

A Research on Profit Misappropriation by Controlling Shareholders: Taking ST Zhongzhu as an Example

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Abstract. This paper selects Zhongzhu Healthcare Holding Co.,Ltd (ST Zhongzhu) as the research object, introduces the means of ST Zhongzhu's controlling shareholders' interest appropriation, studies the factors leading to the behaviour of interest appropriation, and puts forward targeted solution measures. This paper includes the following six parts. The first section is an introduction, combing the related literature and summarizing the background and significance of writing. The third part is the introduction of the case of ST Zhongzhu controlling shareholders encroaching on the interests of listed companies, the controlling shareholders of ST Zhongzhu encroach on the huge interests of listed companies mainly through the appropriation of funds by the related parties and the violation of the provision of guarantees for the related parties, etc., and at the same time elaborates on the negative impacts caused by this behaviour. The fourth part is the reason why the controlling shareholders of ST Zhongzhu's interest encroachment behaviour can be realized. The fifth part is the measures to prevent the controlling shareholders' interest encroachment, and puts forward the countermeasures to solve the encroachment of the company's interests by the controlling shareholders of ST Zhongzhu. The sixth part is the conclusion of this paper. This paper analyses in-depth the current situation of interest encroachment in ST, and puts forward specific measures to solve the problem in view of the contributing factors. Contribute to the corresponding theoretical research.

1 Introduction

The global financial crisis and scandalous events have also highlighted the risk of controlling shareholders' interests being infringed upon, with controlling shareholders' encroachment on the interests of listed companies becoming more and more serious and insidious, with controlling shareholders taking advantage of their controlling position in the company to encroach on the interests of the listed company or other shareholders in an unfair and non-compliant manner, which is usually carried out through the misuse of power and control of resources, resulting in the controlling shareholders gaining illegal economic benefits while the interests of other shareholders are jeopardized. And the emptying means of the major shareholders in the continuous updating, mainly equity pledge, non-fair related transactions, non-operational possession, related guarantees and violation of information disclosure and so on a series of ways [1]. The number of encroachment and the loss of capital market up to the same amount of money, resulting in the lack of stability of China's capital market, the listed company's share price collapse risk is higher, the blow and even destroy the enthusiasm of investors to invest, hindering the healthy development of the capital market, and even induce financial crisis. If the level of corporate governance is low, the controlling

shareholders of listed companies use connected transactions to hollow out the company in a very serious situation. It is found through empirical evidence that the proportion of shares held by the first largest shareholder has an inverted U-shaped relationship with the probability of occurrence of connected transactions [2]. This has led to a profound rethinking of corporate governance and regulatory mechanisms. The context of studying this issue requires consideration of multiple factors, such as corporate governance, legal environment, and market mechanism, in order to more comprehensively understand and address the challenge of controlling shareholders' interest infringement. Currently, scholars at home and abroad lack research and analysis of causes and solutions based on typical cases, but mostly focus on empirical analysis of the factors that motivate controlling shareholders to encroach on the interests of the company's behavior.²⁰ On September 12, 2023 ST Zhongzhu Limited announced that the company's de facto controller, Xu Delai, had been arrested on suspicion of the crime of misappropriation of funds. The company and investors suffered significant losses as a result of Xu Delai's violations such as failure to fulfill decision-making procedures and information disclosure obligations in connection with connected transactions, non-operational fund appropriation by

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controlling shareholders and their affiliates, and significant deficiencies in internal control [3].

The in-depth study of controlling shareholders' interests encroachment problem is to deepen the understanding of corporate governance, market operation and regulations, to study the mechanism of controlling shareholders' interests encroachment problem and the influencing factors, to explore the inherent mechanism as well as the prevention mechanism, to prevent financial statement fraud, to help the financial market healthier and more transparent, to protect the interests of investors, and to improve the quality of listed companies [4]. This paper mainly analyses and researches from the specific analysis of ST Zhongzhu, points out the problems and solutions from all aspects, gives other companies certain inspiration and promotes the long-term development. Internationally, the research on controlling shareholders' interest infringement has made certain progress, covering many aspects from the motivation to the countermeasures. However, there is relatively little research in this field in China, which requires more in-depth excavation and theory construction.

