking in detail, disclosure requirements and any coherent form of governance structure.<sup>896</sup> Chinese legislators are now largely aware of this fact, and have posited various reforms to different aspects of the non-profit sector.<sup>897</sup> Meanwhile, various measures have been adopted over recent years to foster partnership between the Chinese Government and non-profit groups, which is a significant departure from previous practices.<sup>898</sup>

Since the presence of, and ideas behind, non-profits in China are generally less developed, and therefore attract little attention within academic circles, often this has meant little or no research has been carried out in relation to comprehensively reviewing regulations in this sector.<sup>899</sup> As mainstream academic literature in China tends to focus on predicting the attitude of the Chinese Government, analysing every detailed aspect of law and regulation in relation to this and its implementation, this has meant little has been done from the outset of exploring strategies to improve non-profit governance itself. And very little attention has been focused upon the matter of how could non-profits counterbalance the power and intervention of the Chinese Government.

However, given the current performance of non-profit boards in China, improving board governance would appear to be particularly urgent and important. As we shall

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<sup>896</sup> Wu, (n875)

<sup>897</sup> Hasmath and Hsu, (n34) 49

<sup>898</sup> For instance, the Plan was officially released in the 25<sup>th</sup> session of the National People's Congress in 2013. This plan incorporates significant content on legislation that affects the Chinese non-profit sector. Also the Charity Law 2016, as the greatest reform to the non-profit sector in China, enacted in March 2016; see The State Council Institutional Reform and Transformation of Functions Plan, 'Plan for the Institutional Restructuring of the State Council and Transformation of Functions Thereof' (*China's leader in online legal research*, 2013)

<<http://www.lawinfochina.com/display.aspx?lib=law&id=13554&CGid>> accessed 02 March 2016

<sup>899</sup> Gazley and Kissman, (n291)

note in the following analysis, compared to those good practices in many Western countries, the non-profit board in China often fails to play its role effectively. For example, a non-profit board in China has no power to dismiss itself, nor does it have the influential decision-making power over the non-profit governance and management.<sup>900</sup> Hence, the politically weak board in China has long been criticized to be ‘ineffective in supervising directors and managers who are often appointed by, and generally have good connections with the Government’, the major funder of many non-profits.<sup>901</sup> In this respect, although the Amendments of the Company Law 2005 gives more power to the board, it does not provide any relevant practical instrument/mechanism to exercise the monitoring power.<sup>902</sup>

Accordingly, this work has opted not to follow the mainstream, and shall instead aim to test whether the current legal framework has underperformed and is counterproductive. To achieve this, this chapter will list relevant regulations in this area to consider whether they are able to satisfy the blueprint proposed. In doing so, this chapter is divided into three sections. Section 8.2 briefly summarizes the legal system for non-profits in China; section 8.3 reviews regulations in relation to Chinese foundations under a modified blueprint; and section 8.4 then examines the performances of SOs and CNIs.

## 8.2 Non-profit legal regulations and our research focus

The most important regulations in relation to non-profits in China are the ‘*Regulations on the Management of Foundations*’<sup>903</sup> (herein, the Foundation Regulations), the ‘*Regulations on the Registration and Administration of Social Organisations*’<sup>904</sup> (the SO regulations), and ‘*Temporary Regulations on Registration and Administration of*

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<sup>900</sup> Despite the fact that the Chinese Company’s Law 1993 itself assumes a monitoring role as to supervise the conduct of directors and managers, the non-profit board cannot actually well play the role. *ibid* 136

<sup>901</sup> Shi, (n746)

<sup>902</sup> *ibid* 172

<sup>903</sup> The Regulations on the Management of Foundations[基金会管理条例] (the Foundation Regulations hereafter)

<sup>904</sup> Regulations on the Registration and Administration of Social Organisations[社会团体登记管理条例] (the SO Regulations hereafter)

*Civil Non-business Institutions*<sup>905</sup> (the CNI Regulations). Since the Charity Law 2016 only came into force in September 2016,<sup>906</sup> this Chapter 8 shall omit any discussion of that Act. Instead, Chapter 9 considers the Act as a whole, making a comprehensive discussion. This chapter will predominately focus on the first three regulations to explore the extent to which these may be regarded as helping to improve non-profit board governance in China.

Ahead of doing so, we shall narrow the scope of our research by addressing the type of board.

In contrast with the UK non-profit sector that operates using a one-tier board system, the Chinese legal system (both profit-based and non-profit organisations) imposes a two-tier board structure. In China, two separate boards of directors (the supervisory board and management board) work together in order to govern a business.<sup>907</sup> The role accorded to the board in our blueprint largely corresponds to the function of the supervisory board under the Chinese legal system. Accordingly, in our discussion here, we shall consider the roles and attributes of the supervisory board in the non-profit sector. When doing so, we shall use the term ‘board’ (except where we mention the executive board specifically) to mean the supervisory board.

### **8.3 Regulations on Chinese foundations**

#### **8.3.1 Foundations**

The Foundation Regulations, which came into effect in 2004, were the first comprehensive national rules on the subject to be issued in over 15 years.<sup>908</sup> These Regulations replaced the Rules on the Management of Foundations<sup>909</sup> (hereafter

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<sup>905</sup> Temporary Regulations on Registration and Administration of Civil Non-business Institutions [民办非企业单位登记管理暂行条例] (the CNI Regulations hereafter)

<sup>906</sup> It is statute of the non-profit sector. So the full implementation and effect of the law itself remain difficult to predict as yet. Discussion of the three important regulations in Chapter 8 shall serve as a comparison with discussion of the Charity Law 2016 in Chapter 9.

<sup>907</sup> The supervisory board is responsible for advising and monitoring management, strategy process and long-term decision making, while the management board (or executive board) works for the day-to-day management and operation; see Shi, (n746)

<sup>908</sup> W Cheng, 'One and Two-Tier Governance Systems' (*BT invest*, 11 April 2014)

<<http://www.btinvest.com.sg/specials/boardroom/one-and-two-tier-governance-systems/>> accessed 26 March 2015

<sup>909</sup> Measures for the Administration of Foundations [基金会管理办法] (the Foundation Measures 1988)

Foundation Rules 1988). The latter were widely regarded as extremely short and vague.<sup>910</sup> When compared with the Foundation Rules 1988, the Foundation Regulations provide a relatively comprehensive administrative regime, such as foundation classifications, disclosure requirements, and relevant governance structures.<sup>911</sup> Accordingly, this section shall consider the effect Foundation Regulations have had in the Chinese context.

The meaning of the word ‘*foundation*’ varies according different jurisdictions. In the UK, for example, Keen notes that whilst the term appears in the names of some charities (e.g. the British Heart Foundation), it is ‘not commonly used in English law, and (unlike in civil law systems) has no precise meaning.’<sup>912</sup> In China, the Foundation Regulations define foundations as ‘non-profit legal persons, which [...] utilize assets donated by natural or legal persons or other organisations to pursue a public benefit purpose’.<sup>913</sup> Foundations in China can be divided into one of two sorts, *fundraising* and *non-fundraising* ones.

The former Foundation Measures 1988<sup>914</sup> stated that all foundations were expressly granted the right to raise funds, and ‘the amount of uniform endowment capital was prescribed as RMB 100,000 Yuan (circa US\$ 17,000)’.<sup>915</sup> However, this rule has been replaced by the Foundation Regulations that hold a notably ‘restrictive stance’. In the Foundation Regulations, the endowment capital requirement is connected with the permission to raise fund in a unique approach, through which it introduced a new classification of foundations. This classification distinguishes between non-fundraising/endowment foundations, which are not permitted to raise funds publicly, and fundraising-oriented foundations, which may raise funds publicly.<sup>916</sup> The fundraising-oriented foundations could be further divided into two groups based on ‘whether they can raise funds nationally’ or only in the particular area where they are

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hereafter)

<sup>910</sup> Von Hippel and Pissler, (n664) 451

<sup>911</sup> Based upon the efforts of researchers and MoCA officials, changes in the Foundation Regulations reflect an attempt by the Chinese Government to reform this area of law, demonstrating a more open and welcoming attitude towards the public participating in the non-profit activities.

<sup>912</sup> Von Hippel and Pissler, (n664) 449

<sup>913</sup> Official Commentary on Foundations, reg 52

<sup>914</sup> Measures for the Administration of Foundations [基金会管理办法]

<sup>915</sup> Foundation Measures 1988, reg 3 (2)

<sup>916</sup> Foundation Regulations 2004, reg 3 (1)



firstly registered.<sup>917</sup>

Foundations in China bear a variety of features which make them different to SOs and CNIs. The first and foremost of these is their membership. Since there is no provision in the Foundation Regulations describing this matter, the actual practices imply a fact that foundations do not have a membership in China.<sup>918</sup> Accordingly, unlike SOs that are membership-based, foundations are typically financial institutions.<sup>919</sup>

Second, the Foundation Regulations hold that a Chinese foundation may only pursue purposes with a public benefit, which is again different from CNIs.<sup>920</sup> However, the Foundation Regulations remain silent on which purposes may be considered as being for the public benefit. Based on the Official Commentary on Foundations, ‘reference may be made to the designated public benefit purposes in the Donation Law of 1999,<sup>921</sup> which covers a wide range of social aspects’.<sup>922</sup> According to the official statistical data on different organisational forms of non-profits in China, there has been a steady decline in the number of foundations formed until 2004, when the Foundation Regulations 2004 were enacted.<sup>923</sup>

### 8.3.2 Board size

Foundation Regulations delineate the expected board size by noting ‘...foundations must have an *executive board* composed of 5-25 directors’.<sup>924</sup> Similarly, foundations must consist of a supervisory board which is primarily responsible for monitoring, advising and long-term decision-making. Unfortunately, in contrast with the specific

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<sup>917</sup> Administrative regions are, within provinces, autonomous regions and municipalities directly under the central government of China; see Foundation Regulations 2004, reg 3 (2)

<sup>918</sup> R Keen, *Charity and the Voluntary Sector: Statistics* (House of Commons Library, 2015) <<http://researchbriefings.parliament.uk/ResearchBriefing/Summary/SN05428#fullreport>> accessed 23 March 2016

<sup>919</sup> *ibid*

<sup>920</sup> Foundation Regulations 2004, reg 3 (1)

<sup>921</sup> Donation Law 1999, reg 3

<sup>922</sup> That is: ‘disaster relief, poverty alleviation, assistance to the handicapped, and other activities for SOs and individuals in difficult circumstances; education, scientific, cultural, public health, and sport undertakings; environmental protection and construction of public facilities; and other public welfare undertakings promoting social development and progress’; see Foundation Regulations 2004, reg 4 (1)

<sup>923</sup> Von Hippel and Pissler, (n664) 437

<sup>924</sup> Foundation Regulations 2004, reg 5 (3)

requirement on the size of the executive board, Foundation Regulations fail to specify the number of directors in the supervisory board. In other words, this gap in the law enables foundations to elect their desired number of directors to the supervisory board, which may vary significantly. As the discussion in section 7.3 suggested, a large supervisory board may better facilitate fund raising in the Chinese context, given the complex *guanxi* and a heavy Government intervention that exists surrounding non-profits in China. However, the Foundation Regulations apparently fail to account for the pitfalls of an oversized board, particular in terms of cost, or by encouraging group-thinking in the decision-making process.

### **8.3.3 Board characteristics**

#### **8.3.3.1 Director independence**

Evidence pertaining to the importance of director's independence was summarized in section 7.4. The Foundation Regulations, in order to guarantee the independence of directors from one another, provide that:

‘For non-public foundations established with private properties, the total number of foundation board members that have close relatives with each other may not exceed 1/3 of the full board. For other foundations, those who are close relatives with each other may not serve the board concurrently’.<sup>925</sup>

The use of ‘*board member*’ in this context refers to the executive board. In terms of the supervisory board, the requirement in the Foundation Regulations is stricter than that of the executive board:

‘A foundation shall set up the position of supervisors. Term of office of a supervisor is the same as that of a board member. No board member, or close relative of any board member or accounting staff member of the foundation may concurrently hold position as supervisor’.<sup>926</sup>

Building upon this, the Foundation Regulations also list special situations that may

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<sup>925</sup> Foundation Regulations 2004, reg 2 (20)

<sup>926</sup> Foundation Regulations 2004, reg 2 (20)

affect a director's independent judgment:

‘Where personal interests of any board member of a foundation are related to interests of the foundation, such board member may not participate in decision-making of related issues. None of the board members or supervisors or their close relatives may be engaged in any transactions with the foundation they are serving’.<sup>927</sup>

Thus, the Foundation Regulations do legally emphasize the importance of directors' independence. Most directors both in the executive and supervisory board are prohibited from working with those with whom they have a close family relationship. However, it is noteworthy here that the requirement on the executive board is less strict than the supervisory board. Foundation Regulations do not require all directors to be relationally independent; rather, non-public foundations can institute an exemption that allows for ‘*a quarter of directors to have close family tie*’.<sup>928</sup> Research presumes that this may be because the Foundation Regulations have already taken account of the social factors we addressed in the modified blueprint (e.g. *guanxi* and Chinese collectivism), and link them with director's independence.<sup>929</sup>

However, deficiencies in this particular article of the law would seem obvious. Firstly, although close family relationships between directors are restricted in foundations, these articles above fail to officially specify what constitutes a ‘close family relationship’. A variety of Chinese regulations attempt to define this concept in different legal contexts and in different approaches.<sup>930</sup> Unfortunately, these regulations fail to reach an agreement, and none of them provides a clear and specific explanation. For example, there are distinctiveness and contradictions between the ‘General Principles of Civil Law 1988’ and ‘Provisional Measures on the Administration of Disclosure by Trust and Investment Companies 2005’.<sup>931</sup>

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<sup>927</sup> Foundation Regulations 2004, reg 2 (20)

<sup>928</sup> Foundation Regulations 2004, reg 2 (5)

<sup>929</sup> Kaur, (n646)

<sup>930</sup> The People's Supreme Court Opinion on Several Questions of the Implementation of the ‘People's Republic of China General Principles of Civil Law’ (trial implementation), art 12

<sup>931</sup> On the one hand, the General Principles of Civil Law 1988 state that ‘close relatives include spouses, parents, children, siblings, grandparents and grandsons’. On the other hand, provisional Measures on the Administration of Disclosure by Trust and Investment Companies 2005 holds that ‘close relatives’ in these measures include parents, spouses, siblings and their spouses, children past the age of majority and their spouses, parents of spouses, siblings of spouses and their spouses, siblings of parents and their

Secondly, since the Foundation Regulations have allowed for the existence of individual connections and family ties, approaches to evaluating the director's independence of judgment need to be further specified. Regulations could also provide a set of standards to distinguish positive *guanxi* from negative *guanxi*.<sup>932</sup> This standard would appear to be particularly important to foundations in China. Unlike non-profits in the West, which are mostly privately initiated, a great many foundations in China were transformed by China's state-owned enterprises/government departments. Consequently, a large proportion of board members were government officials. Such government related experience enables directors of this kind to have increasing connections with the Chinese Government, even if they are not working for the Government itself.<sup>933</sup> Therefore, how to define and require director's independence of judgment in this context should ideally be clearly outlined within the Foundation Regulations.

