

**The History of Corporate Ownership in China**

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**Introduction**

The historical development of corporate enterprise in China is particularly interesting in the context of the current trend towards the globalization of Western-style corporate governance. Roughly a century ago, during the last great period of globalization, the Imperial government promulgated a set of laws that created a framework for modern, Western-style limited liability corporations in China. The government was clearly responding to competition and stimulus from foreign business enterprises in China, however, the new corporate structure collided in interesting ways with an existing business environment based on family firms and state patronage. In this paper, we examine the emergence of corporate ownership in China from the final decades of the Qing empire in the late 19<sup>th</sup> century to the early Republican period in the 1910s and 1920s. By analyzing the actual process of incorporation, the development of the legal and financial environment, and the role of the state, we ask whether this “top-down” approach, in which the central government established a legal framework for corporate enterprise based on Western models and the assumption that it would work as it did for Western firms and markets, was a viable approach to the modernization of a financial system traditionally dominated by family businesses and economic state patronage. Using business records from turn-of-the-century Chinese corporations, this paper argues that the government’s “top-down” approach,

while clearly well-intentioned, created a framework which only insufficiently promoted the system of corporate capitalism. As our analysis shows, Chinese business institutions essentially imitated the form of Western corporate institutions without fully installing essential structures and features of the corporate system according to our Western interpretation. Although China's first corporate code contained many elements of the modern formula for privatization — including some requirements for transparency, separation of ownership and control, and annual auditing and reporting requirements —, it ultimately failed to effectively transform business enterprise. Why? We argue that the code fell short on two counts. First, it did not sufficiently shift ownership and control from managers, previously empowered by government patronage, to shareholders – despite vigorous attempts by shareholders to assert their rights. Second, the company code was not effective in stimulating the emergence of an active share market that would induce family-owned firms and entrepreneurial managers to exchange control for access to shareholder capital and the liquidity of an active exchange. While a market for domestic Chinese companies began in Shanghai as early as the 1870's, it was subject to a series of booms and busts that prevented it from being an effective means to tap investor savings. In contrast, during this same period the Shanghai Stock Exchange for foreign-domiciled companies became one of the world's most active equity markets.

This paper is structured as follows. After discussing the changing role of government participation in companies in the 19<sup>th</sup> century in the first part of this paper, the second part is dedicated to the Company Law of 1904 and its impact on the development of corporate business structures. In the third section we examine the issue of control and ownership by exploring the role of shareholders, their rights and representation, investment opportunities and the development of capital markets. The conclusion discusses the lessons that modern market

reformers can learn from the historical Chinese experience. Considering the “top-down” approach of the current Chinese government and the hope of other nations around the world to create effective capital markets, this paper has implications for the modern challenges of privatization and introduction of corporate capitalist structures in the 21<sup>st</sup> century.

## **I. Business Institutions in 19<sup>th</sup> Century China: State Governance through Patronage and Sponsorship**

Before the introduction of China’s first Company Law in 1904 and the founding of the Republic in 1911, family businesses, many of them of substantial size and scope, were the central institutions for domestic private economic activities in Ming and Qing China. The largest and most successful of these enterprises also relied upon some form of state sponsorship. All of the famous mercantile family firms such as those of the Yangzhou salt merchants or the Huizhou merchants in the pawnshop business operated under and were dependent upon government patronage. Family businesses had a long tradition in China, but only changes in business law, which came about first in the treaty ports and then by 1904 in the rest of China, were conducive to the incorporation of those private business institutions.

By contrast, foreign corporate enterprise developed vigorously in Chinese treaty ports during the late 19<sup>th</sup> Century. Shares of foreign-registered corporations doing business in China began trading in Shanghai in the 1860’s, and the Shanghai Stock Exchange served as a conduit for domestic and foreign investment in China for the next 70 years. While Chinese domestic corporations did not trade on this colonial stock exchange, the evolution of a domestic Chinese corporate code and domestic capital markets must be studied against a backdrop of a colonial

business that was regarded by the Chinese government both as a foreign competitor to domestic business and, eventually, a useful structure for adaptation to China's own purposes.

The issue of Chinese "imitation" of Western practice in this period has been much discussed, and numerous authors have pointed out legitimate domestic precursors to nearly every kind of large-scale business enterprise in China before the appearance of foreign capitalism in the treaty ports. There is no doubt that China before Western influence possessed the seeds of a long-distance/interregional banking system, experience with large-scale business institutions, the capacity to plan and execute large-sale infrastructure improvements, and countless manufacturing and mercantile entrepreneurs whose firms employed numerous workers and whose business ventures extended great distances. Given the existence of large-scale domestic business ventures in China prior to the presence of Western enterprises, we suggest that the utilization of a Western-style corporate code in 1904 should be thought of as an adaptation of an international financial and managerial "technology" to Chinese business needs. The term technology is appropriate here because the early champions of Western-style finance in China regarded it as a tool to advance the goal of improvement to China's social, military, and economic well-being, rather than as a means to "Westernization" or acquiescence to foreign influence.

Indeed, the processes of adaptation began well before the formal introduction of the corporate code in 1904. These processes were largely motivated by a sense of competition with the West, rather than a sense of imitation. The first attempts to build large-scale industrial enterprises on the Western model were undertaken by concerned government officials after the end of the Taiping Rebellion in 1864. In the wake of this major political crisis, the Qing government experienced a substantial weakening of its central authority. As one would expect, whatever little industrialization that existed in China before 1895 was characterized by a focus on heavy industries

serving the government's military and defense purposes.<sup>1</sup> This circumstance was directly linked to the program of the so-called Self-Strengthening Movement in which reform-minded government officials — mostly politically powerful provincial governor-generals — attempted to revive the national economy and military after the devastating Taiping Rebellion during the Tongzhi Restoration period between 1862 and 1874.

When Li Hongzhang (1823-1901) was appointed governor-general of Zhili and Imperial Commissioner of the Northern Ports in 1870, he became the most ardent proponent of the Self-Strengthening Movement. One significant part of his plan was to acquire knowledge from the West — including knowledge of Western industrial and financial practices. He secured permission from the imperial government to send Chinese students to study in France in the 1870's. One of them, his protégé, reformer Ma Jianzhong, made a careful study of Western railroad finance in 1879, and proposed the adoption of public bond issues for infrastructure development in China.<sup>2</sup>

Together with moderately reform-minded officials and political authorities such as Zeng Guofan (1811-1872) and Zuo Zongtang (1812-1885), Li Hongzhang demanded that the Chinese government strive to improve its military equipment and technology in order to defend against the Western powers who had displayed their military superiority so forcefully at China's expense. However, these government officials were not proponents of launching an industrial revolution or a modern economy in China. On the contrary, they wanted to restore the traditional economy,

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<sup>1</sup> Albert Feuerwerker, "Economic Trends in the Late Ch'ing Empire" in *The Cambridge History of China*, ed. Denis Twitchett and John K. Fairbank, vol.11, part 2, pp. 1-69, Cambridge: Cambridge University Press, 1980.; Lloyd E. Eastman, *Family, Fields and Ancestors: Constancy and Change in China's Social and Economic History, 1550-1949*. Oxford: Oxford University Press, 1989, pp. 172-173.

<sup>2</sup> Paul Bailey, *Strengthen the Country and Enrich the People: The Reform Writings of Ma Jianzhong (1845-1900)*. Surrey: Curzon, (Durham East Asian Series No. 2), p.14.

including agriculture and commerce, and were not planning on “enhancing the strength and wealth of the country at the cost of its traditional institutions.”<sup>3</sup>

Thus the initial establishment of industrial enterprises has to be interpreted as a step towards regaining military strength and national pride without contesting the status quo of government and society, rather than as a step towards planned economic development. In order to secure control over this policy, any industrial enterprise founded before 1895 required not only sanction or permission, but even active supervision and sponsorship from the government and its agents, the official bureaucrats. Notable examples of this promotion of industrial enterprises under government sponsorship in the 1860s and 1870s included the Jiangnan Arsenal (Jiangnan zhizao ju) and the China Merchants’ Steamship Navigation Company (Lunchuan zhaoshang ju), both in Shanghai, as well as the Kaiping Coal Mines (Kaiping meikuang) near Tianjin.

Curiously, the China Merchants’ Steamship Navigation Company evolved from a business proposal by Yung Wing, an 1857 Yale College graduate, who, like Ma Jianzhong drew upon his experience overseas to propose innovations in Chinese enterprise. Albert Feuerwerker notes that the idea of beating the West at its own game, that is, adopting Western-style corporate business practices to government-controlled enterprise was present in Wing’s initial conception. Quoting Wing’s autobiography, “No foreigner was to be allowed to be a stockholder in the company. It was to be a purely Chinese Company managed and worked by Chinese exclusively.”<sup>4</sup> Once formed, the China Merchants’ Steamship Navigation Company competed vigorously and effectively against Western shipping firms in Shanghai, fulfilling the original dreams of its founders, for whom the

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<sup>3</sup> Mary Clabaugh Wright, *The Last Stand of Chinese Conservatism: The T’ung-chih Restoration, 1862-1874*. Stanford: Stanford University Press, 1957, p. 153.