It improves corporate governance, strengthens regulations and systems, warns investors, reveal weaknesses in corporate governance, improves market transparency, promotes sustainable economic development, improves the governance efficiency of listed companies, and maintains the order of the domestic capital market. Based on the research of scholars at home and abroad on this topic, the research in this paper can supplement the relevant theoretical foundation and analyse the research with typical cases. It mainly analyses and researches from the specific analysis of ST Zhongzhu, points out the problems and solutions from all aspects, gives other companies certain inspiration, promotes the long-term development of other companies, and maintains the healthy operation of China's capital market. Internationally, the research on controlling shareholders' interest infringement has made certain progress, covering various aspects from the causes to the countermeasures. However, there is relatively little research in this field in China, which requires more in-depth excavation and theory construction.

2 A case analysis of ST Zhongzhu

2.1 Company description

The basic situation of the company is that the business of ST Zhongzhu Limited mainly involves pharmaceuticals, medical treatment and real estate. Among them, the

pharmaceutical aspects of the production and sales of subsidiary Qianjiang Pharmaceutical ophthalmology field of special drugs; medical, medical products are mainly wholly-owned subsidiary of the one medical owned by the field of oncology treatment related products production and sales; real estate business, mainly by the subordinate holding subsidiary for development and sales, mainly residential real estate development. According to ST Zhongzhu disclosed on September 12, the company's actual controller Xu Delai was arrested on August 30 for the crime of misappropriation of funds, approved by Qianjiang City Procuratorate. According to the first financial comb, as of the end of June 2023, the funds occupied by ST Zhongzhu and other related parties of ST Zhongzhu are expected to total 568 million yuan. Among them, 71.09 million yuan of interest, which has been in arrears for five years is still not repaid. And in the first half of this year, the listed company's operating income is only 253 million yuan, net profit loss of 244 million yuan. Xu Delai has almost no shareholding in ST Zhongzhu at present, and the shares of the listed company indirectly held by him through ST Zhongzhu are only 20,000 shares left after several auctions since the beginning of 2020. The shareholding structure of ST Zhongzhu is As of January 2023, the shareholding structure of ST Zhongzhu is as follows: Longland Technology holds 380 million shares of the company, accounting for 19.077% of the total share capital of the company, becoming the largest shareholder of the company. The equity of Longland Technology held by Huang Xinhao and Huang Chao, shareholders of Longland Technology, is entrusted by SZSH on behalf of SZSH.

2.2 Mode of encroachment

There are many ways for controlling shareholders to misappropriated interests, and ST Zhongzhu's irregular misappropriation behaviours are mainly the following three.

The first one is the violation of guarantee, during 2017-2018, ST Zhongzhu provided continuous guarantee for the related parties such as participating shareholders, subsidiaries of participating shareholders and the parent company etc. In April 2018, ST Zhongzhu transgressed the approval procedure and deposited RMB50 million into the designated bank account to provide performance guarantee and deposit for the gap make-up agreement between ST Zhongzhu and Zheshang Bank specifically for the capital management plan. This guarantee remained unreleased and without a predetermined term until the end of 2019, resulting in ST Zhongzhu's 50 mln funds always being restricted.

Table 1. 2018-2019 Statement of Violation of Guarantees for Related Parties by ST Zhongzhu .

*The following data content is taken from the 2019 Annual Report of Central Pearl Healthcare.

Year of disclosure	related party	actual controller	Amount of guarantee (in millions of RMB)	Whether the guarantee was fulfilled during the year
2018	investing as one	Liu Danning	185.9	clogged

2018	Hengqin Zhongzhu Astronergy Medical	Xu Delai	50	clogged
2018	Zhongzhu Group	Xu Delai	50	clogged
2019	One Group, One Jungrun	Liu Danning	20	clogged
2019	investment in a picture frame (e.g. bank)	Liu Yiqing	190	clogged

During the period from January to June 2018, Zhongzhu Medical guaranteed a loan to Qianjiang Zhongzhu, which was guaranteed by Zhongzhu Group, Xu Delai personally and Zhongzhu Medical, and up to 2019, there is still an outstanding loan of RMB 110 million. As the second shareholder of Zhongzhu Medical, One Medical, a subsidiary of One Medical, has also made illegal guarantees for its related parties. During this period, One Medical transferred a total of RMB 185.9 million to the Ping An Bank margin account, which was used as a pledge guarantee for the RMB 175 million loan of One Medical, and it was only until January 23, 2019, that the margin account was formally released from the restricted status (see Table 1). The private use of the RMB 185.9 million was not approved by the company, but was merely the personal behavior of

Liu Danning, the majority shareholder of One Group and former legal representative of One Medical [5].