Unfortunately, the Foundation Regulations, as the most fundamental set of legal rules in this area, fail to detail any specific approach which secures directors' independence as such. There is an absence of requirement such as whether directors who have been employees of the company previously, have had or still have a material relationship with organisations before, or have a partner or relative within the organisation they serve, may be considered independent. This requirement for benchmarking was emphasized in the blueprint, which details the need to promote director integrity, accountability and effective oversight.<sup>934</sup> As argued in 7.4.2.1, without such restrictions, directors may be at risk of making biased decisions that present a conflict of interest, or the undue influence of interested parties.<sup>935</sup>

Admittedly, the benchmark for directors' independence can vary depending on the changing social contexts, and it is not always possible to explicitly cover all factors

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spouses and the children past the age of majority of siblings of spouses and their spouses'. General Principles of Civil Law 1988, s6; Provisional Measures on the Administration of Disclosure by Trust and Investment Companies 2005, art 9

<sup>932</sup> As we have argued in 7.4.2, this could help non-profits to secure directors' independence of judgement without sacrificing directors' boundary spanning skills.

<sup>933</sup> Huang and others, (n41) 50

<sup>934</sup> Von Hippel and Pissler, (n664) 437

<sup>935</sup> The legal silence is likely to give directors the impression that they can build and rely upon any kind of *guanxi* (both positively and negatively) rather than opting to behave independently.

influencing a director's independence through the Foundation Regulations. However, addressing a few typical cases within the regulations and official legal explanations with respect to what may at least give the impression to non-profits and the public that a director's independence has been breached would prove of use.<sup>936</sup> For instance, Chapter 5 listed a range of UK regulations encouraging the director's independent judgment. *The Model Statute of Non-profit Sector* also recommends that circumstances such as interlocking directorate and conflicts of interest within non-profits should be listed within the Foundation Regulations.<sup>937</sup>

### **8.3.3.2 Government representatives**

Chapter 7 detailed some of the advantages and disadvantages of Government representatives and professional directors sitting on boards. In terms of professional directors, although discussion in Chapters 4 and 7 have emphasized the importance of professional knowledge and the role this has in board governance, the Foundation Regulations fail to specify an entry requirement on the qualification of candidate directors. In practice, even though many foundations will have indicated their preference for recruiting directors with high qualifications, the importance of professional directors has not been fully realized.<sup>938</sup> This section shall mainly concentrate on the government representatives and examine relevant legal regulations as they apply in the present context.

#### **8.3.3.2.1 Departure from the Foundation Regulations**

Discussion within section 7.4.2.2 has already indicated how including government representatives on the board may help facilitate fund-raising collection and thus improve the boundary-spanning role of non-profits. However, based on the previous argument in 7.4.2.2, there is little doubt that overreliance on the Government will undermine a foundation's independence, and with it the risk of becoming the government-affiliated institutions. Some 41% of respondents to a survey conducted in

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<sup>936</sup> Von Hippel and Pissler, (n664) 438

<sup>937</sup> Huang and others, (n41)

<sup>938</sup> J Chen, J Jin and P Liu, *The Recommended Model Statute of Non-Profit Sector* (Social Sciences Academic Press 2010)

2012 observed that the Government in China moderately supervises and controls board activities in foundations through its introduction of representatives.<sup>939</sup> At the same time, the chairperson to most foundations is often equipped with a strong government background and connections.<sup>940</sup>

However, the Foundation Regulations only state that ‘...*current government officials may not concurrently become Chairperson, Vice Chairperson(s) or the Secretary General of a foundation*’.<sup>941</sup> At first sight then, the regulations would appear to conform with the blueprint proposed, as it seeks to prevent interventions from the Government. However, this is not without a number of identifiable weaknesses. Firstly, it is unclear who may be regarded as ‘*government officials*’. Based on the Official Commentary on Foundations, the general and vague definition of ‘government officials’ is the same as that applied under Chinese Criminal Law, which need to ‘be construed more narrowly in its application to foundation law’.<sup>942</sup> Secondly, the Foundation Regulations fail to control the total number of government representatives, nor do they specify the positions, power and functions of government representatives on the board. Even if the Government, as one among a number of potential non-profit stakeholders, is permitted to place representatives on the board, the number of representatives and the extent to which it is involved in governance activities is inconsistent with the blueprint.

### **8.3.3.2.2 Discretionary authority by the Chinese Government**

In addition to the vagueness and ambiguity of the Foundation Regulations regarding the matter of government representatives, the abuse of the ‘*discretionary authority*’ by the Chinese Government also indicates a departure from the blueprint (see section 7.4.2.2.1). By ‘discretionary authority’, this refers to ‘*the ability to exercise powers that may not be expressly granted by law*’.<sup>943</sup> Research indicates that ‘discretionary

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<sup>939</sup> Guo and Zhang, (n38)

<sup>940</sup> Han, (n37) 216

<sup>941</sup> Huang and others, (n41) 165

<sup>942</sup> People’s Republic of China Criminal Law [中华人民共和国刑法], s93

<sup>943</sup> R J Estes, *Emerging Chinese Foundations: The Role of Private Philanthropy in the New China* (Aspen Institute 1998)

authority commonly extends beyond government offices'.<sup>944</sup> Government often executes its discretionary authority through those government related agencies, which may include 'central banks, internal revenue services, antitrust authorities, public prosecutors and energy regulators'.<sup>945</sup> Those government agencies in the West may be regarded as organisations 'in the machinery of government with a certain amount of autonomy and independence from political influence in the execution of their functions in oversight and administration'.<sup>946</sup>

The legal regulations would often 'leave considerable freedom to these institutions to choose among different possible courses of action according to their own judgement'.<sup>947</sup> However, this authority should obviously be subject to restrictions and limitations. For example, many bureaucratic functions of the British government 'are written policies regarding the liberties and limitation of their discretionary authority'.<sup>948</sup> In addition, 'those government related agencies may only exercise discretionary authority when certain conditions are met, although they are not required to exercise their power of discretionary authority at any time'.<sup>949</sup>

However, there is a danger that either the government or these agencies may abuse/misuse the discretionary authority for 'illegitimate purposes' such as a repression of political sensitive business activities. These business activities, as research indicates, are supposed to be managed by mechanisms from commercial market. Theorists also define "an excessive level of involvement as 'big government'".<sup>950</sup> In China, the existence, and potential misuse of, discretionary authority in respect of foundations can be identified from the perspective of two areas: *negative administrative power* and the *dual management system*.

As to the first of these, although the Foundation Regulations have clearly outlined

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<sup>944</sup> M P Schinkel, L Tóth and J Tuinstra, 'Discretionary Authority and Prioritizing in Government Agencies' (2015) Amsterdam Center for Law & Economics Working Paper 2014

<sup>945</sup> *ibid*

<sup>946</sup> N Rose and P Miller, 'Political Power Beyond the State: Problematics of Government' (1992) *British Journal of Sociology* 173

<sup>947</sup> Schinkel, Tóth and Tuinstra, (n945) 5

<sup>948</sup> D Levi-Faur, 'From "Big Government" to "Big Governance"' (2012) *The Oxford handbook of governance* 3

<sup>949</sup> *ibid*

<sup>950</sup> Schinkel, Tóth and Tuinstra, (n945) 7

requirements for an organisation to register as a foundation, neither the Chinese Constitution nor Foundation Regulations grant a positive right to establish a foundation. Instead, this right belongs exclusively to the Chinese Government. The department of the Government maintains discretionary authority to review the qualifications for applicant organisations, and can withhold approval of establishment even when all legal requirements have been satisfied.<sup>951</sup>

This may be supported by the *second point – the dual management system* which leads to excessive government intervention. Under Article 6 and 7 of the Foundation Regulations,<sup>952</sup> a so-called ‘sponsor organisation’ is involved alongside the Government body in charge of the Foundation Registrations. This dual management system is a unique feature to the Chinese Government – a non-profit supervision mechanism, which is applied to foundations, SOs and CNIs since 1998. Upon filing an establishment application with the competent registration and administrative authority, the establishment of any foundation in China must gain an initial consent from a sponsor institution, which is normally Government related agencies.<sup>953</sup>

The deficiencies of this dual-management system seem to be apparent. Firstly, the entry criteria are unspecified and obscure, which gives government related agencies too much discretionary authority to make decisions. Put differently, government agencies are able to decide whether applicant organisations are competent to get registered depending on their personal (maybe subjective) judgement. The dominant position of the Government in relation to foundations derives from its ability to threaten the withholding of consent.<sup>954</sup> From another perspective, the monopoly of the government sponsored foundations all across China clearly indicates the abuse of this discretionary

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<sup>951</sup> Guo and Saxton, (n734)

<sup>952</sup> Regulations 6 and 7 in Foundation Regulations note that: ‘The Ministry of Civil Affairs of the State Council and departments of civil affairs under provincial, autonomous regional and municipal people's governments shall be the authorities in charge of registration of foundations’. Relevant departments of the State Council or organisations authorized by the State Council are competent to act as the professional supervisory organisations of foundations and representative offices of overseas foundations that have registered with the Ministry of Civil Affairs of the State Council’. Foundation Regulations 2004, reg6, and reg7

<sup>953</sup> Foundation Regulations 2004, reg 6 (34)

<sup>954</sup> CDB, ‘Charity Law Draft Limits Public Fundraising Foundations’ Management Fee to 10% of Expenditures’ (*China Develop Brief*, 14 March 2016) <<http://chinadevelopmentbrief.cn/news/charity-law-draft-limits-public-fundraising-foundations-management-fee-to-10-of-expenditures/>> accessed 13 May 2016



authority. According to the statistics in 2013, more than one thousand fundraising foundations, charities and more than two thousands semi-official Red Cross organisations which were founded by the Chinese Government monopolized over 90% of donated resources in China.<sup>955</sup> These organisations were mostly controlled by the Government, which in turn meant many private charitable organisations were left short of resources.

### **8.3.3.2.3 Efforts to reduce the discretionary authority**

In spite of the government's discretionary power authorized by Foundation Regulations, there is a tendency that in the last few years, the Chinese Government has gradually withdrawn its discretionary authority over non-profit governance. Firstly, the voice of those advocating the abolition of these complex and time-consuming administrative mechanisms would appear to be becoming increasingly stronger. The Government has demonstrated a willingness to loosen control over the administrative process of non-profits, and has sought to create a relatively open and free environment for non-profits to operate within.<sup>956</sup> The Chinese Government has endeavoured to make the administrative apparatus leaner and more efficient. The biggest step forward here has been the enactment of the Charity Law 2016, which shall be discussed in Chapter 9.

Moreover, several mechanisms have been brought in to force over the last decade in order to facilitate the registration and application of foundations. For example, as we have mentioned, to register as an officially recognized non-profit, organisations must find a qualified sponsor which has always been difficult. In 2013, the MoCA itself was permitted by the Government to act as the sponsor in a number of cases, which obviously encouraged a great number of private foundations to register.<sup>957</sup>

The other major improvement here has been the Government's advance of the '*State Council Institutional Reform and Transformation of Functions Plan*' (Plan 2013

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<sup>955</sup> Schinkel, Tóth and Tuinstra, (n945)

<sup>956</sup> Guo, (n36)

<sup>957</sup> Such as Heung Kong Bright Future Foundation, Huamin Charity Foundation, and the Aiyou Huaxia Charity Foundation.

hereafter), which has been regarded as a symbolic piece of legislation and an important piece of government guidance.<sup>958</sup> Plan 2013, with the objective of developing Chinese philanthropy, sends a clear message to the public that the Government has officially accepted the tremendous growth of the non-profit sector, confirmed its contribution to society, and is now ready to reform this sector.<sup>959</sup> It sheds light on the social reform that China is likely to witness within the coming years. Indeed, it makes clear the government has prepared to replace the dual management system with the one level administration system (minus the supervisory unit), as previously discussed.<sup>960</sup> However, Plan 2013 also pinpoints that the reform outlined will only be taken with consideration to four categories of social organisation.<sup>961</sup> This four-category restriction has been criticized as being against the nature of Chinese citizens' human rights of free association – this being that all non-profit institutions regardless of their organisational objectives should be treated equally.