<sup>4</sup> Quoted in Albert Feuerwerker, *China’s Early Industrialization - Sheng Hsuan-Huai (1844-1916) and Mandarin Enterprise*. Cambridge/Mass.: Harvard University Press, 1958, p. 97.

joint-stock enterprise form was simply a means to the end of reducing China's dependence upon foreigners.

In fact, all three enterprises self-evidently demonstrate the immediate goals of the Self-Strengthening Movement: the Jiangnan Arsenal was to improve China's military strength by manufacturing modern arms, the steamship company was to facilitate the grain transport for the government as well as make China less dependent upon foreign-owned transportation companies, while the mines were supposed to provide the power for national transportation facilities and limited private consumption.<sup>5</sup> This strategy was certainly not an ambitious program aimed at nation-wide industrialization through private initiatives. In order to stress their close relationship with the government's agenda, these new industrial enterprises carried the character *ju* for governmental bureau in their names instead of the characters for factory (*chang*) or industrial company (*gongsi*) which would have indicated a private business concern. While each of these firms was funded in part by the issuance of shares to Chinese merchants, they were not floated on a public capital market in the manner we understand today, nor indeed were they funded through a public issue in the manner used by foreign-registered corporations in Shanghai at the time.

Despite their public/private genesis, the shares of these first Chinese joint-stock companies did trade publicly in the first decade after their founding and they seem to have been part of China's first stock market "bubble." In fact, Chinese speculators evidently also took a strong interest in the shares of these first domestic firms. Trading in the 1880's was handled by at least one broker (the Pingzhun Stock Company) registered to trade and publish prices, and the prices appeared in local

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<sup>5</sup> See Feuerwerker, *China's Early Industrialization*; Chi-kong Lai, "The Qing State and Merchant Enterprise: The China Merchants' Company, 1872-1902" in *To Achieve Security and Wealth - The Qing Imperial State and the Economy, 1644-1911*, ed. Jane Kate Leonard and John R. Watt, pp. 139-55. Ithaca: Cornell University Press, 1992; Ellsworth C. Carlson, *The Kaiping Mines (1877-1912)*. Cambridge/Mass.: East Asian Research Center, Harvard University, 1971.

Chinese language newspapers.<sup>6</sup> A chart of these prices shows that they were trading at a 20% premium to par by 1882 only to drop to half of that by the middle of the 1880's. (See Figure 1: Equal-Weighted Index of Chinese Stocks in Shanghai, 1882-1887) Speculations and price manipulations of some of the companies' major shareholders who often were also the managers of the companies, contributed to the crisis.<sup>7</sup> Thus it is curious that, at about the time that the robber-barons Gould and Fisk were manipulating prices of railroad securities on the New York Stock Exchange, the Shanghai market suffered from the same problems of insider trading. This was thus not a failure of corporate law *per se* but rather a regulatory failure. While the NYSE eventually managed to recover the trust of investors and serve as a conduit for investor capital, the domestic Shanghai market was not so lucky. After the crash of 1883, the Shanghai market for domestic shares did not recover for decades. Except for a flurry of speculative trading in domestic railroad companies IPO's in the first decade of the 20<sup>th</sup> Century, public quotes for shares were few and far between. As David Faure notes, "tradition-bound attitudes were not replaced by share-holding in the modern companies. Rather, it was share-holding that was being absorbed into the Chinese business tradition".<sup>8</sup> Indeed, from 1887 to the 1920's, when a formal exchange was finally created for Chinese firms in Shanghai, the public market for shares was moribund.

This market failure was particularly unfortunate, for, as we will show later in the paper, it removed one of the major motivations for entrepreneurs and managers to accede control to outside shareholders. If the public would not willingly commit new capital to the enterprise, and if privately

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<sup>6</sup> Andrea McElderry, "Shanghai Securities Exchanges: Past and Present," *Occasional Paper Series of the Asian Business History Centre No.4*, History Department, University of Queensland, 2001, pp. 5-6.

<sup>7</sup> David Faure, *China and Capitalism - Business Enterprise in Modern China*. Hong Kong: Division of Humanities, Hong Kong University of Science and Technology, 1994, pp. 38-40; McElderry, "Shanghai Securities Exchanges", p. 5.

<sup>8</sup> Faure, *China and Capitalism*, p.39.

held shares were worth relatively little in the public market, why should owner-managers give up the private value of ownership and control?<sup>9</sup>

One way to overcome the predicament of the lack of public markets would have been to establish the new enterprises as government monopolies similar to the economic strategy of the Meiji government in Japan during the 1870's and 1880's. However, given its strained financial situation, the Qing government did not have sufficient funds available for such investment. In addition, the machinery, the technological and managerial procedures of the new enterprises required expertise which government officials with their administrative background could not provide.<sup>10</sup>

It is important to point out that the financial problems China faced in the 1870's and 1880's were not unique. This was the era of a worldwide transportation revolution, and the challenge of financing the construction of large-scale transportation networks confronted virtually every sovereign nation in some form. Major infrastructure projects like rail, gas and electrification required a quantum leap in financial technology. It was the fundamental nature of these projects that their benefits were only experienced after large up-front costs were incurred. Most nations, including China, turned to the foreign capital markets in London, Paris and Brussels to fund construction through railroad bonds and deals with foreign railroad companies. However, these deals were conceptually at odds with the initial motivation for establishing domestic firms to

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<sup>9</sup> See Zhu, Yingui, "Three Market Crashes and Shanghai Securities Market in Late 1880's and Early 1900's," *China Economy History Research*, 1998, Issue 3, pp. 58-70, as well as McElderry, "Shanghai Securities Exchanges". A time-series comparison of prices of domestic and foreign shares can be found in William N. Goetzmann, Andrey Ukhov and Ning Zhu, 2001, "China and the World Financial Markets 1870-1930: Modern Lessons from Historical Globalization," Working Paper, International Center for Finance, Yale School of Management.

<sup>10</sup> For a general introduction see Wellington K. K. Chan, "Government, Merchants and Industry to 1911" in *The Cambridge History of China*, ed. Denis Twitchett and John K. Fairbank, vol. 11, part 2, pp. 416-62. Cambridge: Cambridge University Press, 1980. On Japan's industrial development see Johannes Hirschmeier, *The Origins of Entrepreneurship in Meiji Japan*, Cambridge/Mass: Harvard University Press, 1964, and Thomas C. Smith, *Political Change and Industrial Development in Japan: Government Enterprises, 1868-1880*. Stanford: Stanford University Press, 1968 (1955).

compete against foreign businesses. China possessed considerable economic potential at the turn of the century, however, without a functioning domestic capital market, it was unable to tap these resources to retain control of its own technological development.

In order to address some of the failures of the domestic capital marketplace, new industrial enterprises established in the 1870s and 1880s took the form of government-sponsored enterprises, known as *guandu shangban* (government supervision and merchant management) enterprises. The bureaucratic term for this type of enterprise had its origin in the traditional set-up of the government's salt monopoly where merchants had provided capital and management while government officials maintained control of production and trade quotas. Under the new scheme for large-scale industrial enterprises, private investors, mostly merchants, were expected to put up the capital and to manage their investment under the supervision of government officials. This arrangement meant that apart from some financial sponsorship through government loans, the merchants bore all the financial risks of the enterprise which often became joint-stock operations. In addition, they were required to work under the thumb of supervising government officials who often followed their own, not necessarily government-directed business agendas and who introduced bribes, corruption, and inflexible management into these enterprises. Albert Feuerwerker and Guohui Zhang have shown in detail the manifold problems these industrial government enterprises encountered due to the peculiar financial and managerial arrangements.<sup>11</sup> Not surprisingly, the financial profit for the private investors in these *guandu shangban* enterprises in the 1870's and 1880's was rather limited.