The second is the transfer of illegal related transactions, compared to the direct related party transactions to encroach on the funds of listed companies, Zhongzhu Group's encroachment method is more dazzling, multiple transactions before and after the encroachment of up to 1.258 billion yuan RMB. from January 2019 to May 2019, three grandchildren of Zhongzhu Medical subordinate companies, Spring Dawn Real Estate, Bridgestone Trading, and Chak Hung Co., acquired Henghong Investment in three separate transactions, Zhongzhu Commerce and Trade and Qianhai Shunyaoxiang, whose assets totaled a total of RMB125.8 billion (see Table 2).

Table 2. Zhongzhu Medical Acquisition.

*The following data content is taken from the 2019 Annual Report of Central Pearl Healthcare.

Acquirer	Relationship with Zhongzhu	Subject company	Acquisition target	Purchase price
Spring Dawn Real Estate	wholly owned subsidiary	Heng Hong Investment	Heng Hong Layer Mall	398 million RMB
Bridgestone Trading	wholly owned subsidiary	Zhongzhu Trading	Zhongzhu Trade Center, 1st to 3rd floor shopping mall	313 million RMB
Chak Hung Co.	wholly owned subsidiary	Qianhai Shunyaoxiang	30% Zhongzhu Commercial Shares	630 million RMB

Between January 18 and 23, Chunxiao Real Estate had paid RMB 365 million to HHI, with the transaction completed in seven installments. Another transfer of RMB24 million was made on May 29, totaling RMB389 million. Qiaoshi Trading had transferred RMB200 million and RMB39 million to Zhongzhu Trading on two occasions during the same period of the transaction with Henghong Investment. Zehong transferred RMB250 million to Qianhai Shunyaoxiang on May 22, 2019 for the acquisition and paid RMB380 million to Liaoning Zhongzhu in lieu of Qianhai Shunyaoxiang's equity transfer, by which time Zhongzhu Medical's payment had reached RMB630 million. It was only after the money had been transferred that a public announcement was made to publicize the above three transactions. Such behavior ignored the regulation and was subsequently given a warning by the Hubei Securities Regulatory Bureau.

The third is the problem of funds utilization, in 2016 -2019, this ratio of Zhongzhu Medical is 11.55%,

14.71%, 18.82% and 9.22% respectively (see Figure 1), this ratio of Zhongzhu Medical is too much higher than the average value of the same industry, which indicates that Zhongzhu Medical's capital occupation is very serious, especially in 2018, the capital occupation situation has reached the The highest in recent years, and which is mainly reflected in the occupation of the controlling shareholders and their related parties, the initial principal amount of funds owed by the controlling shareholders and related parties of Zhongzhu Medical was RMB989.437 million, and as of December 31, 2018, the total principal amount of the owed funds and the interest amounted to RMB887.7145 million, and from May 16 to May 29, 2019, Zhongzhu Group and its related parties paid RMB380.34 million through cash repayment of RMB 380.34 million, so the ratio has decreased from 2018, nevertheless, the ratio of Zhongzhu Medical is still much higher than the industry average [6].



Fig. 1. The Utilization of funds (Photo/Picture credit: Original).

*The above data is from the detailed financial analysis report of Central Pearl Healthcare for 2019.