#### 8.3.4 Board structure

On the matter of board structure, the Foundation Regulations apply a two-tier system and suggest that appointing a supervisory board is a compulsory requirement.<sup>962</sup> Owing to the more sustainable management of foundations, the application of a two-tier system is generally thought to achieve an improved compliance of the social market system, the result of which is more monitoring, less aggressive performance targets and a dissemination of power by not allowing the CEO to be the chairman.<sup>963</sup> With respect to anti-corruption, discussion in section 7.5 detailed the proposition of the committee, however there has been no particular mention of this in the Foundation Regulations. Following the extremely negative impact of the Red Cross foundation scandals, the anti-corruption campaign in recent years has already listed the Chinese foundation as a

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<sup>958</sup> The State Council Institutional Reform and Transformation of Functions Plan, 'Plan for the Institutional Restructuring of the State Council and Transformation of Functions There of' (China's leader in online legal research 03 October 2013)

<sup>959</sup> Chao Guo, Jun Xu, David H S and Zhibin Zhang, 'Civil Society, Chinese Style: The Rise of the Non-profit Sector in Post-Mao China' <<http://non-profitquarterly.org/2012/10/25/civil-society-chinese-stylethe-rise-of-the-non-profit-sector-in-post-mao-chinaby/>> accessed 23 March 2016

<sup>960</sup> *ibid*

<sup>961</sup> These include 'trade of associations and chambers of commerce, science and technology organisations, public welfare and charitable organisations, or community service organisations'. These four types of organisations are estimated to cover over 80% of Chinese non-profits; see *ibid*

<sup>962</sup> Foundation Regulations 2004, reg 22

<sup>963</sup> Guo, (n36)

top monitoring target, and investigations have since been carried out nation-wide. Accordingly, in line with the amended blueprint, this work suggests that establishing an anti-corruption committee in foundation boardrooms would prove promising for the future.

### **8.3.5 Board process**

Article 9 of the Foundation Regulations details a number of requirements concerning the process of board meetings.<sup>964</sup> However, the Foundation Regulations do not address the matters we discussed in the blueprint. It seems that the Regulations intend to offer enough flexibility for foundations to choose and design their own form of decision-making process as to ensure such a requirement works in accordance with their preference.

## **8.4 Regulations on SOs and CNIs**

### **8.4.1 Introduction**

Regulations concerning SOs and CNIs are very similar. We shall therefore address these organisations together. Indeed, the vast majority of the articles contained in the CNI Regulations, particularly with respect to board governance, are a direct copy of the SO Regulations, without any further adaptation. Accordingly, to begin, this section shall briefly summarize in section 8.4.2 the key characteristics of SOs and CNIs and identify their different features compared to foundations. Following this, the legal regulations of SOs and CNIs will be examined in section 8.4.3. Before continuing to further examine SOs and CNIs, Table 8.1 below provides an outline of the following sections, summarizing the distinctive features of SOs/CNIs and the impact on board design:

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<sup>964</sup> Foundation Regulations 2004, reg 9 (4)

**Table 8.1 Board blueprint and SOs/CNIs**

Board attributes		SO/CNI features	Differences in Board design (Compared with blueprint of foundations)	
Board size		CNI and foundations --non-membership SO --membership based	SO board needs to consider stakeholder's interests, particularly their member's interests, can be larger than CNI's and foundation's	
Board characteristics	Director's independence	SO and CNI have less connected with the Government  Government could hold more suspicious attitude towards them	Take more efforts to connect with the Government→ achieve trust→ less intervention and more organisational independence	
	Director's identity	Government representatives	No unique feature that can bring significant difference	Cannot bring any difference in board design
		<i>danwei</i> system	No unique feature that can bring significant difference	Cannot bring any difference in board design
		Professionals	Due to the features above, SO/CNI needs more efforts to build and maintain <i>guanxi</i> with the Government	Recruit professional directors
	Board culture		No unique features that can bring significant difference	Cannot bring any difference in board design
Board structure		Establishing network with Government	Government connecting committee (Resource collection committee)	
Board process		No unique features that can bring significant difference	Cannot bring any difference in board design	

## 8.4.2 SOs and CNIs

### 8.4.2.1 SOs' purpose, characteristics and establishment

SOs are defined as ‘organisations voluntarily formed by Chinese citizens in order to realize a common intention by developing non-profit activities in accordance with their statutes’.<sup>965</sup> According to the SO Regulations themselves, ‘...social organisations’ (SOs) should ‘promote the construction of socialist material and spiritual civilization’.<sup>966</sup> Membership is seen as one central characteristic that distinguishes SOs from foundations and CNIs. Although SO Regulations do not refer to membership, in practice SOs are required to have and maintain members if they intend to be officially registered in China.<sup>967</sup> Although SO Regulations remain silent on whether SOs may undertake public fund-raising, research and practices indicate that SOs are permitted to receive donations and financial aid through public channels, such as ‘television, radio, newspapers, setting up collection boxes in public spaces, holding charitable performances, sales, competitions, gala dinners’.<sup>968</sup>

When compared to foundations, obtaining official registration as a SO is subject to more modest entry requirements. SOs are required to consist of at least 50 members, and must hold a capital of ‘RMB 30,000 yuan for local and inter-area SOs (RMB 100,000 yuan for national SOs)’.<sup>969</sup>

In addition to these requirements above, there are obstacles that SOs cannot always overcome. First, as with the foundation, the dual management system that we introduced in Chapter 7 is also applicable to SOs, which means the establishment of a

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<sup>965</sup> SO Regulations, reg2

<sup>966</sup> SO Regulations, reg2; also see, e.g., Bureau for Politics and Law of the Legislative Affairs Office of the State Council [国务院法制办法政司]/Non-profit Organisation Bureau of the Ministry of Civil Affairs [民政部民间组织管理局] (eds.), “Commentary on the Registration and Administration of Social Organisations” and the “Temporary Regulations on Registration and Administration of Civil Non-business Institutions” [《社会团体登记管理条例》《民办非企业单位登记管理暂行条例》释义] Beijing 1999 (cited as: Official Commentary on SOs and CNIs)

<sup>967</sup> SO Regulations, reg3 (29)

<sup>968</sup> Many studies also indicated that until now, in practice at least, the SO concept does not seem to be applied in strict manner. Indeed, there are many SOs that undertake public fund-raising, which appear to be more like foundations in accordance with the Western definition. For example, the China Charity Federation is registered as a social organisation.

<sup>969</sup> SO Regulations, reg10 (1)

SO is on the condition that it can have ‘the consent of a sponsor organisation’.<sup>970</sup> At the same time, the registration of a SO needs to be taken on the national level ‘either with the MoCA or with corresponding departments for civil affairs’.<sup>971</sup> Although this regulation has been annulled in some areas of China, the enforcement of this is really dependent upon the discretionary power of local government, which shall be discussed later. Secondly, unlike foundations, MoCA will only approve the establishment of a SO when ‘there is no pre-existing SO with the same purpose in the same administrative region’.<sup>972</sup> Moreover, the Commentary further adds that ‘blind competition’ can be taken between different SOs with the same objective in the same area.<sup>973</sup> However, there have been a number of changes to this regime which shall be discuss in the context of the Charity Law 2016 addressed in Chapter 9.

#### **8.4.2.2 CNIs’ purpose, characteristics and establishment**

CNIs were not introduced for use until 1998.<sup>974</sup> Much like SOs, CNIs are required to ‘promote the construction of socialist material and spiritual civilization’.<sup>975</sup> CNIs have no equivalent in Western countries. It remains unclear why this particular type of legal form was introduced in addition to SOs and foundations. It seems it may have been due to a particular historical gap, which has since been closed.<sup>976</sup> CNIs are broadly defined as ‘social entities carrying out social service activities of a non-profit nature, which are run by enterprises, institutional work units, social organisations, other social forces, or individual citizens using non-state assets’.<sup>977</sup> They are characterized in a non-profit

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<sup>970</sup> Huang and others, (n41)

<sup>971</sup> Only a small portion (less than 1%) of SOs are registered on the national level. See statistics of the NPO Affairs Bureau of the MoCA for the year 2006. Also see SO Regulations, reg 6

<sup>972</sup> SO Regulations, reg13 (2)

<sup>973</sup> SO Regulations, reg 13 (2); Also see, e.g., Bureau for Politics and Law of the Legislative Affairs Office of the State Council [国务院法制办政法司]/Non-profit Organisation Bureau of the Ministry of Civil Affairs [民政部民间组织管理局] (eds.).

<sup>974</sup> In August 1996, the General Office of the Central Committee of the Chinese Communist Party and the General Office of the State Council had already issued the “dual management system” for CNIs. Afterward the Circular served the MoCA as a guideline during the drafting process of the CNI Regulations, which were finally adopted in 1998. See Official Commentary on SOs and CNIs.

<sup>975</sup> CNI Regulations, reg 1

<sup>976</sup> The prohibition in the Foundation Measures 1988 against foundations operating an enterprise was so understood that even the operation of non-profit-oriented enterprises was not permitted. This would have created a gap that the organisation form of the CNI would close. Now, however, this gap no longer exists, at least since the Foundation Regulation, under which foundations may operate any form of business. Yang and others, (n686)

<sup>977</sup> CNI Regulations, reg1

oriented manner, offering a number of charitable services. The Official Commentary on SOs and CNIs indicates that CNIs may work in those fields such as ‘education’, ‘health and labour services’, and sometimes ‘legal services’.<sup>978</sup>

Much like any other non-profit, ‘there exists no positive right to establish a CNI’.<sup>979</sup> Moreover, according to the CNI Regulations, the dual management system should be applied to CNIs as well,<sup>980</sup> and the establishment of CNIs should also be taken in a national level by corresponding institutions (either the MoCA or the Civil Affairs department).<sup>981</sup> It seems that it is difficult to be registered as CNIs on the national level, for ‘even more than in the cases of foundations and SOs, only a tiny proportion (0.01%) of CNIs are registered on the national level with the MoCA’.<sup>982</sup> In order to fully comprehend the characteristics of foundations, SOs and CNIs, Table 8.2 sets out their differences.

**Table 8.2 comparison of SO, CNI, and Foundation**

<b>Aspects</b>	<b>Foundations</b>	<b>SOs</b>	<b>CNIs</b>
Establishment	Restrict entry requirement by Foundation Regulations	Lower entry requirement	Lower entry requirement
Legal framework	Foundation Regulation	SO Regulations	CNI Regulations
Membership	Non-membership	Membership	Non-membership
Relationship with Government	Relatively close	No connection	No connection
Board requirement	Compulsory	Optional	Optional

<sup>978</sup> The Official Commentary on SOs and CNIs explains that one characteristic of CNIs is to continuously provide services through an institutionalized organisational structure. In doing so, CNIs would be distinguished from SOs characterized by what the commentary terms a ‘loose institutionalized organisational structure’ (组织结构具有松散性) and non-regular activities.

<sup>979</sup> CNI Regulations, reg 1

<sup>980</sup> CNI Regulations, reg 8 (1)

<sup>981</sup> CNI Regulations, reg 6 and reg 7

<sup>982</sup> See statistics of the NPO Affairs Bureau of the MoCA for the year 2006.

### 8.4.3 Non-profit governance rules in SOs and CNIs

SO and CNI regulations are considered to be an out-dated, vague and temporary set of regulations which remain silent on the subject of board governance. The original regulation governing SOs could be dated back to 1950s, and it then underwent major reform in 1989, followed by a number of revisions in 1998.<sup>983</sup> Based upon the most recent version of law, membership-based SOs are equivalent to associations in many Western countries. Von and Pissler identified that both associations and SOs could be defined as ‘voluntary groups formed by citizens in order to fulfil a shared objective, and to develop non-profit-making activities’.<sup>984</sup> Additional to the SO Regulations were also other rules developed in 1998, namely the CNI Regulations, which for the first time introduced the legal form and organisation referred to as CNI. Aside from the three regulations which have comprised the primary focus of this chapter (Foundation Regulations, SO Regulations and CNI Regulations) issued by the State Council of the Chinese Government, there are a number of model statutes issued by MoCA concerning foundations, SOs, and CNIs.<sup>985</sup> However, compared with the impact of model constitutions in the UK, model statutes in China are less respected and their contents are generally more superficial and symbolic. Therefore, here we shall focus our consideration on the SO and CNI Regulations.

Interestingly perhaps, the public expectation of the SO and CNI Regulations is ‘in the wake of the crackdown on the Democracy Movement, a moment of conservative reaction against demands for political reform and separation between the Party and the government, the state and the society’.<sup>986</sup> However, both the SO Regulations and CNI Regulations are considered to ‘dampen the expectation’ towards a liberal legal

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<sup>983</sup> Regulations on the Registration and Administration of Social Organisations[社会团体登记管理条例], promulgated on October 25, 1989.

<sup>984</sup> Von Hippel and Pissler, (n664)

<sup>985</sup> Model Statutes for Foundations [基金会章程示范文本]; Model Statutes for SOs [社会团体章程示范文本]; Model Statutes for CNIs (Legal Persons) [民办非企业单位（法人）章程示范文本], Model Statutes for CNIs (Partnerships) [民办非企业单位（合伙）章程示范文本] and Model Statutes for CNIs (Individual Entrepreneurs) [民办非企业单位（个体）章程示范文本]. These three sets of Model Statutes were issued on February 3, 2005, by the MoCA through the Circular for the Distribution of the ‘Model Statutes for CNIs’ [民政部关于印发《民办非企业单位章程示范文本》的通知] (Minhan [2005] No. 24).

<sup>986</sup> ‘Bound and gagged: Freedom of association in China further curtailed under new regulations’ (HRIC, 2013) <<http://www.hrichina.org/en/content/2780>> accessed 19 April 2016



environment for the development of non-profits in China. Since these two rules clearly aim at binding SOs and CNIs more tightly to the Chinese Government, they represent an effort to bring the entire sector under a stricter control, thereby expanding the dual management scheme currently in operation. It is easy to identify a range of articles in these two sets of regulations that exist merely to serve the interests of the Government.<sup>987</sup> In sum, both the SO and CNI Regulations have proven to be very strict on the use and implementation of administration and state supervision mechanisms. However, the regulations remain very general in terms and vague regarding the matter of board governance.