For example, the China Merchants' Steamship Navigation Company attempted for a short while to consolidate the government-business cooperation with its new joint-stock structure

between 1872 and 1884, but continued under dominant government influence in the following years.<sup>12</sup> In the privatization process after 1895, the supervising director of the company appointed by the government, Sheng Xuanhuai (1849-1916), became an appointee of the board of directors, which was more a change in name than in fact, as Sheng, while supervising director, had already acquired substantial shares in the company.<sup>13</sup>

During this period of initial state-directed industrial efforts, Li Hongzhang, in his position as government official and personal supervisor/sponsor, became the most powerful patron of *guandu shangban* enterprises. The China Merchants' Steamship Navigation Company, the Kaiping Mines, and the Shanghai Cotton Cloth Mill were all under his official sponsorship which actually translated his political power in the government into the opportunity to establish his own sphere of economic influence and to control these enterprises in a quasi-monopoly situation. This is not to say that Li Hongzhang's patronage had a completely negative impact on these enterprises. As Chi-kong Lai has shown for the China Merchants' Company, in the beginning Li's sponsorship in fact secured sufficient financial support and autonomy for the merchant managers.<sup>14</sup> Only when Li Hongzhang was eventually unable to prevent the government from assuming more direct control of the management, did the company encounter problems. Extraction, mismanagement, and misuse of funds accompanied the government's growing intervention in the enterprise, leading to decreasing merchant investment. In general, lack of auditing procedures and absence of distinction between

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<sup>11</sup> Feuerwerker, *China's Early Industrialization*; Guohui Zhang, "The Emergence and Development of China's Modern Capitalist Enterprises" in *China's Quest for Modernization: A Historical Perspective*, ed. Frederic Wakeman, Jr. and Wang Xi, pp. 234-249. Berkeley: Institute of East Asian Studies, University of California, 1997.

<sup>12</sup> Lai, "The Qing State and Merchant Enterprise."

<sup>13</sup> See Feuerwerker, *China's Early Industrialization*, especially pp. 161-64; Lai, "The Qing State and Merchant Enterprise".

<sup>14</sup> Chi-kong Lai, "Li Hung-Chang and Modern Enterprise: The China Merchants' Company, 1872-1885" in *Li Hung-chang and China's Early Modernization*, ed. Samuel C. Chu and Kwang Ching-Liu, Armonk/New York: M.E. Sharpe, 1994, pp. 238.

private and company funds characterized these government-sponsored enterprises as much as any family business at the time.

In order to attract private investment from merchants who had become less and less willing to risk their money in government-sponsored enterprises in the 1880s, the government devised a compromise and promoted a more attractive kind of cooperation for merchants in the form of *guanshang heban* (official and merchant joint management) enterprises. According to this new arrangement, merchants were to be more in control of the management and the allocation of the capital invested. However, this move by the government towards more flexibility and private financial as well as managerial involvement never really materialized and did not trigger the desired outpouring of investment funds. In fact, the dissatisfaction of the merchants grew during the early 1890s and was even acknowledged by government officials.<sup>15</sup>

Certainly, the now more restrained presence of the government in *guanshang heban* enterprises still offered private investors some advantages with regard to official protection against inconvenient national and foreign competition. Nevertheless, creating a positive investment climate for private activity in the industrial sector would first require the more drastic step of abolishing the general protectionist mechanism against private enterprises in China, namely, the government policy which did not allow Chinese nationals independently to open private industrial enterprises anywhere in the empire.

The turning point came in 1895 with a new phase of industrial entrepreneurship in China.<sup>16</sup> From that year on, enterprises in light industry and in the consumer goods industry were founded in greater numbers with a significant shift from government sponsored enterprises to enterprises with private involvement in ownership and management. For example, a boom in establishing cotton

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<sup>15</sup> Chan, "Government, Merchants and Industry to 1911", pp. 434-35.

mills with full Chinese ownership took place after 1895. Between 1890 and 1894 only a total of five cotton spinning mills had been successfully established (all but one with government involvement), while by 1916 thirty new mills were in operation, all of them under private merchant management (*shangban*).<sup>17</sup> The statistics of weaving mills is even more impressive. While only one factory in private management was operating in 1897, by 1916, 81 private weaving mills were in business.<sup>18</sup>

In another important sector, 35 mining enterprises were founded between 1895 and 1911 as private enterprises (*shangban*) in contrast to nine mining enterprises in total government ownership (*guanban*), ten other enterprises under joint government-merchant management (*guanshang heban*), and only two as government supervised-merchant management operations (*guandu shangban*).<sup>19</sup> As the government withdrew from direct involvement in the enterprises remaining under joint management, new forms of private business operations developed, now supported by structural aspects of incorporation, limited liability, and legal accreditation. The incentives for increased industrial activity and the changing ownership conditions did not originate in deliberate government reforms out of concern for a weak national economy; rather, they resulted from events in connection with China's foreign policy.

The Treaty of Shimonoseki at the end of the Sino-Japanese war in 1895 for the first time granted foreigners permission to engage in manufacturing operations in Chinese treaty ports. Since permission had been given to foreigners for building factories in China, it was impossible for the government to prevent its own nationals from engaging in industry any longer. However, the fall of

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<sup>16</sup> Quan, Hansheng, *Zhongguo jingjishi yanjiu* (Research in Chinese economic history), vol. 2, p. 715. Taipei: Xinya yanjiusuo, 1991.

<sup>17</sup> Du, Xuncheng, *Minzu zibenzhuyi yu jiu Zhongguo zhengfu* (Native capitalism and the government of old China), Shanghai: Shanghai shehui kexueyuan chubanshe, 1992, pp. 286-292. All the mills included in this statistic have a starting capital of at least 10,000 yuan.

<sup>18</sup> *Ibid.*, pp. 293-304. Only five of the 86 new weaving operations established between 1902 and 1916 were under government management (*guanban*).

<sup>19</sup> Du, *Minzu zibenzhuyi yu jiu Zhongguo zhengfu*, pp. 460-70.

Li Hongzhang from power in 1895 was also a vital factor.<sup>20</sup> Li Hongzhang's personal patronage of such enterprises as the Kaiping Mines, the Shanghai Arsenal, and the China Merchants' Steamship Navigation Company had been a crucial reason for their success. Li Hongzhang was powerful not only in Beijing near his power base in Zhili province, but also in Shanghai. There he exerted his influence in the appointment of the Shanghai circuit intendant (*daotai*), the most senior official in Shanghai's administration, and worked successfully for his operations by networking through fellow provincials, colleagues, and fellow examination graduates.<sup>21</sup> Through these formal and informal relationships Li Hongzhang was able to gain support from Shanghai and Jiangsu officials as well as from merchants and gentry members who either were attracted by Li's financial awards or by their own vested interests in the enterprises. In short, as long as Li Hongzhang was in power, the operations under his supervision were protected through his patronage and thus also through their exceptional monopoly status.

Despite the fall of Li Hongzhang and his monopolistic restrictions and the opening of the industrial realm to private initiatives, it took more than a decade before China was to experience substantial industrialization in regard to the number of factories and their output, and it was not until the post-1900 Qing reforms that the imperial court openly encouraged private business and industrial enterprise.<sup>22</sup> Establishing factories for light industry production, transportation or banking businesses required considerable private capital investment from merchants or businessmen. Even without interference from the government and influential officials, the risk of investing private capital in major industrial operations such as cotton spinning mills or silk filatures was still

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<sup>20</sup> Shao, Xunzheng, "Guanyu Yangwupai minyong qiye de xingzhi he daolu - lun guanliao shangban" (Concerning characteristics and ways of civil enterprises of the Yangwupai - discussion on officialdom and merchant management) in *Shao Xunzheng lishi lunwenji* (Collection of Shao Xunzheng's historical essays), ed. Li Kezhen, pp. 349-371. Beijing: Beijing daxue chubanshe, 1985, especially p. 369.

<sup>21</sup> Yuen-sang Leung, "The Shanghai-Tientsin Connection: Li Hung-Chang's Political Control Over Shanghai" in *Li Hung-Chang and China's Early Modernization*, ed. Samuel C. Chu and Kwang-Ching Liu, pp. 108-118.

<sup>22</sup> See also Faure, *China and Capitalism*, pp. 46-48.

considerable in the early twentieth century. Without an open and accessible capital market for domestic shares, the raising of capital was still one of the major problems in founding private enterprises, with the exception of family businesses which recruited their capital from kinship and native-place networks.

There were, however, instances during this post-1900 period when the potential for full development of a Chinese share market appeared. Lee En-han documents the evolution of the Chinese Railway Rights Recovery Movement from 1904 to 1911, a period in which a number of domestic Chinese railroad companies were chartered and capitalized in the wake of nationalistic efforts to recover the railroad concessions made to foreign development firms.<sup>23</sup> Nineteen major provincial railway companies were formed with Chinese capital raised through a combination of public share issuance, domestic, and overseas Chinese merchant investment and provincial government sponsorship. In some cases, these firms were given development rights that were stripped from foreign entities. Virtually all of these ventures foundered in the late Qing or early Republican period; some for political reasons associated with the suspension of their charters by the Imperial government, others from lack of capital, mismanagement or lack of managerial experience. The process of their failure itself is interesting. Lee En-han documents aggressive proxy contests challenging managerial expropriation, some of which emerge in the evolution of one major Chinese firm, the Dasheng cotton mills, that we will examine in some detail in the following section of this paper.