In February 2018, Zhongzhu Group received RMB50 million of acquisition intention money from Zhongzhu Medical; in addition, Zhongzhu Medical also entrusted a total of RMB300 million of funds to Guangsheng Hengye by way of trust financial management, Tianshui Mechatronics received RMB50 million of commercial promissory notes from Zhongzhu Zhengtai, a wholly-owned subsidiary of Zhongzhu Medical; Zhongzhu Financing, a subsidiary of Zhongzhu Medical, transferred RMB310 million RMB gold to Zhongzhu

Building Materials, a subsidiary of the controlling shareholder, by way of finance lease, and ultimately all the funds flowed to Zhongzhu Group. As audited by the accounting firm, at the end of 2017, the net assets of Zhongzhu Medical was RMB614.6 billion, and after the above process of fund borrowing and lending, an additional RMB710 million of occupied funds was added in 2018, accounting for 11.54% of the total assets, which had a serious impact on the normal operation of Zhongzhu Medical's funds (see Table 3).

Table 3. Zhongzhu Healthcare's New Capital Expenditures in 2018.

*The following data content is taken from the 2019 Annual Report of Central Pearl Healthcare.

particular year	occupier	Occupancy pattern	Amount of occupancy (in millions of RMB)	Share of net assets (%)
2018	Guangsheng Hengye, PRC human rights activist	Trust product	300	4.88
	Zhongzhu Building Materials	External financial lease lending	310	5.04
	Tianshui Electromechanical	commercial promissory note	50	0.81
	Zhongzhu Group	Acquisition Deposit	50	0.81
Total			710	11.54

3 Consequences of misappropriation of interests by controlling shareholders

As of the end of June 2023, the funds occupied by Zhongzhu Group and other related parties of ST Zhongzhu are expected to total 568 million yuan. Among them, 71.09 million yuan of interest, which has been in arrears for five years is still not repaid. In the first half of this year, the operating income of the listed company was only 253 million yuan, and the net profit was a loss of 244 million yuan. As the company's audited net profit for the two fiscal years of 2018 and 2019 has been negative for two consecutive years, the

total assets of the current period compared with the previous period decreased by 14.93%, and the company's financial situation deteriorated. The Company's shares will be subject to the special treatment of delisting risk warning after the disclosure of the 2019 annual report, as detailed in the Company's annual report disclosed on January 18, 2020, and the Company's financial condition has deteriorated. Announcement of Zhongzhu Medical Holding Company Limited on the Possible Implementation of Delisting Risk Alert on the Company's Shares disclosed on January 18, 2020 The behavior of the Controlling Shareholders may result in the Company being unable to operate and develop normally. As a result of the encroachment of resources,

the Company may lack funds for business expansion, research and development of new products or marketing, which may affect its long-term development strategy.

Benefit encroachment may put the Company in financial difficulties and increase operational risks. After suffering from interest encroachment, the Company may adopt short-term operational means to maintain its business, which tends to exacerbate operational instability and increase the Company's operational risk. In 2018, Zhongzhu Medical realized operating revenues of 573 million yuan, a year-on-year decrease of 41.61%, and net profit of approximately -1.894 billion yuan, a year-on-year decrease of 1,219%.

Benefit misappropriation may lead to dilution and impairment of the interests of ordinary shareholders, making the financial position and performance of the company constantly jeopardized. This is a deprivation of legitimate rights and interests for the majority of minority shareholders. Xu Delai has left the position of chairman and president of CZM, but is still the real controller of CZM and its parent company, CZG, making it difficult for small and medium-sized shareholders to play a role in supervision. Xu Delai, as a party acting in concert with shareholders holding more than 5% of the shares, passively reduced his shareholding due to judicial enforcement, failed to fulfill the obligation of pre-disclosure of the reduction of shareholding 15 trading days in advance according to the regulations after receiving notification from the relevant parties, and failed to disclose the reduction of shareholding in a timely manner after it was completed, which was in violation of the relevant regulations. Small and medium-sized shareholders are unable to supervise the forged business because of information asymmetry. Secondly, as the major shareholder has absolute control and the supervisory board has limited supervision over the company's strategic decisions, it will breed the behavior of controlling shareholders' interest appropriation, thus harming the interests of small and medium-sized shareholders. After the investigation issued by the SFC, the share price of Zhongzhu Medical was on a sharp downward trend. According to the disclosure, in April last year, 119 million shares of ST Zhongzhu held by Zhongzhu Group were auctioned by the court at a price of RMB 1.92/share and RMB 230 million. After the auction was completed, Zhongzhu Group's shareholding dropped from 6.009% to 0.001%. After the share price fluctuation, the market value of Zhongzhu Medical has evaporated substantially, which has seriously damaged the interests of small and medium shareholders and investors.