#### **8.4.4 Government interventions and SO/CNI's independence**

As we have mentioned at the beginning of this section, there is no provision in the SO/CNI Regulations addressing the matter of board governance, which means none of the four attributes in the modified blueprint in Chapter 7 has ever been discussed in SO/CNI regulations. Therefore, instead of analysing SO/CNI Regulations and identifying the conformance and departure compared to the blueprint, this section shall focus on one essential issue within the attributes of the blueprint—SO/CNI's independent governance.<sup>988</sup> The interaction between the Government's intervention and the independence of non-profit has been discussed in the blueprint, and as we shall demonstrate, this issue is considered to be particularly important to the SO/CNI governance. This section shall be divided into three parts. 8.4.4.1 shall propose that compared to foundations, SOs/CNIs are less likely to maintain organisation's independence/autonomy, and their internal governance are more easily affected by the Government. Section 8.4.4.2 then intends to develop this point by proposing an argument which, so far as I am aware, has not been advanced before. It is that, by accepting some limitations on independence, SO/CNI's can build greater trust with the Government, and by doing so, paradoxically ensure greater real autonomy. Finally,

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<sup>987</sup> To further prove this statement, I list the following Articles in SOs and CNIs (SO Regulations, reg10, reg 11, reg 13, reg19, reg 27); Von Hippel and Pissler, (n664)

<sup>988</sup> The rest of board attributes will not be discussed in this section. This is primarily because when compared to the law on foundations in the rest of board attributes, the organisational characters of SOs and CNIs do not indicate any significant difference in the application of the blueprint described in Chapter 7. Therefore, relevant practices can be referred to the argument made within the discussion and evidence outlined in section 8.3.

8.4.4.3 explores how SO/CNI can gain trust from the Government, and thus maintain an organisation's independence.

#### **8.4.4.1 Intervention from the Chinese Government**

In the past two decades, the Government has always carried out a number of interventions to interfere with the SOs/CNIs' governance. As noted in 7.3.1, these interventions could be divided into two categories—internal governance and external governance.<sup>989</sup> One of the typical approaches has been via the dual management system employed by the Government. As analysed in 7.3.2.2, the dual management system has always been considered as a deliberate and fundamental barrier set by the Chinese Government to control the establishment and management of a non-profit organisation in China. Although the dual management policy has been eliminated in many types of non-profits, the Government still has the discretionary authority that enables them to subjectively refuse or cancel the registration, and control every aspect of the non-profit activities.

In terms of the Government's attitude towards SOs/CNIs, the fieldwork at present indicates that the entry requirement as well as relevant government regulations toward SOs/CNIs' operations are much stricter on SOs and CNIs than those of foundations. The Government's actual attitude towards SOs/CNIs is far from certain, varying significantly on a case-by-case basis.<sup>990</sup>

#### **8.4.4.2 Reasons for the Government control**

Accordingly, to improve SO/CNI's governance, we have to find out the intention of the Government by taking this high degree of intervention. Academic researchers and practitioners may hold two contrasting points of view toward this issue, and we shall

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<sup>989</sup> Relevant approaches include but are not limited to, appointing government representatives in the boardroom, influencing legal regulations and using its discretionary authority through the government related agencies.

<sup>990</sup> Z Liu, "Zhengfu yu Feizhengfu Zuzhi guanxi: Boyi, Chongtu ji Qi Zhili" [Relation between government and NGOs: Game theory, conflict, and their governance], (2008) 1 Jianghai Xuekan [Jianghai Academic Journal] 94

now investigate which one is more convincing in light of the social determinants we outlined in Chapter 7.

#### **8.4.4.2.1 Government's deliberate suppression**

Firstly, many studies insist that the Chinese Government attempts to suppress the development of the entire non-profit sector in order to tighten its control over the Chinese society. As Yang, Wilkinson and Zhang held, 'under authoritarian governance, NGO activities may threaten the interests or authority of the government, and those that give support to dissenting voices are likely to be restricted'.<sup>991</sup> As a result, the Government shall control and enable SOs/CNIs to be its affiliated bodies.

However, in past two decades the Government has been 'gradually withdrawing from many responsibilities, initiating policies that allow civil society to expand'.<sup>992</sup> It seems that the Chinese Government attempts, in a variety of ways, to encourage non-profits to be autonomous. For example, it is outlined in the Plan 2013 that non-profits in China should be responsible for entire section of society than become affiliated.<sup>993</sup> Moreover, Plan 2013 was set in train to reform the government affiliated institutional structure (i.e. the organisation's independence and autonomy, and be free of government control) over the coming years. Aside from the legal/governmental mechanisms, senior government officials would also appear to send a clear signal that the Chinese Government is rethinking its attitude toward non-profit governance and thereby considering a reduction in its control over such bodies.<sup>994</sup> In 2013, Ligu Li, Minister of the MoCA said that '...after the reform of social organisation and the management system, the scope, pace and intensity of the transfer of governmental functions to social

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<sup>991</sup> T Hildebrandt, *Social Organizations and the Authoritarian State in China* (Cambridge University Press 2013)

<sup>992</sup> Y Yang, M Wilkinson and X Zhang, 'Beyond the Abolition of Dual Administration: The Challenges to NGO Governance in 21st Century China' (2016) 27 *International Journal of Voluntary and Nonprofit Organizations* 2292

<sup>993</sup> Plan 2013 makes clear that the Government intends to hand most of its social functions over to the non-profit sector over the next five years. This policy is targeting most of the public services both in the for-profit and non-profit sectors which the Chinese Government is currently responsible over to the society. Xinhua She, '关于国务院机构改革和职能转变方案的说明' ([www.gov.cn](http://www.gov.cn), 2013) <[http://www.gov.cn/2013lh/content\\_2350848.htm](http://www.gov.cn/2013lh/content_2350848.htm)> accessed 23 March 2016

<sup>994</sup> T Branigan, 'China's new premier, Li Keqiang, vows to tackle bureaucracy and corruption' (*Quality Journalism*, 2013) <<http://www.theguardian.com/world/2013/mar/17/china-premier-li-keqiang-bureaucracy>> Accessed 14 April 2016

organisations will increase and get faster, transferring some administrative and charity functions to social organisations, which will help improve the governments administrative efficiency'.<sup>995</sup>

With respect to the SOs and CNIs, since the Chinese Government has increasingly realized their declining capacity to implement policy consistently geared toward socially demanding roles and functions, SOs and CNIs are actually welcomed by local Government authorities, which are otherwise at breaking point.<sup>996</sup> Services that SOs supply are mostly targeted on groups under 'heavily moralistic institutionalized prejudice', such AIDS-related issues, 'supporting sex workers or the welfare protection of migrant workers' children'.<sup>997</sup> CNIs are largely about education, arts, museums and culture. Such issues cannot be efficiently resolved by the local Government as groups do not trust the government, while on the other hand, the SOs and CNIs are more specialized and professional in relation to information access, volunteer training, and service provision, for example.<sup>998</sup> In keeping with the above argument, the Government's attitude may alter with SO/CNI's performance.

Admittedly, the Chinese Government has an extremely high expectation with respect to the development of SOs and CNIs, as they can help to alleviate government pressure and facilitate social contribution. Over the course of the past two years, the Government has attempted to reduce the overregulation on non-profit organisations through the enactment of the Reform of State-Owned Enterprises and Non-profits Policy Guidance (Guidance 2015) and the Charity Law 2016.<sup>999</sup> Crucially, the Guidance 2015 outlines the Chinese Government attempts to relinquish its control over non-profits, and to set a clear and strict boundary line over board governance, without cutting their funding, thereby promising a brighter future for their development.<sup>1000</sup>

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<sup>995</sup> Yang, Wilkinson and Zhang, (n992)

<sup>996</sup> T M o C Affairs, 'Top Ten Major Events for Social Organizations in 2013' (*China Development Brief*, 21 March 2014) <<http://chinadevelopmentbrief.cn/articles/the-ministry-of-civil-affairs-top-ten-major-events-for-social-organizations-in-2013/>> accessed 24 March 2016

<sup>997</sup> Hildebrandt, (n991) 17

<sup>998</sup> *ibid*

<sup>999</sup> *ibid*

<sup>1000</sup> R Summerfield, 'China's Soe Reform' (*Financier*, February 2015) <<https://www.financierworldwide.com/chinas-soe-reform/#.WG7-F7aLSqA>> accessed 17 March 2015; Q He, 'Tag Archives: Mixed Ownership' (*China Changes*, 2015) <<http://chinachange.org/tag/mixed-ownership/>> accessed 7 October 2015

Although there exists no strict rule in restricting the number of government representatives active in non-profits, it specifically emphasizes the importance of reducing the number of government representatives on a non-profit's board to build an equal and independent relationship between the government and non-profits.<sup>1001</sup> These efforts made by the Chinese Government clearly indicate that non-profits, should they wish to, may exist and perform as a separate entity beyond the Government's control.

#### **8.4.4.2.2 Government distrust due to a lack of information**

Given the discussion so far, it would seem to be irrational to define those government interventions as a political repression, which leads us to concentrate on the second explanation. Many studies argue that the Chinese Government does not intend to step in to control the non-profit governance, and transform non-profits governance into the Government-dominant model. Instead, the close supervision and high degree of intervention are primarily owing to two Government concerns.

Firstly, given there has not been any sufficient legal system systematically regulating the non-profit governance, the Government could consider that 'autonomy may not always be a positive factor in the development of NGOs', which could allow the flourish of corruptions and director's misconducts.<sup>1002</sup> Accordingly, the Government would then use its discretionary authority to supervise the governance. Secondly, the Government is likely to be cautious on those political contentious activities which may cause social instability, chaos, and violence. Research indicates that those political sensitive issues can be defined with four characteristics,<sup>1003</sup> and many activities held by SOs/CNIs fall into these categories.

Indeed, SOs/CNIs are often pursuing 'activism in areas which officials have often

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<sup>1001</sup> Y Bai, 'Guiding Opinions on Strengthening and Reform of State-Owned Enterprises' (*Xinhua Net*, 13 September 2015) <[http://news.xinhuanet.com/politics/2015-09/13/c\\_1116547305.htm](http://news.xinhuanet.com/politics/2015-09/13/c_1116547305.htm)> accessed 13 September 2015

<sup>1002</sup> Peterson, (n869)

<sup>1003</sup> This could include '1. Involving advocacy, e.g., human rights, labour issues, and environmental policy. 2. Involving international affairs, e.g., programs promoting international cultural exchanges. 3. Involving religious or ethnic issues, e.g., Christian activities and Tibet issues. 4. Involving the police or the legal system, or related social stability (weiwen) issues'; see Q Ma, 'The Governance of NGOs in China since 1978: How Much Autonomy?' (2002) 31 *Nonprofit and Voluntary Sector Quarterly* 305, 310

found worrying'.<sup>1004</sup> SOs are associations that regularly need to hold membership-based activities in public areas, such as parades, assemblies, associations and protests, for example. These social service activities carried out by CNIs ranging from the field of health care, labour to legal services, some of which would appear to be sensitive to the Government. Moreover, when compared to most foundations with a strong government background, CNIs are mostly private-owned small business, and so the Government is less likely to have opportunity taking informal conversation with CNIs and getting familiar with their business operation.<sup>1005</sup> Hence, the Government would appear to be more cautious with respect to activities taking place in CNIs, as they may know very little about each aspect of the CNI from the outset.

However, there are apparently a great number of SOs/CNIs taking activities irrelevant to these political sensitive issues but which have nevertheless been suspected and mistreated. The reaction of SOs/CNIs is intensifying the suspicious attitude of the Chinese Government. Most SOs/CNIs are showing a passive attitude and refuse to collaborate with the Government. Without the government background, they presume that they are more vulnerable, and in an opposite position to, the Chinese Government, when compared to foundations.

As a result, most SOs/CNIs choose to hide from the Government surveillance, and avoid any opportunity to get in touch with the Government. Some of them simply opt not to get official registration as SO/CNI owing to the sensitivity of this legal format.<sup>1006</sup> Apparently, those inactive reactions toward the Government intervention are inefficient and may lead to an unpleasant result. It is likely to result in a more suspicious attitude, a closer monitor by the Government. Also this type of practice seriously limits the scope of a SOs or CNIs work, as it exposes them to taxation and enables the Government to freeze their operation citing various causes.<sup>1007</sup>

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<sup>1004</sup> *ibid*

<sup>1005</sup> A Saich, *Providing Public Goods in Transitional China* (Springer 2008) 56

<sup>1006</sup> Guo and others, (n627)

<sup>1007</sup> *ibid* 95

#### **8.4.4.3 Approaches to encourage SO/CNI's independence**

According to the discussion so far, we shall propose that in order to reduce the suspicions of the Government, SOs/CNIs should build trust with, rather than hide from, the Government. Research evidence also indicates that a number of SOs and CNIs have successfully taken back control of their organisation's governance and have been increasingly less affected by the Chinese Government as the Government has faith and confidence towards them.<sup>1008</sup> Accordingly, this section shall explore how non-profits, particularly SOs and CNIs, could interact with the Government in an equal and collaborative way, so as to gain trust and support from the Government. In doing so, we shall propose three steps. These three steps are interrelated and interactive, which could progressively help non-profits achieve the organisation's autonomy and independence in the greatest extent.