## **II. The Power of the Law? Chinese Company Legislation in 1904**

In the wake of the late Qing reforms, China's first Company Law (*gongsi lü*) was issued by the newly created Ministry of Commerce on January 21, 1904, based on Japanese and English company

laws, but in much abbreviated form. The document was intended to redefine the terms of Chinese corporate enterprise.

It is important to recognize that China did not lag too far behind Western legal corporate reform in the late 19<sup>th</sup> Century. Britain, for example, only codified limited liability with its Companies Act of 1862, and from the mid 1860's through the 1880's British companies doing business in China experimented with adapting the Act and British law to the needs of overseas enterprise. Most major British firms in Shanghai only became limited liability companies in the 1880's, and before 1907, most Shanghai-based British firms typically registered their official domicile in Hong Kong in order to avoid the ambiguities of a treaty port legal environment – governed as it was by a multitude of nationalities.<sup>24</sup> Thus, in the 1870's and 1880's, the Western corporate model itself was evolving to address the challenges of international investment and business enterprise. The fact that shares of British firms traded as early as 1866 in Shanghai suggests that China was exposed quite early to the developing financial technology of British-style corporate capitalism. The creation of the China Merchants' Steamship Navigation Company as a Chinese corporate enterprise of sorts in 1872 — ten years after the Companies Act — indicates that China was, even at that time, choosing to take its own financial course in the context of an evolving structure of capitalism in the late 19<sup>th</sup> century. Thus, the code of 1904 should not be viewed as a beginning of corporate capitalism in China in any sense, but rather a top down “revision” of the course that large-scale Chinese business enterprise had taken over the previous three decades – a course that had already freely interacted with, and adapted from, Western style business models.

A new legal framework was certainly not inevitable, given the developments up to this time. The alternative to promulgating a code in 1904 was the *laissez-faire* course of allowing the

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<sup>23</sup> En-han Lee, *China's Quest for Railway Autonomy: 1904-1911*. Singapore: Singapore University Press, 1977.

continuation of firm level adaptation and development under local official patronage. The code took a different approach than previous government forays into business enterprise. Rather than the “hands on” inclusion of government officials in the governance structure, the code was “hands-off” – eliminating the direct participation of the government in the corporate entity, and instead replacing that presence with a set of external rules and structures designed to make the corporation responsive to shareholders. It thus sought to encourage the establishment of Chinese companies modeled on Western corporate structures which would be able to compete with the foreign companies producing and selling goods in China. With regard to existing Chinese company structures, the company law was supposed “to overcome the constraints of the partnership” which, lacking the limited liability concept, in William Kirby’s words “could be limiting, but not limited.”<sup>25</sup>

The 1904 Company Law contained 131 articles in 11 sections and stipulated issues such as company organizational forms, ways to report a company’s founding, methods of business management and shareholder rights.<sup>26</sup> For example, it stipulated that the Board of Directors be elected at a general meeting of the shareholders who also obtained the right to pass resolutions at those meetings. According to the code, businesses in the form of partnerships with unlimited or limited liability, joint-stock companies with unlimited or limited liability, and sole proprietorships with unlimited liability were allowed to register.<sup>27</sup> Between 1904 and 1908, some 272 companies

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<sup>24</sup> W.A. Thomas, *Western Capitalism in China: A History of the Shanghai Stock Exchange*. Ashgate, 2001, p. 28 and ff.

<sup>25</sup> William C. Kirby, “China Unincorporated: Company Law and Business Enterprise in Twentieth-Century China”, *Journal of Asian Studies*, vol. 54, no.1, pp. 43-63, quote p. 47.

<sup>26</sup> Zhu, Ying, “Lun Qing mo de jingji fagui (Economic legal regulations at the end of the Qing dynasty)”, *Lishi Yanjiu* (Historical Reserach), 1993, vol. 5, pp. 92-109.

<sup>27</sup> Shangwu Yinshuguan Bianyisuo, *Da Qing Guangxu xin faling* (New legal regulations of the Guangxu period in the Qing dynasty). 20 *ce*. Shanghai: Shangwu yinshuguan, 1909. ‘Gongsi lü’ (Company code), 2:a.

had registered with the Chinese government, over half of them as joint-stock companies with limited liability.<sup>28</sup>

Here are some examples of how existing Chinese businesses responded to the new Company Law. The Nanyang Brothers Tobacco Company was registered under English law in Hong Kong in 1905 and later as a joint-stock company with the Beijing government under Chinese law in 1918.<sup>29</sup> The management of the company, especially its debts and credit arrangements, had always been problematic because of the use of former compradors, since it was never clear whether they acted as agents or principals. With the new holding structure of the business company, Sherman Cochran documents a managerial innovation in the appointment of a financial controller in 1919 who was responsible for reorganizing the company's finances.<sup>30</sup>

Many families opted not to register their firms for fear of losing control over management and equity. Even those family firms that registered with the Chinese government (and most family firms in the treaty ports did not), did not necessarily give up their family business structure. The Yong'an (Wing On) company, famous for its department stores in Shanghai and founded by the Guo family in Hong Kong in 1907, is example of a large family business that was registered under English law and continued to exist as a joint-stock limited liability company in 1912. The family exerted its strong financial control over the company's shareholding structure.<sup>31</sup> Despite taking the company public, the Guo brothers were able to achieve almost a consolidation between ownership and control through shareholdings from extended family, overseas and native place networks,

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<sup>28</sup> Wellington K.K. Chan, *Merchants, Mandarins and Modern Enterprise in Late Ch'ing China*. Cambridge/Mass.: Harvard University Press, 1977, pp. 180-82.

<sup>29</sup> Sherman Cochran, *Big Business in China: Sino-Foreign Rivalry in the Cigarette Industry, 1890-1930*. Cambridge/Mass.: Harvard University Press, 1980, pp. 56, 100-101.

<sup>30</sup> *Ibid.*, pp. 151-152.

<sup>31</sup> Shanghai Shehui Kexueyuan Jingji Yanjiusuo, *Shanghai Yong'an gongsi de chansheng, fazhan he gaizao* (The establishment, development, and transformation of the Shanghai Yong'an Company). Shanghai: Renmin chubanshe, 1981, p.7.

interlocking directorships and inter-company loans.<sup>32</sup>

Needless to say, the treaty ports, not rural areas, became preferred locations for Chinese to establish their new incorporated enterprises. Treaty ports were of course the places where foreign corporate capitalism presented the greatest competition to domestic enterprise – and also the places where new “financial technology” was first introduced to China. Compradors working for foreign firms quickly understood and mastered the structure of corporate capitalism, and were among the first to introduce these methods to Chinese businesses. Chinese merchants and businessmen in turn valued the cooperation with compradors in the treaty ports in order to gain access to new financial sources and foreign products and technology. Finally, Chinese investors used the presence of foreign settlements and their special legal administration in order to register their companies under the protection of foreign legal statutes.

The role of the imperial government in the registration process was not dominant but remarkably restrained. According to the 1904 law, businessmen had to register their companies with the local chamber of commerce. Then the registration would then be forwarded to the central government in Beijing. As a clear affirmation of the much more visible hand of the Republican government, this practice was abolished in the law’s 1914 revised and expanded form when registration now had to take place directly with the government.

In order to assess in detail the impact of the company law on the lifecycle of a Chinese business from the late 19<sup>th</sup> to the early 20<sup>th</sup> century, we shall now turn to the Dasheng enterprise, by any measure a major business enterprise at the time. Its experience in many ways is typical of firms studied by economic historians interested in late Qing business history. It reveals the strengths and weaknesses of industrial enterprises founded in the wake of 1895, and the transition that came about

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<sup>32</sup> Wellington K. K. Chan, “The Origins and Early Years of the Wing On Company Group in Australia, Fiji, Hong Kong and Shanghai: Organisation and Strategy of a New Enterprise” in *Chinese Business Enterprise in Asia*, ed.

with the privatization process. Dasheng was originally conceived as a regional enterprise in the form of a *guanshang heban* operation; it was officially initiated by Governor-general Zhang Zhidong who lent his support as the patron in the beginning. However, in contrast to the previous system under Li Hongzhang, Zhang Zhidong who represented the *guan* or official side in the enterprise, did not represent the government as a corporate body but acted as an individual official. In this position he offered patronage and ineffective official protection for the enterprise, but not much else.<sup>33</sup>

One could say that the watering down of government patronage to individual official patronage eventually led to the complete disappearance of involvement by individual officials in the enterprise. Zhang Zhidong was unable to offer Dasheng vital financial support, and without financial leverage his official influence faded from the picture. The originally government-sponsored enterprise thus became soon a privatized operation under the strong impact of the founder's family without ever developing into a family business. Registered officially as a shareholding company with limited liability in 1907, Dasheng then grew into a major industrial complex with considerable financial success and a substantial life-span.