4 Implementation

Through the above research on ST Zhongzhu appropriation means and analysis of financial data, SY Zhongzhu can be through the violation of the guarantee, illegal related transactions transfer and other ways to appropriation of the interests of shareholders, can be from the company's governance structure, improper supervision to analyze the reasons for the realization.

Small and medium-sized shareholders often occupy a very important role in the capital market, and the interests of large and medium-sized shareholders are seriously divergent. In addition to obtaining the legitimate common income, large shareholders are able to manipulate listed companies to transfer the resources of the enterprise to their own enterprises with absolute dominance, thus infringing on the interests of the listed enterprises, while other small-scale investors can only obtain a small portion of the benefits through the value-addedness of the shares or the sale and purchase of shares. Benefits [7]. According to Tonglian Data Datayes, ST Zhongzhu's net attributable profit reached a record level in 2016. However, subsequent data showed that the cumulative balance of funds occupied by the company by the majority shareholder Zhongzhu Group and its related parties reached 500 million in the 2019 annual report. This fund appropriation behavior directly harms the interests of small and medium-sized shareholders.

ST Zhongzhu and its controlling shares have been concerned and penalized by the regulatory authorities for violations of information and disclosure, capital appropriation and other violations. For example, on November 7, 2023, the Hubei Securities Regulatory Bureau announced that on March 9, 2020, the SSE issued the "Disciplinary Decision" showing that, due to the company and its controlling shareholder Zhongzhu Group, the actual controller and the then chairman and general manager of the company Xu Delai, in the areas of information disclosure, standardized operation and other aspects of the duties of the responsible persons in the performance of irregularities in the duties of the company, in accordance with the relevant provisions of Zhongzhu Medical and its controlling shareholder Zhongzhu Group, the actual controller and then chairman of the board of directors and general manager Xu Delai shall be publicly condemned, and publicly determined that the company's actual controller and then chairman of the board of directors and general manager Xu Delai is not suitable to serve as a listed company's directors, supervisors and senior management personnel within 10 years; and the relevant responsible persons shall be notified of the criticism.

On November 16, 2020, because the Company, the controlling shareholder Zhongzhu Group, the actual controller Xu Delai also existed related transactions did not fulfill the decision-making procedures and information disclosure obligations, the controlling shareholder and its related parties non-operational funds occupation, the existence of significant deficiencies in internal control and other irregularities, the relevant responsible persons for the above additional violations of the responsibility of the actual controller, the then chairman and general manager Xu Delai was again to be Public condemnation.

On June 21, 2021, due to untimely information disclosure, the Hubei Supervision Bureau of the SFC decided to take the administrative supervisory measures of issuing warning letters to Zhongzhu Group and its chairman Xu Delai. On September 15, 2021, due to the irregularities in information disclosure and

standardized operation, according to the relevant regulations, the SSE issued a public condemnation to ST Zhongzhu, the company's controlling shareholder Zhongzhu Group, the company's de facto controller and then chairman and General Manager Xu Delai, were publicly condemned.

On October 27, 2022, the SSE issued the Decision on Supervisory Warning on Xu Delai. ST Zhongzhu's shareholder Xu Delai, as a party acting in concert with shareholders holding more than 5% of the shares, was given a supervisory warning due to irregularities in information disclosure. ST Zhongzhu and the chairman of the company, among other things, received a warning letter. These irregularities may have provided opportunities for the major shareholders to encroach on the interests of the company and the small and medium-sized shareholders.

The reasons for the realization of the interests of shareholders misappropriated by the majority shareholders of ST Zhongzhu relate to the internal management of the company and the regulatory environment. In order to protect the rights and interests of small and medium-sized shareholders, it is crucial to strengthen the company's internal management and improve the level of corporate governance. At the same time, the regulator should also strengthen the supervision of listed companies to ensure their compliance and maintain the fairness and transparency of the market.