##### **8.4.4.3.1 Build trust through familiarity**

'Familiarity is a precondition for trust', Gefen held that 'trust, in a broad sense, is the confidence a person has in his or her favourable expectations of what other people will do, based, in many cases, on previous interactions,' and these previous interactions constitute the familiarity.<sup>1009</sup> Therefore, in the SO/CNI—Government relations, as long as familiarity exists, the Chinese Government could place more confidence and faith in SOs/CNIs, and less monitor and control over their internal governance.<sup>1010</sup>

##### **8.4.4.3.2 Maintain the positive *guanxi***

In doing so, SOs/CNIs have to build and maintain positive *guanxi* with Government officials, as to improve familiarity and trust, secure tolerance for their performances

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<sup>1008</sup> *ibid* 96

<sup>1009</sup> 'Although another party's (person or persons) previous behavior cannot guarantee that that party will behave as one expects, previous interactions in which that party behaved as expected increase trust, that is the belief that the other will behave as one anticipates'; see D Gefen, 'E-Commerce: The Role of Familiarity and Trust' (2000) 28 *Omega* 725

<sup>1010</sup> *ibid*

and operations, thus maximizing their autonomy.<sup>1011</sup> The empirical work of Ma has suggested that SOs/CNIs in China exhibit more autonomy than imagined by the West.<sup>1012</sup> The closer the tie between the Government and SOs/CNIs, the more trust that may be established, thus the greater governance independence that may be achieved.

For most SOs/CNIs, connecting with Government does require tactical measures. This may include notifying the changes of government officials and the release of new national policy, being acquainted with the local Government and getting to appreciate the factors that influence their decision-making.<sup>1013</sup> Similarly, the condition and requirements of SOs/CNIs themselves need to be considered, such as the organisation's long-term strategic plan, organisation's short-term target, financial situation, and stakeholder input, for example.<sup>1014</sup> Therefore, SOs/CNIs need to recruit relevant expertise and skills from those who may act as their 'government connectors'. These connectors may preferably have skills such as negotiation, facilitating interpersonal relationship and 'bureaucracy acquaintance'.<sup>1015</sup>

#### **8.4.4.3.3 Equal and independent partnership**

As I have mentioned in 7.3.1, there is a danger that non-profits could become Government affiliated body if they overreliance on the Government's support. Moreover, misconducts such as corruptions are likely to occur if non-profits overstep the boundary and convert positive *guanxi* to the negative one. Accordingly, when dealing with the Government, non-profits need to set a baseline for themselves to secure their governance independence. For example, government representatives are welcome to sit in the boardroom, but their power should be restrained and clearly spelled out by their organisation's constitution.

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<sup>1011</sup> As noted in section 7.3.1, *guanxi* can be divided into positive and negative categories, and they should be treated differently. Referring to the discussion of *guanxi* in section 7.4, it will be noted that the relationship between the Chinese Government and foundations can be treated as *shuren*; or even a family-like connection, as a newly registered CNI is equivalent to a strangers/*shengren* to the Government.

<sup>1012</sup> Lane, (n832)

<sup>1013</sup> Shi, (n746)

<sup>1014</sup> Braendle, Gasser and Noll, (n784) 395

<sup>1015</sup> *ibid*



Deng and Jing also indicate that the relationship between non-profit and the Chinese Government should be taken as a form of ‘constructive interaction’.<sup>1016</sup> This interaction is believed to be a negotiation and collaboration between non-profits and the Government. During this process, both the Government and non-profits need to bear in mind that this interaction is ‘a partnership of equals, rather than the subordinate position of non-profits’.<sup>1017</sup> The board of SOs/CNIs should also keep their independent thinking skills, and be prepared to counterbalance and challenge government authorities. As Deng and Jing further demonstrate, the partnership between the Government and non-profits should take place in ‘a private sphere where members of society engage in economic and social activities following the rule of contract and voluntary principle as well as based on autonomous governance; it is also a non-governmental public sphere for participation in policy discussion and decision making’.<sup>1018</sup>

However, our previous argument has demonstrated that non-profits–government partnerships are difficult to manage even in Western society, where NGOs are socially and historically well established. It is not possible for NGOs to be totally unaffected by the government in partnership, particularly when in receipt of government funding. There is clearly a power imbalance when the sector collaborates with either the government or the business sector.<sup>1019</sup> How to keep the balance between self-independence and interaction with the Government is a challenge to SOs/CNIs and needs a further exploration on a case-by-case basis.

## 8.5 Conclusion

This chapter looks at three sets of the most important regulations within the non-profit sector in China, which are Foundation Regulations, SO Regulations and CNI Regulations. By reviewing these three sets of regulations under the modified blueprint, the potential legal gaps and deficiencies can be identified. Accordingly, strategies in improving the board governance in the Chinese context have been proposed. Meantime,

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<sup>1016</sup> Z Deng and Y Jing, 'The Construction of the Chinese Civil Society' in Z Deng (ed), *State and Civil Society: The Chinese Perspective* (World Scientific Publishing Company 2010) 28

<sup>1017</sup> *ibid* 29

<sup>1018</sup> *ibid*

<sup>1019</sup> Z Deng, *State and Civil Society: The Chinese Perspective*, vol 2 (World Scientific 2011)

Chapter 8 also provides guidance and recommendations on the drafting of legislations in the future.

## Chapter 9 | Reviewing the Charity Law 2016

### 9.1 Introduction

Chapters 6, 7 and 8 have each considered the social determinants that seem likely to impact upon the application of my blueprint in the Chinese context, and the impact regulations (i.e. Foundation Regulations, SO Regulations, and CNI Regulations) may have upon the governance of non-profits. I have identified a number of concerns about these regulations, and in particular the extremely high entrance bar, strict dual management system, and lack of provisions for non-profit governance. Additionally, there has been no statute in the Chinese non-profit sector, in order to guide subordinate (secondary) regulations.<sup>1020</sup>

Against this backdrop, on 23 March 2016 the Chinese Government passed its first major statute law at the national level – the Charity Law 2016 – concerned primarily with regulating non-profit organisations and rebuilding confidence in the scandal-hit sector. As ‘the first fundamental and comprehensive law on the construction of philanthropy in China’, the Charity Law 2016 immediately raised concern among scholars, participants in civil society organisations, and non-profit practitioners in China.<sup>1021</sup> The law itself is expected to reshape and redefine the whole non-profit sector in order to allow for greater accountability in non-profit activities on a number of important matters, including reducing ‘red tape’, encouraging fundraising, increasing organisation’s autonomy and adding transparency measures to the law, among others. The enactment of the Charity Law 2016 was designed to ‘provide a boost for China’s lagging non-profit sector and economy’.<sup>1022</sup>

Ahead of the enactment of the law itself, commentators from various backgrounds in China held very different and often conflicting views on the proposed reforms. As researchers such as Finder, Guo and Meng argued, the Charity Law 2016 should be regarded as a step forward, since it reduces the regulatory burden placed upon

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<sup>1020</sup> In theory, legislation issued by administrative organs is subordinate to that issued by the basic law released by state-power organs and the enactments of rules by administrative organs must not conflict with the basic law.

<sup>1021</sup> Deng, (n1019)

<sup>1022</sup> Z Meng, 'Understanding the Core Essence of the Charity Law' (2016) 9 China Journal of Social Work 184, 195

organisations in the non-profit sector.<sup>1023</sup> In spite of these positive comments, professionals and practitioners remain cautious about some of the less clear, more ambiguous, areas of the Charity Law 2016, such as those which impose restrictions on agency costs or management fees, and information updating or monitoring mechanisms. From this point of view, the Charity Law 2016 presents an interesting *paradox* in the field of non-profit governance in China. On the one hand, the law has created a relatively clear, accountable and sustainable environment for both registered and grassroots non-profits. On the other hand, a number of provisions within the law continue emphasizing the importance of external control in the non-profit governance, which could then make it easier for the Chinese Government to engage in arbitrary interventions.<sup>1024</sup> Further discussion of this shall be made in section 9.3.

The Charity Law 2016 itself can be divided into nine sections, covering different aspects of the non-profit sector in China, including ‘temporary activities’, ‘regulation of conduct’, ‘supervision and management’ and ‘legal responsibility’.<sup>1025</sup> This chapter focuses only on those articles and provisions that are most relevant to non-profit board governance. Section 9.2 summarizes some of the basic features and the scope of Charity Law 2016. Following this, section 9.3 reviews whether the Charity Law 2016 is a suitable means through which to facilitate good governance within non-profits. Sections 9.4—9.6 then consider how these different provisions of the law may influence board governance in NPOs.

## **9.2 An overview of the Charity Law 2016**

### **9.2.1 Hierarchy of regulations in non-profit sector in China**

The charity sector in China has always lacked the presence of any formal statutory regulation.<sup>1026</sup> The enactment of Charity Law 2016 has therefore filled this gap. To understand the legal status of the law itself, it is necessary to explain the hierarchy of

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<sup>1023</sup> Agence France-Presse, ‘China aims to increase giving with first charity law’ (*Global post*, 2016) <<http://www.globalpost.com/article/6743856/2016/03/09/china-aims-increase-giving-first-charity-law>> accessed 25 April 2016

<sup>1024</sup> *ibid*

<sup>1025</sup> The Charity Law 2016, s5

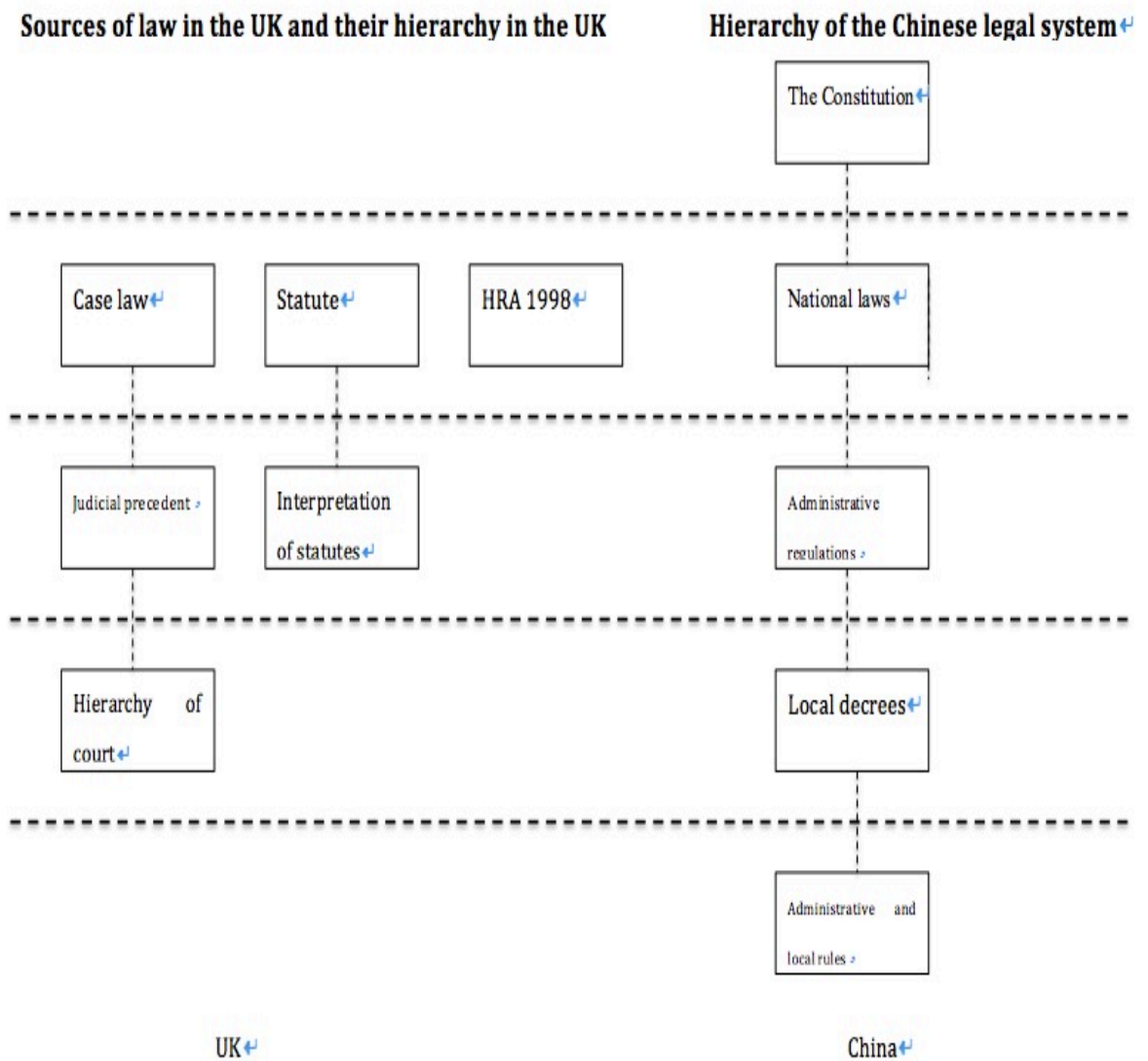
<sup>1026</sup> Meng, (n1022)

law and regulation in China, and compare this with the UK legal system. Briefly, the hierarchy of the Chinese legal system can be divided into five levels:

1. The Constitution of the People's Republic of China
2. National laws, which are issued by the National People's Congress
3. Administrative regulations, which are issued by the State Council
4. Local decrees, which are issued by local People's Congresses
5. Administrative and local rules, which are issued by an administrative agency or by a local People's Congress

To illustrate this difference, Table 9.1 has listed a comparison of the hierarchy of laws and regulations between UK and China.

**Table 9.1 Hierarchy of laws**



As the table above clearly indicates, the Constitution of the People's Republic of China is the highest legal authority, while Administrative and local rules rank lowest. Naturally, the lower level laws are guided to develop consistently with higher-level regulations. If any circumstance arises where the content of lower level laws or regulations contradict higher ones, the resolution of that conflict requires reference to, and the following of, higher level laws.<sup>1027</sup> Foundation Regulations/SO Regulations/CNI Regulations belong to the third level—administrative regulation. The Charity Law 2016, by contrast, is regarded as *national* law. Accordingly, in case of inconsistencies and contradictions between the three regulations mentioned, and the

<sup>1027</sup> Feng, Advisors and Zhang, (n632)

Charity Law 2016, the latter remains the higher authority.