It is difficult to establish the exact date when Chinese enterprises like Dasheng, or more precisely the Dasheng No.1 mill, acquired private, corporate status as a legal entity. After extensive search in various archives it is safe to say that no documents exist that formally dissolved the initial form of the enterprise at its foundation as a *guanshang heban* (official-merchant joint management) operation. The text printed on share certificates from 1897 and from 1903 still stated that the Dasheng spinning mills

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Rajeswary A. Brown, pp. 80-95. London and New York: Routledge, 1995, especially p. 89.

<sup>33</sup> For a detailed study of the Dasheng business between the late 19<sup>th</sup> century and the early 1950s see Elisabeth Köll, *From Cotton Mill to Business Empire: The Emergence of Regional Enterprise in Modern China*. Cambridge/Mass: Harvard Asia Center, Harvard East Asian Monographs No. 229, Fall 2003.

... were established in Tongzhou with approval granted by edict in response to a memorial from the Minister of the Southern Ports [i.e. Zhang Zhidong]..., by contract set up for perpetuity to be jointly managed (*yongyuan heban*) by officials and gentry...<sup>34</sup>

In March 1905 the *Dagongbao* newspaper published an announcement which listed the Dasheng No.1 Cotton Mill as approved and registered by the Ministry of Commerce (*shangbu*) together with ten other companies (*gongsi*) established by Dasheng's founder, Zhang Jian.<sup>35</sup> This was the official recognition of the company registration required by the Company Law (*gongsi li*) as promulgated in 1904.<sup>36</sup> Finally, we know from the published report of the first shareholder meeting in 1907 that the Dasheng No.1 Cotton Mill had now taken on the form of a stockholding company with limited liability (*gufen youxian gongsi*).<sup>37</sup>

What did the shareholders of the newly incorporated companies say? We must not forget that although Dasheng had been operating with private share capital since its establishment in 1898, shareholders had no public forum within the enterprise to voice their suggestions or criticism regarding the company's policies. Thus the new legal status of the company seems to have been met with great enthusiasm from the shareholders. Zheng Xiaoxu (1860-1938), one of the most prominent shareholders with an active career in business and national politics, most notably as a staunch Manchu loyalist<sup>38</sup>, is quoted in the 1907 shareholder report, which documents the lively discussions at Dasheng's first ever shareholder meeting:

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<sup>34</sup> Nantong Textile Museum (Nantong fangzhi bowuguan): doc.247, share certificate from 1897; doc.182, share certificate from 1903. Share certificates from the years 1898 to 1903 with the same text are also kept in the Nantong Municipal Archives (Nantong shi dang'anguan): B 402-111-1.

<sup>35</sup> *Dagongbao*, March 4, 1905, 2a-2b; March 6, 1905, 2a.

<sup>36</sup> Shangwu Yinshuguan Bianyisuo, *Da Qing Guangxu xin faling*, 'gongsi li', 10:3b.

<sup>37</sup> Nantong Municipal Archives: B 402-111-445, 13b.

<sup>38</sup> For the biography of Zheng Xiaoxu (1860-1938) see Howard L. Boorman, *Biographical Dictionary of Republican China*. vol. 1, pp. 271-275, New York: Columbia University Press, 1967-71. Zheng Xiaoxu is probably most famous for his Manchu loyalism and his refusal to recognize the Republic of China. Between 1925 and 1932 he served as assistant to the former Xuantong emperor Puyi.

Formerly all the organization of this mill was unlimited and untouched by any law<sup>39</sup>. Now that we have shareholders' meetings, the unlimited and without-law status should be changed into a company that is limited and with a complete law. We should first decide on its name as Dasheng Stockholding Company With Limited Liability (Dasheng gufen youxian gongsi).<sup>40</sup>

One would expect that the new share certificates of the Dasheng No.1 mill from 1907 onwards would bear reference to the new legal status of the company — but they do not. The certificates only refer to the Dasheng Spinning and Weaving Company (Dasheng fangzhi gongsi) without indicating its new legal status. However, the text on share certificates from the years 1915 and 1919 at least no longer mentions the previous involvement of the government in the establishment of the company.<sup>41</sup>

While some companies like Dasheng, through incorporation, rid themselves of government patronage, some enterprises actively continued to seek and exploit government patronage during the Republican period when political power became even more fragmented. The Lanzhou Mining Company (Beiyang Lanzhou guankuang youxian gongsi) and the Qixin Cement Company (Qixin yanghui gongsi) are examples of such privatized enterprises under rejuvenated patterns of political patronage. Their founder, the government official Zhou Xuexi (1869-1947), enjoyed the political patronage of Yuan Shikai who, first as governor-general of Zhili and later as president of the Republic, had great influence in the Beijing government. Yuan's support of the Qixin company through partial exemption from custom duties and its placement as major supplier of cement for the government-owned railways fortified the positive relationship between the most successful industrialist in northern China and the Beijing government. Although the establishment of the Nanjing government in 1927 meant a drastic change in the political scenario and thus a shift in the

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<sup>39</sup> To translate 'wufa' with 'illegal' would be beside the point, as there was no company law with required registration before 1904, and thus a company without official registration was not an illegal operation.

<sup>40</sup> Nantong Municipal Archives: B 402-111-445, 12b.

<sup>41</sup> Nantong Textile Museum: doc.No.193, share certificate from 1915; doc.No.198, share certificate from 1919.

patronage advantages for Zhou Xuexi, his companies were already so well established that they continued their business with success in the 1930s.<sup>42</sup>

In general, the change to limited liability evidently did not evoke great changes in terms of the business organization of Chinese enterprises.<sup>43</sup> The introduction of annual shareholder meetings appears as the most significant result of their legal transformation into a private, incorporated companies. The new legal status did not affect the internal managerial or the overall structure of the business. The line of hierarchy was basically unchanged as the department heads were still appointed by the managing director, now in consultation with the board of directors (*dongshiju*).<sup>44</sup>

In addition, according to the stipulations of the 1904 Company Law, two auditors (*chazhangyuan*) were appointed to examine the company's finances. However, it should be pointed out that the law did not specify that these auditors had to be independent, only that company directors could not simultaneously serve as auditors for their own companies.<sup>45</sup> This meant that legally auditors could still be selected from the remaining members of the board. For example, in the case of Dasheng auditors were recruited among the board members and thus from within the company management under Zhang Jian's immediate influence.<sup>46</sup> These auditors more or less rubber-stamped Dasheng's annual reports and signed the minutes of the shareholder meetings. We should not interpret their role as controllers who represented the interests of shareholders regarding financial clarity and critical examination. In fact, as part of the management, the auditors were there to defend the financial decisions they had approved on the board earlier on.

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<sup>42</sup> Albert Feuerwerker, "Industrial Enterprise in Twentieth-Century China: The Chee Hsin Cement Co" in *Studies in the Economic History of Late Imperial China: Handicraft, Modern Industry, and the State*, ed. Albert Feuerwerker, pp. 273-308. Ann Arbor: Center for Chinese Studies, The University of Michigan, 1995, in particular pp. 287-302; Carlson, *The Kaiping Mines*, pp. 105-17.

<sup>43</sup> For example, after 1907 the name of the company did not give any evidence of the newly acquired limited liability concept, as none of the successive shareholder and company reports or the official company correspondence actually referred to Dasheng as a *youxian gongsi*, a company with limited liability.

<sup>44</sup> Nantong Municipal Archives: B 402-111-445, 17a-b.

<sup>45</sup> Shangwu Yinshuguan Bianyisuo, *Da Qing Guangxu xin faling*, 'gongsi lü', 10:7a-8b.

On the whole, it seems that the new legal status of incorporation, which we tend to associate with the form of a ‘modern’ business enterprise in the Western sense, did not lead to significant improvements with regard to protecting shareholders rights or curbing the power of the managing director. Judging from the complaints at shareholder meetings of Liu Hongsheng’s or Zhang Jian’s enterprises and their complete ineffectiveness in every respect, with all the potential prospects of openness and accountability through incorporation, shareholders were still placed at a disadvantage. The balance of power did not change in the company. Apparently the top down approach encountered resistance at the managerial level.

In line with common business practice used in government-sponsored enterprises, shareholders in companies that started after 1895 and incorporated relatively early, received guaranteed interest payments at a fixed rate of eight per cent on their share investment. They collected their interest annually in person from the accounting office at the factories.<sup>47</sup> Thus the common shares resembled what we now think of as preferred shares – at least insofar as the dividend payments were fixed and relatively high. This practice clearly increased the risk of the enterprise – while reducing the fluctuation of income to shareholders, it also reduced the discretion of management to fund growth and investment from cash generated by operations. This would not be a major problem in a liquid capital market, in which managers could raise needed funds by issuing additional debt or equity. However, the domestic Chinese share market still suffered from the illiquidity of the 1880’s crash – it did not provide the means to easily finance growth.

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<sup>46</sup> Nantong Municipal Archives: B 402-111-445, 4a.