5 Measures to prevent the misappropriation of the interests of controlling shareholders

The problem of controlling shareholders' interests encroachment is a "persistent problem" in China's securities market, in recent years, the Securities and Futures Commission (SFC) has taken a series of supervisory measures, but it still has little effect [8]. The problem of major shareholders encroaching on the interests of minority shareholders needs to be solved both internally and externally. Improving corporate governance is an important part, which involves improving the level of business management and standardized operation of listed companies, and gradually strengthening their internal oversight checks and balances mechanism. Strict implementation of the corporate governance structure and standardization of corporate management practices.

ST Zhongzhu can establish a sound internal control system to ensure standardized and transparent management of the company and reduce management risks and losses. Corporate governance should be sound and the shareholding structure clear. Internal control is an effective means of corporate governance and an important safeguard. It can enhance the level of corporate management, ensure the implementation of corporate management policy, and also help to realize the business objectives [9]. ST Zhongzhu needs to increase the proportion of shares held by major shareholders, optimize the shareholding structure, and prevent minority shareholders from encroaching on

interests. At the level of institutional regulation, some specific measures can be taken, such as rationally optimizing the shareholding structure to avoid excessive concentration of shareholding leading to excessive control of the company by the majority shareholders. Reasonably control the power of shareholders and maintain the balance between the interests of the company and the interests of shareholders. ST Zhongzhu Medical can prevent shareholders from misappropriating interests by formulating the articles of association, clarifying the decision-making procedures of the shareholders' meetings, and ensuring that the shareholders' meetings are lawful, just, fair and independent. Enhance the transparency of shareholders' participation and communication, and strengthen the intensity of shareholders' supervision. ST Zhongzhu Medical can enhance shareholders' trust and participation in the company and jointly safeguard the interests of the company by regularly announcing the operating status of the enterprise and relevant information, and maintaining active communication and exchange.

Through enhanced legislative efforts, the Company Law and the Securities Law should be amended to add special provisions restricting the relevant rights of large shareholders and protecting the rights and interests of small and medium-sized shareholders. Finally, the use of economic, legal and administrative means to strengthen external supervision of the behaviour of large shareholders can also be considered.

For the major shareholders themselves, they can also take active action to prevent conflicts of interest from occurring. For example, they can try to control their profit distribution behaviour so that it meets the needs of the company's development while taking care of the interests of minority shareholders.

In general, preventing major shareholders from encroaching on the interests of minority shareholders requires multifaceted efforts, including improvement of corporate governance, optimization of the shareholding structure, enhancement of legislative efforts and self-restraint on the part of major shareholders themselves [10].

6 Conclusion

In recent years, controlling shareholders encroach on the interests of small and medium-sized shareholders of the case occurred frequently, to a certain extent, hindered the sustained and healthy development of the capital market, and harm to investors controlling shareholders encroach on the interests of shareholders mainly through equity pledges, non-fair related transactions, non-operational possession, related guarantees and violation of information disclosure and other ways. Benefit appropriation behaviour will cause bad negative effects, light is to affect the performance and development of enterprises, heavy may directly lead to corporate bankruptcy, stock delisting, at the same time will inevitably increase the risk of the majority of investors will even seriously damage the legitimate rights and interests of enterprises and small and medium-sized

investors. This paper takes ST Zhongzhu as an example to carry out the research, for the reasons that ST Zhongzhu's shareholders' interests encroachment can be realized, and puts forward the following suggestions as the company's preventive and improvement measures. Strengthening the role of small and medium-sized shareholders' constraints. Improve the shareholding structure of one-share dominance and limit the over-inflated control rights of Kangde Group and its interference in the allocation of company resources: at the same time, the independence of the company's cash flow rights should be improved. Secondly, improve the awareness of participation of small and medium-sized shareholders. Improve the governance structure of the company. This is done by establishing a mechanism for reviewing and monitoring related-party transactions, improving the screening system for board members, increasing the number of independent directors, improving the composition of the general meeting of shareholders, and improving internal controls. Strengthening external supervision. Measures can be taken to create a transparent, open and accurate information disclosure system to regulate corporate behavior; to strengthen supervision and improve laws and regulations; and to strengthen the supervisory role of external auditing.

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Authors contribution

All the authors contributed equally and their names were listed in alphabetical order.

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