### 9.2.2 The scope of the Charity Law 2016

Although the terms ‘charity’ and ‘charitable’ appear frequently throughout the Charity Law 2016, the Law itself does not regulate only charitable organisations. Rather, it is designed to regulate the entire non-profit sector in China, on which two points may be noted. First, the definition of philanthropic organisations and charitable activities under the Charity Law 2016 is broader than the common understanding of charitable organisations in the UK.<sup>1028</sup> In the UK, charities or charitable organisations cover those non-profits with charitable purpose such as the ‘British Heart Foundation’, which is equivalent to foundations in China. However, by contrast, the Charity Law 2016 refers to all non-profit organisations. Second, Article 3 of the law holds that ‘charitable activity’, as used in the Act, indicates the initiation of relevant non-profit activities on a voluntary basis, by natural persons, legal persons or other organisations through means such as donating property or providing volunteer services.<sup>1029</sup> Article 9 sets out the basic requirements that charitable organisations must meet, and these requirements effectively constitute a further explanation of the scope of charitable organisations in the Charity Law 2016.<sup>1030</sup>

Moreover, the common understanding of ‘charitable/charity’ among Chinese non-profit practitioners and researchers is one that is in line with the definition used in the Charity

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<sup>1028</sup> Meng, (n1022) 195

<sup>1029</sup> Article 3: ‘Charitable activity as used in this law indicates initiation of the following non-profit activities on a voluntary basis by natural persons, legal persons or other organisations through means such as donating property or providing volunteer services:

- (1) poverty relief and helping the elderly, young, disabled or other disadvantaged groups;
- (2) relief from damage caused by natural disasters and other emergencies;
- (3) promotion of the development of areas such as education, science, culture, health, and sports;
- (4) prevention and control of pollution and other public harms, and protection and improvement of the environment;
- (5) other activities consistent with the societal public interest’; see the Charity Law 2016, s3

<sup>1030</sup> Article 9: Charitable organisations shall comply with the following requirements:

- ‘(1) Have carried out charitable activities as its main purpose;
- (2) Not have a profit-making purpose;
- (3) Have its own name and location;
- (4) Have an organisational charter;
- (5) Have necessary assets;
- (6) Have institutional framework and responsible parties meeting requirements;
- (7) Other requirements provided for by laws and administrative regulations’; see the Charity Law 2016, s3 and s9

Law 2016. Zhang and Wang's survey, based on 795 million pieces of literature from 500 major newspapers, reveals that "the key words 'philanthropy' and 'charity' were interchangeably used with the terms 'non-profit', 'voluntary', and they are often considered with the similar meaning in the Chinese context".<sup>1031</sup>

### **9.3 Reviewing the Charity Law 2016 (converting blueprint attributes into four factors)**

Unfortunately, the Charity Law 2016 itself does not specify any non-profit internal governance mechanism, nor does any single chapter, even a single provision, mention anything regarding four attributes addressed in the board governance blueprint developed in this thesis.

There would appear to be two reasons for this omission. First, the development of Chinese non-profits is still in its early phase. Both the Charity Law 2016 and the Chinese Government appear to be focusing their attention on issues such as non-profit registration procedures and fund-raising resources/approaches, since these would appear to be closely connected to matters of national security and social stability.<sup>1032</sup> The reform of the *governance mechanisms* inherent in Chinese non-profits would appear, by contrast, to be considered rather less important. Naturally, this work argues that this is unfortunate, and suggests that improving the governance of Chinese non-profits is one of the most essential and urgent issues for the Chinese government, and should have been included in the new law.<sup>1033</sup>

The Charity Law 2016, which sits high in the legal hierarchy and authority, should be able to provide proper guidance on non-profit governance in China. It would also, because of the Chinese hierarchy of legal norms referred to earlier, provide clearer guidance on, and the means for resolving inconsistencies in, lower level rules. Similarly, without guidance by the Charity Law 2016, there may also occur conflicts and contradictions within certain rules in the same legal hierarchy. Consequently, this will bring inconsistencies to the approach taken to non-profit governance. Nevertheless,

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<sup>1031</sup> Meng, (n1022) 188

<sup>1032</sup> Huang and others, (n41)

<sup>1033</sup> Han, (n37)



opponents insist that the Charity Law 2016 is not supposed to concern itself with too great an amount of detail.<sup>1034</sup> With respect to the restrictions relating to non-profit board governance, the legislator may have intended to leave these to administrative regulations, which normally provide further explanation of the Charity Law 2016.<sup>1035</sup> Although the existing administrative regulations in the non-profit sector (Foundation, SO, CNI Regulations) have not yet been revised, these are likely to be modified further to the Charity Law 2016.

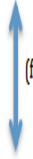
Since the Charity Law 2016 failed to provide any detailed provision concerning the governance of Chinese non-profit boards, it is, obviously, not possible to directly review the Act's treatment of these four attributes. However, there are still many provisions within Charity Law 2016 that potentially affect the non-profit governance mechanism, both positively and negatively. In order to explore the impact and efficiency of the Charity Law 2016 on the non-profit board governance in China, and identify to what extent the Charity Law 2016 is conforming with or departing from the blueprint, we shall convert the four attributes within the original blueprint into a new standard. Table 9.2 shall briefly summarize the relationship between the four board attributes in the blueprint and four factors we shall analyse in this section. These factors include the *relationship with the Chinese government, organisation's autonomy/independence, public trust, and director's behaviour*.

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<sup>1034</sup> *ibid*

<sup>1035</sup> Meng, (n1022)

**Table 9.2 The relationship between board attributes and four factors**

Attributes of good CG		Approach to achieve good CG (my blueprint) in the Chinese context	Core value (Ultimate objective)	Essence/ Summary of Core Value
Board Size		Include more or less government representatives	1, Facilitate fundraising 2, Avoid reducing NPO autonomy	<p>Autonomy</p>  <p>(find the balance point)</p> <p>Government Control</p>
Board Characters	Director's independence	1, Build up positive/negative guanxi with government/outside 2, Clarify director's personal connections	1, Facilitate fundraising/admin 2, Bind director's character to avoid shirking/corruption	
	Government representative	Establish government connections	1, Facilitate fundraising 2, Avoid government control	
	Professionals	Director's qualification	1, Individual qualification 2, NPO autonomy	
Board structure		1, Avoid director's shirking/corruption 2, Improve working efficiency 3, Manager VS Chairman	1, Individual Character 2, Avoid government control	Individual character/Qualification
Board decision-making process		Work efficiency/number of attendances	1, Individual character 2, NPO autonomy	<p>Fundraising ↔ Public Trust</p>

In order to understand better the influence of the Charity Law 2016 on the governance of Chinese non-profits boards then, these four factors shall be justified below.

### 9.3.1 The Government control and intervention

The relationship between the Chinese Government and non-profits has been addressed in Chapters 7 and 8. According to research considered in these chapters, historically, Chinese non-profits have always had a much closer tie with the Government than their Western counterparts.<sup>1036</sup> Nowadays, non-profits in China exist within a limited scope, defined by the Government, with many being in a transitional phase between complete dependence upon the Chinese Government and a greater degree of autonomy.<sup>1037</sup> The Government can ‘enable and impede their development based on policy or regulation changes’.<sup>1038</sup> Hence, to what extent the Government maintains control over non-profits, and significantly influences governance strategies in China, remains debatable.

### 9.3.2 Autonomy/Independence of non-profits

According to Chapters 7 and 8, a great majority of non-profits are required to maintain affiliation with the Chinese Government and its agencies for the purpose of getting both administrative and financial support. These non-profits, however, are criticized for losing their autonomy and independence. Fisher argues that ‘autonomy is the defining criterion for non-profits because it vitalizes a non-profit’s functions and enables it to influence government, and thus to play a part in advance of political pluralism’.<sup>1039</sup> Of course this statement is general and may not necessarily apply to the Chinese context. From this argument at least, it may be implied that a significant number of Chinese non-profits, particularly GONGOs, cannot be defined as legitimate non-profits according. As the discussion in Chapters 7 and 8 has suggested, the notion of autonomy should be understood differently in China when compared to those in Western countries. ‘Interdependence between government and NGOs may be functional for achieving a positive socioeconomic impact’.<sup>1040</sup> Inviting government representatives to sit as part of the board is merely to create more convenient avenues to resources, which is a means rather than an end (organisational objective).

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<sup>1036</sup> *ibid* 546

<sup>1037</sup> Yang and others, (n686) 550

<sup>1038</sup> *ibid*

<sup>1039</sup> *ibid* 547

<sup>1040</sup> In the Chinese context, it is not necessarily essential for the non-profits to contribute to socio-economic development; see Jing, (n51) 548

Without sufficient legislation in place and adequate government monitoring, corruption may easily flourish within the Chinese non-profit sector.<sup>1041</sup> It is not expected Chinese non-profits are to be entirely independent of the Government, and thereby achieve a similar autonomy to those based in industrialized countries.<sup>1042</sup> Furthermore, it would seem impossible to behave in such a way, owing to a range of factors discussed in Chapters 7 and 8. Chinese non-profits, like many organisations which operate in China, must still consider *guanxi*, resource collection, political power and impact as essential elements of their strategy for survival. However, Chinese non-profits must still maintain their autonomy against the dominance and control of the Chinese Government. Indeed, Chinese non-profits are required to tread a narrow and careful path between organisational independence and government assistance/control.<sup>1043</sup>

### 9.3.3 Public trust

As with most organisations, and especially with non-profits, public trust is able to facilitate more sustainable development. As research by Sargeant and Lee has made clear, ‘higher degrees of trust in a charity are associated with a greater willingness to become a donor and give greater sums’.<sup>1044</sup> With the depletion in government funding over recent years, an increasing number of non-profits in China are dependent upon donations and volunteers from the public.<sup>1045</sup> As section 6.2 demonstrated, the serious crisis in trust has largely been due to widespread scandals and the reduction of basic social trust in non-profits, within Chinese society. Accordingly, gaining public trust has become ever more important for the survival and thriving of Chinese non-profits.<sup>1046</sup> Without this, non-profits in China may encounter significant obstacles to fund-raising, volunteer recruitment, and carrying out public activities. The Charity Law 2016 itself

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<sup>1041</sup> Yang and others, (n686)

<sup>1042</sup> K M Chan, 'The Development of NGOs under a Post-Totalitarian Regime: The Case of China' in R P Weller (ed), *Civil Life, Globalization, and Political Change in Asia: Organizing between Family and State* (Routledge 2005)

<sup>1043</sup> Jaskyte and Holland, (n376) 546

<sup>1044</sup> Chua and Morris, (n777) 550

<sup>1045</sup> Yang and others, (n686)

<sup>1046</sup> Huang and others, (n41)

has outlined a set of provisions relevant to building up public trust, which are discussed later in section 9.6.

### **9.3.4 Individual director's behaviours**

Both Table 9.2, above, and the blueprint discussed in Chapter 7, emphasize that proper standards with respect to directors' behaviour is vital to the appropriate governance of non-profits in the Chinese context. Chapter 8 further indicates that skills and knowledge of establishing *guanxi* with the Government should be added to the directors' list of essentials attributes.

## **9.4 Government control versus organisational independence (autonomy)**

### **9.4.1 Dual management system, a broader definition of non-profits and legal rights of unregistered non-profits**

An important aspect of the Charity Law 2016 is that it includes a more expansive view of the business sectors that a non-profit may operate within. These include 'the promotion of health, environmental protection and other activities consistent with the societal public interest'.<sup>1047</sup> This has been widely seen as a big step forward for non-profits, and 'in the right direction given the importance of the term non-profit in Chinese discourse on civil society'.<sup>1048</sup>

Moreover, the law also now allows non-profits to obtain direct registration, thereby getting ride of the old dual management system (we discussed in Chapter 8) in which non-profits had to find a qualified monitoring institution before they were able to register with MoCA. Article 9 states that charitable organisations would have to meet 'other conditions stipulated by law and administrative regulations', so leaves open the possibility that many other laws in China, such as the Overseas NGO Law or a variety of other regulations concerning registration and management of non-profits could also

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<sup>1047</sup> The Charity Law 2016, s5

<sup>1048</sup> Huang and others, (n41)

be taken into account.<sup>1049</sup> In any case, Article 18 in the Charity Law 2016 notes that ‘even when a non-profit organisation with the purpose of conducting charitable activities is not registered, it can still conduct charitable activities within its limits, but shall comply with the relevant provisions of this Law and benefit from relevant rights and interests according to law’.<sup>1050</sup> This article clearly indicates that those unregistered/grassroots non-profits we have discussed in Chapter 6 should not be treated as illegal organisations and should be permitted to undertake charitable activities.

These fundamental improvements brought about by the Charity Law 2016 clearly indicate how the Chinese Government intends to gradually withdraw its administrative powers, and make greater efforts to adapt to new situations and initiate new policies allowing the non-profit sector to expand.<sup>1051</sup> Undoubtedly, these will lead to changes in the Chinese non-profit sector. The Government, first, can never ban any grassroots non-profits, for the sake of their illegal social status. This is ‘a significant step forward from seeing non-profits as illegal, and recognizes that small, community groups or groups consisting of marginalized populations may not have the capacity or desire to register but may still perform an important societal purpose’.<sup>1052</sup> Operating in China has never been straightforward without government control or intervention, before this provision was enacted.<sup>1053</sup> As Chapters 7 and 8 made clear in discussion, a vast majority of non-profits in China undertake their business activities ‘in a grey zone’ as the legal requirement is onerous. To be specific, many of them choose to register as commercial business; some even operate as grassroots organisations.<sup>1054</sup>

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<sup>1049</sup> There have also been talks about drafting a Social Organisations Law, which would address the registration and management of all social organisations, not just charitable ones, but also trade and professional associations, scientific associations, community organisations, among others. Given that the Overseas NGO Law and other related regulations are currently being drafted and revised, their impact on the Charity Law remains to be seen.