<sup>47</sup> Köll, *From Cotton Mill to Business Empire*, chapter 5. These interest payments with passbooks were called *xizhe*. As Ellen Hertz points out, even in China today dividends from Shanghai’s stock market are distributed in person and not through the mail. Ellen Hertz, *The Trading Crowd: An Ethnography of the Shanghai Stock Market*. Cambridge: Cambridge University Press, 1998, p. 37.

Why, then, were dividend payments so high and fixed? It is tempting to consider a modern explanation founded in the limitations of corporate governance – the “free cash flow” hypothesis.<sup>48</sup> In essence, Michael Jensen’s free cash flow theory posits that cash from the operations of a company is a temptation to the manager, who seeks to use it to his own ends rather than return it to shareholders. One way to prevent management from diverting corporate funds — or one way for the manager to prove to shareholders he is not diverting funds — is to set a high, fixed payout ratio. This could be achieved through a high debt-equity ratio, or a mechanism like preferred shares. An alternative way to discipline the managers is to have a market for corporate control, i.e. the ability to take over the company by buying all the shares, and then replacing bad management with good. This, of course necessitates an open and active public market for the shares – something largely lacking for domestic Chinese companies until roughly the third decade of the 20<sup>th</sup> Century. Given the documented concerns that Chinese shareholders might naturally have about diversion of funds by managers and the lack of a market for corporate control, high fixed dividends might be expected to naturally arise as a means to assuage investor concerns.

The capital of the Dasheng No.1 mill remained unchanged at 1.13 million taels between 1903 and 1914.<sup>49</sup> The new legal status of limited liability did not attract tremendous interest or create greater trust among investors and did not prompt the management to seek a capital increase through the public offering of new share subscriptions. Shares of the Dasheng No.1 mill were traded for the first time by the Shanghai Stock Merchants Association in 1917, but the trading volume of this trading association operating with government approval since late 1914

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<sup>48</sup> Michael Jensen, “Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers,” *The American Economic Review* 76:2, May 1986, pp. 323-329.

<sup>49</sup> Nantong Shi Dang’anguan et.al., *Dasheng qiye xitong dang’an xuanbian* (Selection of archival material of the Dasheng business complex). Nanjing: Nanjing daxue chubanshe, 1987, pp. 18-19, 93-103.

seems to have been rather limited.<sup>50</sup> When the Chinese Merchants Stock and Commodity Exchange opened in 1920, shares of the Dasheng No.1 and No.2 Cotton Mill were officially listed, and their market prices regularly reported in the *Shenbao* newspaper.<sup>51</sup> Despite a new boom in domestic stock market speculation after 1920, it is unlikely that this public float of shares served in any meaningful way to discipline management. When the speculative bubble in the market burst at the beginning of 1922, public interest in shares again subsided to the point where, by 1931, virtually all the action on the domestic Shanghai exchanges was in government debt.<sup>52</sup>

In the context of financial transparency and control, the question arises whether the new company legislation of 1904 changed the process of creating and controlling accounts in Chinese enterprises. According to the stipulations in the 1904 Company Law, corporations were required to produce a detailed company report at least once every year. The annual report had to contain a profit and loss statement (*churu zongzhang*), a written statement on the company's commercial situation (*maoyi qingxing jielüe*), the exact loss or profit figure, the amount of money paid out as dividends and set aside for reserves as well as a balance of the company's assets and liabilities.<sup>53</sup> Most of the companies complied with all these basic formal requirements in their annual company reports.

In fact, from the existing published and unpublished company records it is clear that companies like Dasheng were fulfilling these basic publication requirements even before the 1904 legislation, and as a general trend accounting practices did not change significantly in the following decades.<sup>54</sup> One would expect certain changes in the reporting style or at least a more detailed, lucid presentation of the accounts as a result of the introduction of new company legislation. However, a

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<sup>50</sup> McElderry, "Shanghai Securities Exchanges", in particular p. 6 and footnote 1 which gives a partial list of the government securities and government shares traded in 1917.

<sup>51</sup> *Shenbao*, August 1920.

<sup>52</sup> McElderry, "Shanghai Securities Exchanges", p. 9.

<sup>53</sup> Shangwu Yinshuguan Bianyisuo, *Da Qing Guangxu xin faling*, 'gongsi lü', 10:9a.

<sup>54</sup> See the annual company reports in Nantong Shi Dang'anguan et.al., *Dasheng qiye xitong dang'an xuanbian*, covering the period between 1899 and 1930.

look into the Company Law from 1904 reveals that no regulations specified the way company accounts should be compiled and recorded, while the regulations for the annual financial statement were summarized in just two lines.<sup>55</sup> Even the revised Company Law from 1914 under the section company accounting (*gongsi zhi jisuan*) did not contain any further specification for standardized bookkeeping.<sup>56</sup>

In short, the law required an annual company report, but no uniform system for company accounting. It should be pointed out that modern, western-style bookkeeping methods found their way into China only in the 1930s.<sup>57</sup> In general, most companies officially used a standardized, modernized accounting system only in the 1940s.<sup>58</sup> Nevertheless, this is not to say that traditional forms of bookkeeping were inefficient or irrational; even in large-scale industrial enterprises they obviously served their purpose. Companies maintained, at least to the outsider, a complex bookkeeping system which provided some internal control within the branches, factories, and offices.<sup>59</sup>

All these observations confirm William Kirby's analysis of the 1904 Company Law in relation to its very limited impact on the development of Chinese enterprises and modern industries. Only a relatively small number of enterprises registered at all, and of those registered as stockholding companies with limited liability only a few were of substantial size and actually

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<sup>55</sup> Shangwu Yinshuguan Bianyisuo, *Da Qing Guangxu xin faling*, 'gongsi lü', 10:9a.

<sup>56</sup> Zhongguo Di'er Lishi Dang'anguan (ed.), *Zhang Jian nongshang zongzhang renqi jingji ziliao xuanbian* (Selection of economic material from Zhang Jian's tenure as Minister of Agriculture and Commerce). Nanjing: Nanjing daxue chubanshe, 1987, 'Gongsi tiaoli', pp. 46-47.

<sup>57</sup> For the introduction of Western-style accounting to China see Gao, Zhiyu, *Zhongguo kuaiji fazhan jianshi* (A brief history of the development of Chinese accounting), (Henan): Renmin chubanshe, 1985, pp. 84-91. From the 1920s onwards the frequent advertising of bookkeeping manuals for industrial and commercial enterprises in newspapers and journals indicates the increasing demand for accounting knowledge.

<sup>58</sup> Nantong Museum (Nantong bowuyuan): E 124/1334, pp. 6-17, 19-20.

<sup>59</sup> Elisabeth Köll, "Controlling Modern Business in China: The Da Sheng Enterprise, 1895-1926", *Journal of Asian Business*, vol. 14, No.1, 1998, pp. 41-56.

grew into sustainable enterprises.<sup>60</sup> Kirby also mentions the uncertainty of how commercial disputes of corporations would be settled by the imperial court system as a factor, which might have deterred investors and discouraged seeking incorporation.<sup>61</sup>

### **III. Characteristics of Corporate Ownership and Control in early 20<sup>th</sup> Century China**

So, why did people bother to register their companies at all? The fact that Zhang Jian also registered the No.2 branch mill in Chongming with the Ministry of Commerce as early as 1905, two years before this mill was even ready to go into operation, shows that he was actively interested in having his industrial companies registered with the government.<sup>62</sup> Obviously the expectation that incorporation would make the company more attractive to potential investors must have played a role.

The most significant aspect of Chinese companies' incorporation is whether the new Company Law and its requirements like shareholder meetings really led to an empowerment of the shareholders with a simultaneous decrease in personal influence of the company founders and directors. The minutes of the meetings prove that the shareholders were only vaguely familiar with the Company Law and with the new implications that limited liability brought for the enterprise and for their personal involvement with regard to rights and obligations. But it appears that there was a general consensus among those shareholders who voiced their opinion at the first meeting in 1907, that the law supported their claims as owners and provided them with a tool to control the corporate management — or so they thought.

In this spirit, shareholders used their newly won influence to protest for the first time publicly against the reduction of their share profit caused by Dasheng's generous donations to

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<sup>60</sup> Kirby, "China Unincorporated", p. 48.

<sup>61</sup> Ibid.

Zhang Jian's welfare and educational projects which in return reduced their dividends.<sup>63</sup> Again, Zheng Xiaoxu, as a concerned and critical shareholder but with no financial leverage in form of majority shareholding, expressed his opinion in a very outspoken way:

Subsidies spent on the costs of the Normal School ... are the virtues of the general manager [i.e. Zhang Jian] himself and have nothing to do with the company. Now in accordance with the law, we have to discuss separately new regulations for the allocation of bonuses.<sup>64</sup>

Obviously, Zheng interpreted the law as a new protective mechanism for the benefit of shareholders against arbitrary bonus allocation (to managers) and fund distribution by the managing director (*zongli*). However, since Zhang Jian as the managing director of the Dasheng mills had never been forced to seek appointment by a director's board but had automatically slipped into this position when transforming Dasheng from a government-sponsored into a private enterprise, Zheng Xiaoxu's criticism could not endanger Zhang Jian's position in any way.

In fact, the 1907 shareholder report is an excellent document for revealing Zhang Jian's authoritarian management of Dasheng and the simultaneous ineffectiveness of the shareholders' criticism and demands for change. The 1907 document, in recognition of the No.1 mill's incorporation, contains eight clauses composed by Zhang Jian as the managing director for the regulation of issues such as managing working capital, reserves, and the election of members of the board.<sup>65</sup> Interestingly enough, there is no regulation for the election of the managing director. Reading his response to shareholders' complaints in the context of the discussions at the meeting, his words are defensive, and instead of addressing some of the shareholders' complaints, he appeals to their integrity and moral conscience. Several other shareholders continued to voice questions in

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<sup>62</sup> *Dagong Bao*, February 28, 1905, 2b.

<sup>63</sup> Nantong Municipal Archives: B 402-111-445, 20b.

<sup>64</sup> *Ibid.*

<sup>65</sup> *Ibid.*, 9a-12b.

regard to bonus allocation and salaries for the managers; Zhang Jian never replied in person but had other members of the board explain Dasheng's, i.e. his personal, position.

Let us now further investigate shareholding in the context of incorporation and the identity of the shareholders and their investments in 1907. The legal regulations in the Company Law of 1904 required on registration of the company a statement of how many people were providing the capital, their names and addresses, and the overall amount of capital and number of shares.<sup>66</sup> These regulations concerned the initial setup and changes in the shareholding due to expansion and growth as would occur over time. Periodic shareholding inventories are thus invaluable sources for the examination of shareholding structure and the practice of disguising personal accounts in the form of business accounts. In the case of Dasheng the relatively detailed 1903 record shows that, first of all, most of the Dasheng shares were not held under the personal name of a shareholder, but under a business name, that is, in the name of a *tang* (family trust) or *ji* (business).<sup>67</sup> For example, Zhang Jian's son, Zhang Xiaoruo, held shares under the account names of Zhang Xu, Zhang Liang, Zhang Wu, Zhang Chen, and the Zunsu *tang*, but also under Ruo *ji*, Xiao *ji*, and Xuyin *ji*. Of course, if we take into consideration that Zhang Xiaoruo was only five years old in 1903, it is very clear that these were in fact Zhang Jian's own accounts for his personal assets. One has to suspect that in reality Zhang Jian was the actual owner behind many more business accounts which cannot be clearly identified from the record, because in the majority of cases the entry under the personal name (*xingming*) of the shareholder is left blank. For example, the account listed as holding shares under the business name Fengsi *tang* was in fact the account representing the charity land (*yizhuang*) in possession of Zhang Jian's own family. Zunsu *tang* is an account associated with Zhang Jian's family residence in Haimen county. It is only possible to gain this information from Zhang Jian's

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<sup>66</sup> Shangwu Yinshuguan Bianyisuo, *Da Qing Guangxu xin faling*, 'gongsi lü'.

<sup>67</sup> Nantong Municipal Archives: B 402-111-1, 1898-1903.

obituary in 1926, where the distribution of his personal assets is described; the actual ownership is not clear from the company's shareholding register.<sup>68</sup> Needless to say, also investors from outside the family circle are listed with their investments under the names of business accounts.

Even allowing for a considerable margin of error due to the fact that some of the family accounts may not have been identified, clearly control was not tied to majority shareholding in the Dasheng business complex. The 1907 shareholding inventory of the No.1 mill supports this argument with straightforward numbers: The capital stock of 630,000 taels was subscribed by altogether 553 shareholders. The largest single shareholder was the Salt Bureau with its investment of public funds (*gongkuan*) at a value of 23,000 taels or 4 per cent of the total stock capital. Then follows a group of 17 shareholders with investments between 15,000 to 8,000 taels each which gave them ownership of 2.4 per cent to 1.3 per cent of the capital stock each (27 per cent altogether). The remaining capital stock worth 435,000 taels (69 per cent altogether) was subscribed by 535 shareholders who individually owned less than 5,000 taels each in equity. The overwhelming majority of these shareholders owned between one and five shares at 100 taels each. Accounts which can be linked to Zhang Jian's family in one form or another reveal an ownership of 40,300 taels or altogether 6.4 per cent of the total capital stock; a modest percentage even if it was higher than that of the largest single shareholder.<sup>69</sup> This shareholding pattern of a large number of minority shareholders, mostly from the local community and from the director's kinship and social networks, was common among Chinese companies in the early 20<sup>th</sup> century.

It is necessary to point out that holding capital under a business account was a common business practice at least in the late Qing dynasty. In fact, using a business name (*ji* or *hao*) for daily operations and holding property under another name in a trust (*tang*), was a custom already

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<sup>68</sup> *Nantong bao tekan*, October 29, 1926.

<sup>69</sup> Numbers are extracted from Nantong Municipal Archives: B 402-111-2.

adopted by merchants in the Ming dynasty (1368-1644).<sup>70</sup> The use of front men, names of ancestral halls for individual families or associated groups, and assumed names was a frequent method to conceal ownership and true identity from the government which imposed restrictions on the involvement of gentry members in business.<sup>71</sup> However, since the early twentieth century, gentry investment in industrial enterprises had become a legal and approved activity, and there existed no government taxation of income or capital gains which one would have preferred to avoid. Reasons for concealment now lay in the inappropriate use and transfer of company funds to accounts difficult to detect by auditors and shareholders.<sup>72</sup>

### **Conclusion: Characteristics of Chinese Corporate Ownership Past and Present**

Next to the incorporation process itself, the relationship between control and ownership is one of the central issues for understanding business in China. Recent scholarship has shown that in Chinese businesses under strong family influence the control of equity was rarely separated from the control of management, and that succession disputes were of great significance for the continuity of the company.<sup>73</sup> General consensus exists among historians about the restricted and limited influence of shareholders in China's first stockholding companies like the China Merchants' Steamship Navigation Company. The general scholarly evaluation of Dasheng's situation is much more positive. However, evidence suggests that although the Dasheng No.1 Cotton Mill had

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<sup>70</sup> Faure, *China and Capitalism*, p.17.

<sup>71</sup> See Chan, *Merchants, Mandarins, and Modern Enterprise*, pp. 36-37. Based on her analysis of a court case filed in Hong Kong in 1910, Stephanie Chung points out that neither *tang* nor *hao* were recognized by the law as legal persons (*faren*). Stephanie Po-yin Chung, "Faren' gainian de yizhi: xifang shangfa zai Zhongguo" (The idea of 'legal person': the transplantation of Western company law to modern China), *The Hong Kong Baptist University Journal of Historical Studies*, vol.1, 1999: 49-69, in particular p. 60. Even if this decision was made in the context of a legal system under strong Western influence, it confirms the private nature of the *tang*, *hao*, and *ji* and the legal difficulties in case of litigation.

<sup>72</sup> Dasheng's financial crisis due to this inappropriate transfer of funds in order to support ailing subsidiaries and affiliated companies is analyzed in detail in Köll, *From Cotton Mill to Business Empire*, chapter 6.

adopted the legal form of a limited liability company as early as 1907, it was not managed in such a way as to allow the shareholders to curtail the power of the founder-director. Like the Rong family's companies or Liu Hongsheng's enterprises, the newly incorporated companies continued traditional business practices and institutions which had been primarily characteristics of Chinese family enterprises. In addition, members of the Zhang family continued to be involved in the financial and managerial organization of the company, even as a hierarchy of salaried executives came into existence to manage the different parts of the business on a day-to-day basis.

Nevertheless, the new code clearly brought Chinese business structures more in line with global corporate practice — from creation of limited liability to the attempted enactment of transparency and accounting requirements meant to protect the rights of shareholders. In many ways, it is just the kind of corporate governance legislation that is being adopted today in the world's emerging markets. Then, as now, the hope was to create a capital market to support the development of domestic business enterprise. In this respect the 1904 code was a visionary document. Why, then, was its effect so limited?

One explanation is cultural. Until recently, China business historians have tried to capture the essence of Chinese enterprises by focusing on personal relations, in particular in family businesses. Frequently, a business organization has been more or less reduced to the interpretation of being a network, often in the context of a search for the 'spirit of Chinese capitalism'.<sup>74</sup> Scholars have argued that "kinship and collegiality in China play roles analogous to those played by law and individuality in the West", and the growth of the Chinese economy has been explained with

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<sup>73</sup> See David Faure, "The Control of Equity in Chinese Firms within the Modern Sector from the Late Qing to the Early Republic", pp. 60-79, and Chi-cheung Choi, "Competition among Brothers: The Kin Tye Lung Company and its Associate Companies", pp. 98-114, in *Chinese Business Enterprise in Asia*, ed. Rajeswary A. Brown.