<sup>1050</sup> The Charity Law 2016, s18(3)

<sup>1051</sup> S Shieh, 'More Comments on the Charity Law Draft (Public Comments Due November 30!)' (*NGOs in China*, 29 November 2015) <<http://ngochina.blogspot.co.uk/2015/11/more-comments-on-charity-law-draft.html>> accessed 23 March 2016

<sup>1052</sup> Wang, (n745)

<sup>1053</sup> Shieh, (n1051)

<sup>1054</sup> Meng, (n1022)

Secondly, through expanding the definition of non-profits and their diversity, the public may develop a more comprehensive understanding of this sector. Zhang's research observes that there is a tendency in the Chinese society that philanthropists prefer to donate to local groups, focusing on a few single causes which are the most important matters in relation to Chinese social value, such as education, health care and poverty.<sup>1055</sup> Among famed donors in China on the top 100 list, only Ma, the founder of Alibaba donated to those causes with relatively less public attention.<sup>1056</sup> Among a variety of donation causes, education institutions obviously received the most majority of donations. By contrast, environment causes receive only 0.9% donations.<sup>1057</sup> This evidence clearly indicates that the Chinese public has very limited knowledge toward the types of philanthropic organisations that exist.<sup>1058</sup>

Thirdly, the abolition of the dual management system means, at least officially, that the Government cannot intervene in non-profits governance/management activities in the name of the dual management power. At the same time, their discretionary authority, discussed in section 8.3.3.2.1, is effectively constrained. In practice, non-profits are now able to get registered directly as long as they satisfy the legal requirement, which clearly simplifies the procedures compared to the old dual management system. From another perspective, this action by law indicates the supportive attitude and confidence of the Government 'in its administrative capacity, as well as its determination to promote Chinese non-profits'.<sup>1059</sup>

With respect to non-profit board governance, the changes outlined in relation to the Charity Law 2016 operate as something of a double-edged sword. On the one hand, it endows the Chinese non-profit with more autonomy, by reducing the Government's administrative intervention and withholding their power from being abused in relation to non-profits.<sup>1060</sup> Ideally, this will lead to a reduction in government representatives in

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<sup>1055</sup> L Zhang, 'The Future of NGOs in China' (*China File*, 14 May 2015)  
<<https://www.chinafile.com/conversation/future-ngos-china>> accessed 13 March 2016

<sup>1056</sup> *ibid*

<sup>1057</sup> Deng, (n659)

<sup>1058</sup> *ibid*

<sup>1059</sup> *ibid*

<sup>1060</sup> H K L Offices, 'Comments on the New Prc Charity Law' (*Lexology*, 22 March 2016)  
<<http://www.lexology.com/library/detail.aspx?g=c6696266-fd43-4688-8848-249db68d1450>> accessed 4 June 2016

the boardroom, the board size will be slimmed down and Government authorities will not so severely intervene in the board's decision-making process. On the other hand, gaining organisational autonomy means that the tie with government officials (professional supervisory agency) is broken, and relevant government assistance will likely be reduced. As we have argued in Chapters 6, 7 and 8, 'this affiliation gives the organisation the bureaucratic identity necessary to function in the highly governed environment of the Chinese political society'. It enables non-profits to access a variety of resources, ranging from office space to financial funding. The Charity Law 2016 has drawn a clear line between GONGOs and the Chinese Government. At the same time, the Charity Law 2016 indicates that the Government is unwilling to deal with the financial/administrative requirements from non-profits.<sup>1061</sup>

#### **9.4.2 The public donation qualification**

The Charity Law itself uses a whole chapter of the Act (Chapter 3) to address the issue of *Charitable Fundraising*. Disappointingly, it does not make any fundamental change to this practice, and continues to divide non-profits into two classes: public fundraising and non-public fundraising.<sup>1062</sup> In other words, the law still treats GONGOs and other non-profits differently.

However, notably, it does provide non-profits, especially those without the Government background, with more opportunities and approaches to raise funds. Before the enactment of the Charity Law 2016 itself, as we have demonstrated in Chapter 8, only a few GONGOs with strong government background could enjoy the privilege to 'engage in public fundraising'.<sup>1063</sup> At the same time, the process of public fundraising turned out to be extremely 'complex and painstaking'.<sup>1064</sup> Under Article 22 of the Charity Law 2016, non-profits that used to engage in public fundraising can 'keep their privileged status', while other registered non-profits need to apply for the public fundraising

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<sup>1061</sup> Yang and others, (n686) 548

<sup>1062</sup> Public fundraising allowed NPOs to fundraise through public channels such as television, radio, newspapers, setting up collection boxes in public spaces, holding charitable performances, sales, competitions, gala dinners, etc. The private fundraising is only allowed to accept private gifts and donations.

<sup>1063</sup> Yang and others, (n686)

<sup>1064</sup> Yang, Wilkinson and Zhang, (n992)



qualification two years after they are registered, and prove that ‘they operated within the rules and have not violated the previous regulations’.<sup>1065</sup> In addition to that, those ‘unqualified non-profits and individuals’ are allowed to collaborate with qualified non-profit organisations to attract public donations, which will be supervised and managed by the qualified non-profits.<sup>1066</sup>

From an optimistic point of view, we may suggest by looking at Article 22 that the Government is loosening its control, and providing a more liberal environment for the non-profit governance in China.<sup>1067</sup> The Charity Law 2016 discourages non-profits from relying on the Government financial assistance. Meanwhile, a ‘healthy and orderly’ competition environment can be created among non-profits, and the public confidence and donations could be increased accordingly.<sup>1068</sup> Before the enactment of the Charity Law 2016, the Chinese Government had largely been the primary fund provider.<sup>1069</sup> Registered non-profits, without the public fundraising qualification, had to maintain a close *guanxi* with the local Government, in order to secure funding.<sup>1070</sup> Alternatively, grassroots non-profits had to collect resource through private channels. In addition to Government support, over recent decades, foreign donations have turned out to be another major funding source, and a potential trigger for Article 22 of the Charity Law 2016. Foreign donations tend to prefer supporting grassroots non-profits in China, particularly those concerned with international issues.<sup>1071</sup> However, those non-profits receiving foreign-supply fund still need to be subordinate to the Government, in order to establish *guanxi* since local Government has always been very strict and therefore sensitive to foreign funds.

However, we might pause here to offer a different, and rather more pessimistic, view of Article 22. For it may be that the Government has, in fact, never been determined to

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<sup>1065</sup> Offices, (n1060)

<sup>1066</sup> Shieh, (n1051)

<sup>1067</sup> The Charity Law 2016, s22

<sup>1068</sup> Y Yang, 'Evaluation of Public Trust in Charities of China', MS thesis, Beijing Normal University, Beijing, China 2012)

<sup>1069</sup> Offices, (n1060)

<sup>1070</sup> Worth, (n19)

<sup>1071</sup> Meng, (n1022)

give up its control over non-profit internal governance. Providing more fundraising approaches for NPOs is merely a tactic to regain public trust, and enable non-profits to attract more funds from the public.<sup>1072</sup> This may also be regarded as a compromise to the current national economic situation, as the Government cannot afford the economic burden, and needs more flexible fund raising approaches to assist in social construction and the relief of poverty in China. From a purely legal perspective, although this stipulation (Article 22) would appear beneficial to non-profit governance, there is actually a difference between Government related non-profits and those without the Government background.<sup>1073</sup> As we have argued at the beginning, Article 22 requires non-profits to maintain a two-class system for the public fundraising. Essentially, only those non-profits that have close *guanxi* with the Government may be granted public fundraising status, without making any effort, while others have to prove their credentials to obtain these rights.<sup>1074</sup> However, ‘GONGOs are by no means deserving of that status’.<sup>1075</sup> Scandals that have occurred involving GONGOs have rocked the Chinese society, and almost every incident implicated public fundraising with GONGOs. These Government related non-profits should also be required to prove their value, instead of being automatically granted the public fundraising right, by claiming themselves to be big, ‘professional’ and with government background.<sup>1076</sup>

For those non-profits that are required to apply for the qualification of public fundraising, the authorizing power, even with a detailed application process, remains under Government control. Non-profits, particularly those without government background, are already likely to realise that the Government may still control the resource of funding and thus have a say in the non-profit boards’ governance.<sup>1077</sup> Irrespective of the Government’s intention, the Charity Law 2016 has brought welcome change to many grassroots organisations. Before the enactment of the Charity Law

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<sup>1072</sup> Yang and others, (n686)

<sup>1073</sup> Yang, (n1068)

<sup>1074</sup> GONGOs and non-profits that have close *guanxi* with the Government (e.g. non-profits that were in *danwei* system). *ibid*

<sup>1075</sup> Wang, (n745)

<sup>1076</sup> Y Ding, 'China Public Donation Decreased Sharply in June after Guo Meimei Incident' (*Beijing Times*, 8 December 2011) <<http://hausercenter.org/chinanpo/2011/10/china-public-donation-decreased-sharply-in-june-after-guo-meimei-incident/>> accessed 23 March 2016

<sup>1077</sup> Shi, (n746) 107

2016, grassroots organisations conducting sensitive work were often frequently warned by authorities for their violation of law, using this as an excuse to close their business.<sup>1078</sup> However, the new law, which has a high position within the hierarchy, permits the existence of previously neglected grassroots non-profits, which means such authorities can no longer, legally, simply close such NPOs, without an explanation.<sup>1079</sup> However, it must also be remembered that some ‘authorities’ maintain a selective application of regulations’.<sup>1080</sup>

## **9.5 Individual director’s characters and qualifications**

The Charity Law 2016 itself does not address the particular issue of directors’ character and qualifications as UK regulations do (e.g. specifying their duties and responsibility), but touches the most serious problem among directors in China, as noted below.

### **9.5.1 Limitations on the 15% management fee (agency costs)**

Article 60 of the law imposes a cap on annual management fees, which is regarded as an agency cost within governance theory. Article 60 means that: ‘the annual expenditures for charity activities by foundations with the qualifications for public fund-raising shall be no less than 70% of the average revenue of the past three years and the annual management costs shall not exceed 15% of annual expenditures’.<sup>1081</sup> This provision is considered as a reaction to the anti-corruption campaign by President Xi, in order to prevent directors/managers from corruption in non-profits.<sup>1082</sup>

Although manager/directors’ expenses may be reduced, owing to the limitation on the overall administrative budget, the drawback of Article 60 is obvious. First, it does not mention director/manager’s particular responsibility, and fails to provide any further

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<sup>1078</sup> *ibid*

<sup>1079</sup> Meng, (n1022)

<sup>1080</sup> *ibid*

<sup>1081</sup> VOA, 'China Approves Comprehensive Law on Charities, Nonprofits' (*Metrotell*, 2015)

<<http://www.metrotell.co.za/news/china-approves-comprehensive-law-on-charities-nonprofits#.Vy5q4KMrKi4>> accessed 2 March 2016

<sup>1082</sup> CDB, (n954)

restriction on directors' behaviours. As a result, director corruption cannot be effectively controlled at the individual level.<sup>1083</sup> Second, the restriction on agency costs fails to draw a clear boundary between internal governance and external governance, as we have discussed in section 7.2.4. Both legal regulations and government policies belong to the external governance, while cutting the agency cost is the mechanism employed by the use of internal governance.

Although the internal and external can interact and collaborate to reach the optimal consequence, the Government is not supposed to influence the internal mechanism in this way. This provision implies the Government's intention to keep controlling the internal governance of non-profits. Third, Article 60 does not sufficiently limit management fees. This one size fit all policy is unreasonable and the 15% is extremely low. This provision is likely to undermine governance mechanism/strategy, as non-profits have to cut a range of agency costs, which may themselves be reasonable, merely to satisfy the legal requirement. According to research carried out by Wang, it is unreasonable to restrict the agency cost by a fixed number. Agency costs can be highly varied depending on a number of factors such as the organisational objective, membership, activities they are holding, the organisation's size, fund raising and annual income, etc. The average agency cost in many US non-profits can be over 30% of the average revenue, but that does not necessarily mean there is any fault or failure in their governance mechanisms.

Finally, allowing non-profits to spend as little as 15% on staff and overheads will prohibit the board attracting and retaining professionals and expertise. As noted in section 7.4.2.3, recruiting professional and experienced staff has already become a challenge to a majority of non-profits, even before the enactment of the Charity Law 2016. This restriction makes it more difficult for non-profits to hire professionals, as they will struggle to offer an attractive salary. This change in the law will put non-profits in a less competitive position, in terms of attracting skilled workers, when compared with profit-based industry.<sup>1084</sup>

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<sup>1083</sup> Yuen, (n878) 50

<sup>1084</sup> *ibid*

## 9.5.2 Transparency improvement

The new law itself requires registered non-profits to mandatorily update their annual financial reports, organisation constitutions, big events and changes within organisations, detailing this on a Government appointed website.<sup>1085</sup> There is a significant amount of emphasis within the law itself on the importance of transparency and information disclosure, with an entire Chapter of the act (Chapter 8, Article 69-76) devoted to this issue. As discussion in the blueprint has made clear, improving transparency in non-profits is about being able to properly regulate directors' behaviours, enhancing their accountability, and thus improving the board governance mechanism. Nevertheless, one drawback to the new law is that it goes too far and into too much detail in requiring non-profits to specify and report how they shall use their donations. Articles 76 and 77, in particular, 'require a level of reporting that will likely cause compliance difficulties for smaller, grassroots organisations, which lack staff to deal with professional reporting at this level'.<sup>1086</sup> Therefore, researcher such as Meng insist that 'more emphasis should therefore be placed upon self-discipline and self-regulation, and relying more on professional associations and industry standards, and less on government authorities, to regulate this area'.<sup>1087</sup>

## 9.6 Public trust

### 9.6.1 Transparency improvement

The transparency requirement discussed above could provide an easily accessible approach for the public to obtain information they need (e.g. how their donations are being spent and how the organisation has been managed).<sup>1088</sup> This action can obviously boost public confidence towards non-profits, and affects non-profits in number of ways.