<sup>74</sup> This approach can be found, for example, in Gary G. Hamilton and Cheng-shu Kao, "The Institutional Foundations of Chinese Business" in *Chinese Business Enterprise*, ed. Rajeswary A. Brown, vol. 1, pp. 188-204. London: Routledge, 1996, or in S. Gordon Redding, "Weak Organizations and Strong Linkages: Managerial Ideology and

increased economic opportunities and the simultaneous expansion of networks.<sup>75</sup> Of course, business by its nature always involves networks. Considering the emergence of corporate ownership in Chinese companies in the early 20<sup>th</sup> century, the conflict of interest between the founder-director and his shareholders, and divided loyalties between people whose positions relied either upon the authority of the founder or the holding of shares, now becomes the real focus and problem.

Another explanation is institutional and to some extent historical. The top-down approach to creating a robust corporate sector in China around the turn of the last century overlooked the public capital markets as an important disciplinary and motivational institution for corporate managers. One cannot explore the development of early corporations in China without considering the serious effects of the boom and bust cycles in the Chinese capital markets over this same period. In some sense, they are two sides of the same coin – one cannot exist meaningfully without the other. Without an active market for corporate control, i.e. a setting in which shareholders can fire the management, it is impossible to build public trust in equity investment. On the other hand, without the existence of a liquid capital market, managers have no motivation to relinquish control. Without a share market to provide new capital – or at least a market that would allow entrepreneurs to diversify their investment holdings, there is little to induce him to accept shareholder rule.

It is easy to argue in hindsight that the 1904 legislation was doomed from the start because it was not accompanied by a regulatory framework for the capital markets. Another possibility may exist, however. Perhaps the crashes of 1883 and 1922 were simply accidents of history. Perhaps corporate capitalism itself is a more fragile phenomenon than most believers in the invisible hand would like to believe. Some visionary thinkers in the 1870's set China on a vigorous course to

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Chinese Family Business Networks” in *Asian Business Networks*, ed. Gary G. Hamilton, pp. 27-42. Berlin and New York: Walter de Gruyter, 1996.

development of share capitalism that involved its own blend of government patronage and state ownership. Might this new sector have matured and developed along its own course, had the share markets not collapsed? Why did American markets survive the era of crony capitalism and Chinese markets succumb? Perhaps the American markets were just lucky. American markets experienced another crisis in public confidence following the boom and crash of the 1920's. Had the Securities and Exchange Commission not taken steps to restore public confidence, might the U.S. markets have gone the same way as the Chinese exchanges in 1922?

The importance of history in the analysis of markets is that history contains the record of many alternative possible paths that today's markets might have taken. Specific historical circumstances and personalities rather than economic theory may at times better explain why some markets succeed while others — even those built from the same “genetic code” — ultimately fail. This is why China's first foray into capitalism a century ago is immediately relevant to the development of world capital markets today. Governments around the globe are currently eagerly adopting new codes of corporate governance. Russia and China are both engaged in pushing towards greater corporate transparency and shareholder accountability – both leading themes in the Chinese Company Act of 1904. This top-down approach is certainly laudable, for these are most likely necessary conditions for a well-functioning capital market. The early Chinese experience, however, suggests that they are not necessarily sufficient. The development of Chinese domestic stock markets suffered from a series of crashes that caused sustained mistrust in share trading. Whether these crashes and consequent shifts in investor opinion can be avoided through market regulation is an open but important question. For China today, on the course of vigorous economic development, shareholder rights and protections are of immediate importance. Poor disclosure and

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<sup>75</sup> Gary G. Hamilton, “The Organizational Foundations of Western and Chinese Commerce: A Historical and Comparative Analysis”, in *Asian Business Networks*, ed. Gary G. Hamilton, pp. 43-57. Berlin and New York: Walter de

weak regulations are well-known and persistent problems of companies and the stock market in contemporary China, and new legislation with respect to corporate practice is a work in progress. Tumultuous shareholder meetings with angry minority shareholders are not unheard of.<sup>76</sup> The question is whether the visible hand of the state will succeed in creating structures of capitalist ownership with more success this time.

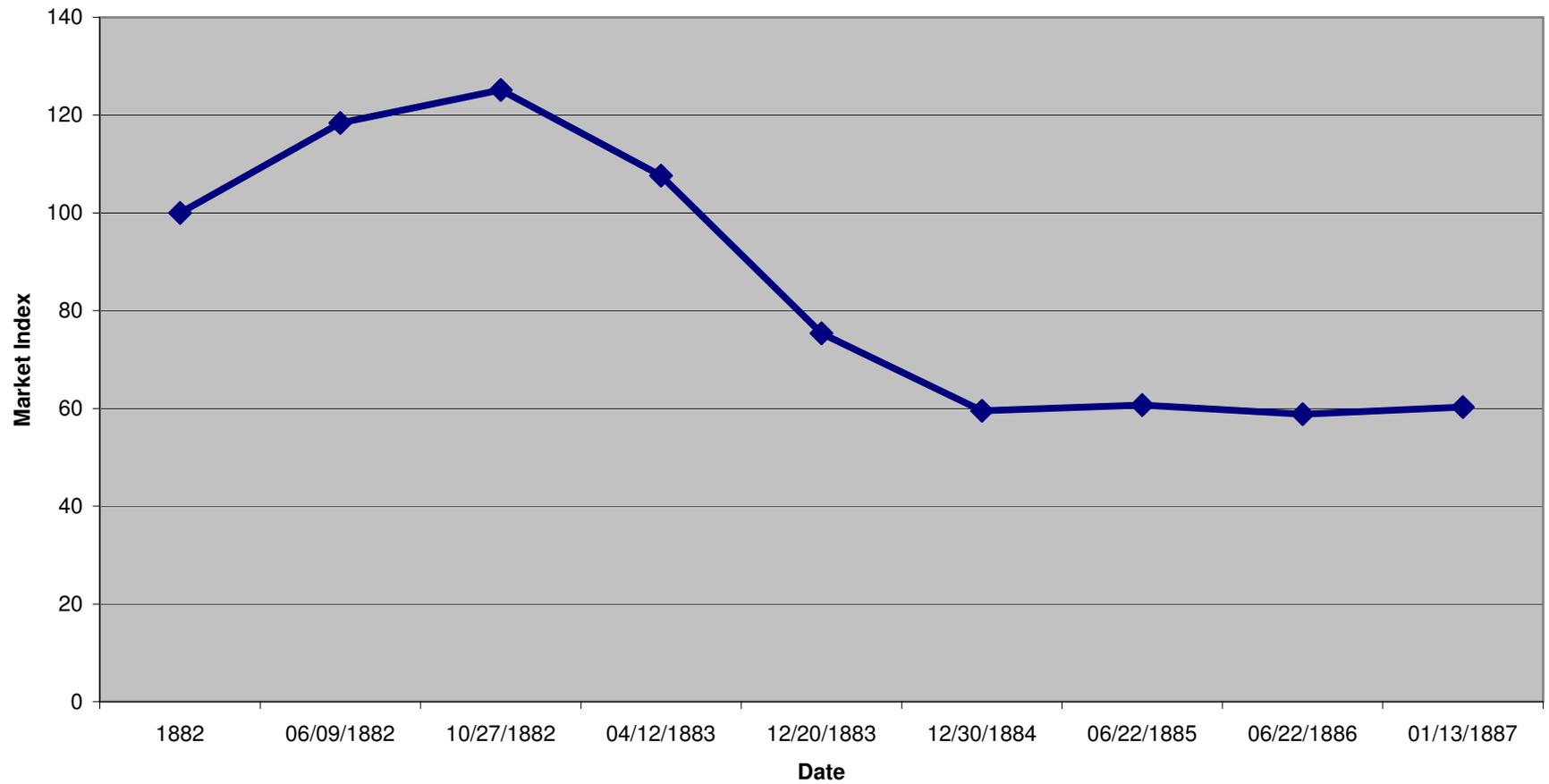
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Gruyter, 1996, in particular pp. 43 (quote), 53-54.

<sup>76</sup> "Let 1,000 Casinos Whither" in *Far Eastern Economic Review*, October 18, 2001.



## Equal-Weighted Index of Chinese Stocks in Shanghai 1882-1887



**Figure 1: Equal-Weighted Index of Chinese Stocks in Shanghai, 1882-1887.** (Source: Goetzmann, Ukhov and Zhu, 2001). The figure represents an equal-weighted index of the capital appreciation of 35 shares of companies listed in the Shanghai Chinese language newspaper *Shenbao*.