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<sup>1085</sup> S Menglu, 'Draft Charity Law Eases Restrictions on Staff Payments' (*Caixin Online*, 3 October 2016) <<http://english.caixin.com/2016-03-10/100918658.html>> accessed 4 December 2016

<sup>1086</sup> The Charity Law 2016, s76, s77

<sup>1087</sup> Meng, (n1022)

<sup>1088</sup> Shieh, (n1051)

### **9.6.2 Encouraging public donation**

As discussed above, before the enactment of the Charity Law 2016, only a handful of non-profits, mostly GONGOs, were permitted to raise funds publicly, while others were restricted to some specific/private donors. However, some of these GONGOs have suffered reputational problems, owing to past scandals. Opening up public fund raising will encourage public donations, since their available choices will have widened.<sup>1089</sup> Combined with this policy, the Charity Law 2016 provides tax credit for donors, offering a waiver on corporate income tax and donations.

### **9.6.3 Reducing agency cost (anti-corruption campaign)**

Owing to the great number of scandals affecting the non-profit sector, combined with severe corruption problems within many Chinese organisations, it would appear to be that before the enactment of the Charity Law 2016, the public has little confidence and trust in Chinese non-profits. As the discussion above has made clear, although the 15% limitation on agency costs within non-profits appears to be harsh and unreasonable, it may still prove to be a good practice to improve the public confidence towards non-profits. By introducing the agency cost limitation in the Charity Law 2016, it clearly indicates a tendency that the Government is reconsidering the importance of the non-profit governance in China. This provision is able to give the impression to the public that there is little chance for board members to escape their work or take on improper behaviour, as the Charity Law 2016 has imposed restrictions on this. Consequently, it is hoped the effect will be to facilitate public fund raising and the recruitment of volunteers.

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<sup>1089</sup> Shi, (n746)

## 9.7 Conclusion (Consistency between the Charity Law 2016 and corporate governance mechanism)

The Charity Law 2016, as the first comprehensive law in the non-profit sector, aimed at helping improve the non-profit sector, alleviate social pressure and achieve economic target in China. Relevant provisions in the Charity Law 2016 have been assessed, focusing on the issues noted above, namely non-profits' autonomy and independence, public trust, and standards of directorial behaviour.

We now attempt to give a short summary on whether the Charity Law 2016 is efficient in improving non-profit board governance in the Chinese context. Certainly, the Charity Law 2016 does much to improve public trust aspect. A great many of its provisions are designed to enhance public trust towards non-profits, and thus encourage donors to contribute their money or efforts. This attitude can easily be explained through the Chinese economic background I have introduced in 6.3.2. With regards to the matter of public trust (fund raising), the non-profit internal governance and the Chinese Government shares the same objective, which leads to the clear position taken in the Charity Law 2016. It aims at 'allowing non-profits to help the government in addressing the needs of the poor as China's economy slows. It will also enable China's new middle and upper classes to more easily donate to approved causes'.<sup>1090</sup>

However, in terms of the tension between Government control versus non-profit autonomy/ independence, the attitude of the Charity Law 2016 appears to be rather ambiguous, which can also be explained by the background information set out in 7.2. Opponents of the Charity Law 2016 insist that there is a danger that this Act could prioritise the Government's own interests at the expense of non-profit autonomy. In spite of the reform in the new Act, the Government can still continue tightening its control over non-profit internal governance in a number of ways.<sup>1091</sup> However, based on my analysis above, it seems clear that most of these provisions will not severely interfere with the government's authority in respect of non-profit governance. The landmark legislation appears to enable the Government to withdraw its power to

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<sup>1090</sup> Meng, (n1022)

<sup>1091</sup> VOA, 'China Approves Comprehensive Law on Charities, Nonprofit' (*Metrotell*, 23 March 2016) <<http://www.voanews.com/a/education-proposals-spark-controversy-in-hong-kong/3250665.html>> accessed 23 March 2016

influence non-profits' internal governance, as evidenced in such provisions as the loosening of regulatory hurdles for non-profits to register. Overall, although the reform of the non-profit sector is not fundamental and revolutionary at this moment, it may seem like the Government is moving towards interfering/controlling non-profits less, and the Government's attitude towards the development of the third sector is getting more supportive. In spite that the Government may continue to exert control over non-profits in the near future, this could be understood as a long process which the Government needs to withdraw its control progressively to ensure the social order and stability. The extent to which the Charity Law 2016 changes the situation, from where charity work is government-led to where everyone may directly participate in charitable activities, is still not entirely clear. Much work remains to explore the full implications of the policy reforms found in the Charity Law 2016 in the future.



## Chapter 10 Conclusion

### 10.1 Summarizing the current situation of non-profit governance in China

China needs a governance model and supplementary governance mechanisms in the non-profit sector that best suit its development in the context of China's unique political, economic and legal cultures. The 'roadmap for the trajectory' of governance reform in China will take time despite the urgency for an effective regulatory regime. According to my analysis on the relevant influencing social determinants, it can be concluded that there cannot be any single reform, but multiple reforms over the decades. Each reform takes a small step forward, but builds on the existing structure. It is a 'gradual and piecemeal' process. My argument, as well as evidence from actual recent Chinese reforms, shows that any 'quick fix', by simply adopting international models, will not resolve fundamental problems. The path of non-profit governance development in the unique Chinese context would be 'evolutionary', not 'revolutionary'.

### 10.2 Research Summary

The introduction to this thesis set out its overarching goal, as follows: to develop a blueprint for an effective board for non-profits, which can be adapted to the distinctive characteristics of the Chinese non-profit sector, and against which current board regulatory requirements in China can then be measured.

#### 10.2.1 Looking at the nature of non-profits

We began by noting that one cannot think about the design rules for an effective non-profit board without thinking about what *role* such a board should play, and one cannot determine *that* without understanding the role of non-profits themselves. We began that task in Chapter 2. There, we focused on the two theories which focus on the demand for non-profits, which theories have dominated much of the literature. The first conceived of non-profits as a correction for the failures in commercial organisations owing to informational asymmetries and the lack of trust these generate. The other explained them as due to 'government failure', primarily caused by governments' tendency to

supply only the level of goods or services that the ‘median voter’ will support. Crucially, we then expanded on these two dominant accounts of the role of non-profits by noting the importance of considering not only the demand for, but also the *supply* of, non-profits. After all, even with a public demand for non-profits, non-profits are unlikely to flourish if individuals are not prepared to come forward and supply them. That led us to emphasise the importance of non-profits in fulfilling the desire for ‘participation’ and ‘expression of values’ by those who create and sustain non-profits.

### **10.2.2 Designing a blueprint through reviewing board governance theories**

Having addressed the role of non-profits themselves, we then turned to the design of our governance blueprint. That was achieved in two chapters, focusing first on the role of the non-profit board (Chapter 3), and then on the attributes a board needs in order to better fulfil that role (Chapter 4). In Chapter 3, we saw how a number of different theories paint non-profit boards as performing a number of different roles, which we built into a three-fold typology: a control role (based on the insights of ‘agency theory’), a service role (based on the insights of resource dependency theory, and stakeholder theory) and a strategic role. The work then developed an argument, which it labelled the ‘integrated model for board governance’, that non-profit boards cannot, and should not, *choose between* these different roles. Rather, a non-profit board can, and should, fulfil *all*. The chapter concluded by considering a number of arguments that might be put against this integrated model. The chapter rejected these arguments, but did accept that accommodating the integrated model had implications for the design of the board, around issues such as multi-tasking, delegation, the structural use of committees, and the like. Chapter 4 then turned to the detailed design of the non-profit board blueprint. This blueprint focused upon four board attributes, namely board size, characteristics, structure and decision-making process.

### **10.2.3 Reviewing UK board governance against my blueprint**

Before seeking to develop, and apply, the blueprint to the context of China, Chapter 5 paused to measure how far the UK’s regulatory regime for non-profits currently corresponds with, or departs from, that blueprint. We focused on the two legal forms

most commonly adopted by non-profits in the UK, namely CLGs and CIOs. We noted that, on the whole, the UK does not contradict or challenge the blueprint, but that this is so largely in the sense that the UK regime for these two legal forms is largely ‘permissive’ – it leaves it open to non-profits to choose their own board governance blueprint. We noted, however, that soft law in the UK to some extent fills this gap, but concluded by noting that this mix of hard and soft law, whilst it works in the UK, may not be appropriate for all countries, including, specifically, for China.

#### **10.2.4 Modifying the UK-based blueprint to the Chinese context**

The thesis then turned its focus squarely onto China. The opening of the for-profit market and partial privatization of state-owned companies has encouraged the development of Chinese corporations on the international stage. However, the non-profit sector is less developed and heavily influenced by the Chinese social context. Despite the potential of these social factors to harmonize the non-profit governance across jurisdictions, the social, economic and especially political conditions under which Chinese governance mechanisms are evolving offers little support for the prospect of full convergence with international non-profit governance models and practices. However, this does not mean that a large measure of convergence cannot be reached, notwithstanding these barriers. A more effective governance mechanism can be achieved in the Chinese context, and specifically so through the modification of the UK-influenced blueprint, developed through Chapters 2-4. But this must take account of the distinctive context for non-profit governance which China presents. Specifically, China is characterized by a weak legal system and strong traditional influences, such as *guanxi*, face saving and the *danwei* system. In order to better apply the blueprint in the Chinese context, these contextual factors had to be taken into account in the process of modification. Among political determinants, we also had to address the fact that the Chinese Government has throughout history played a significant role both as the drafter of the legislation, and as regulator of non-profits.

Chapter 6 looked at the nature of non-profits in China, and also in doing so identified differences/similarities compared with the western world. This chapter helped identify the unique nature of non-profits in China, essential to the analysis of non-profit board

governance in China. Chapter 7 was of the utmost importance to my thesis. It reviewed the Chinese context and synthesised my blueprint with the relevant social determinants in China. The chapter acted as a bridge, linking the UK section with the Chinese part. The chapter contributed significantly to existing literature. Research looking at the non-profit sector in China is notably underdeveloped, and especially compared to research on the Chinese *for-profit* sector. There has not been any attempt to date to design a blueprint for board governance, that examines comprehensively the board attributes encompassed within the blueprint presented here, contextualised to the distinctive environment for non-profits found in China.

### **10.2.5 Reviewing the board governance in the non-profit sector in China**

With the blueprint modified to reflect the Chinese context, Chapter 8 then turned to review how far the current regime for non-profit board governance in China corresponds to that blueprint. In a sense, Chapter 8 therefore sought to repeat, for China, the exercise carried out in Chapter 5 in respect of the UK. We focused on three sets of administrative regulations (Foundation Regulations, SO Regulations, and CNI Regulations). During this process, it was recognized that most provisions in these regulations seem designed to satisfy the regulatory and social needs arising from China's economic development, its reform of the *danwei* system, as well as the Chinese Government's ever changing policies. Insofar as improving board governance in China, the legal contribution of these three sets of rules is, sadly, very limited. But in exposing these deficiencies, we have identified the legal gaps in establishing an effective non-profit board, and a path for future governance reform in China has been mapped-out here. This path is also able to provide insights into how board governance is developing under the fast-changing Chinese context.

Besides these three sets of longstanding regulations, the Charity Law 2016 marks a new, potentially fundamental (and, so far as this thesis was concerned, last minute) addition to the regulatory framework. Therefore, we devoted a whole chapter to identify its advantages/deficiencies, and examine its influence on non-profit governance in China. As we saw in Chapter 10, the Charity Law 2016 is symbolic and, indeed fundamental, as it has taken the first and most important step forward in

bringing Chinese non-profits to a new stage. In spite of the pitfalls of the Charity Law 2016 that we addressed, we also noted a considerable number of changes that are mostly in favour of China's non-profit governance and development. Chapter 10, like Chapter 9 before it, also contribute significantly to the Chinese literature on non-profit governance, in that not only do they provide a deep analysis of the existing regulations on non-profits in China, but also explore the existing legislative gaps and shortcomings, as well as the causes of those shortcomings in terms of existing social and political determinants. More specifically, the analysis presented here suggests that the biggest driving force behind non-profit governance failure is the over-intervention of the Chinese Government. To be sure, it is unlikely that the Chinese Government will completely withdraw from some measure of control over the non-profit sector. Fortunately, our research has managed to find out a range of viable strategies to deal with the intervention of the Government and thus facilitate the survival/governance of Chinese non-profits.

### **10.3 Issues for Future Research**

This thesis makes a small contribution to the literature on non-profits in China, but, inevitably, much more remains to be done. As a final word, then, it is worth flagging up some of the side-roads this thesis has not had time to venture down, but which deserve attention. First, we need much more empirical research on actual boardroom practices in Chinese non-profits. Second, this thesis did not attempt to examine every legal form of non-profits in China. In particular, we excluded both unregistered grassroots non-profits, and those organisations that perform a social role, often acting as non-profits, but which choose to operate through a 'for profit' legal form. Further research needs to be conducted on these phenomena. Finally, the introduction of the Charity Law 2016 presented obvious challenges in drawing this thesis and its research to a conclusion. Our coverage provided a number of important insights about that legislation, but as with any such fundamental change of law, much more research is needed to understand, in the fullness of time, the full impacts of this legislation.

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