

A Study of Controlling Shareholds' Tunneling Behavior

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Abstract. Since the establishment of the Shanghai Stock Exchange and the Shenzhen Stock Exchange in the 1990s, China's capital market has emerged. Over the years, the domestic capital market has achieved certain results, but negative phenomena have gradually emerged, and the problem of tunneling is one of the representative issues. A concentrated ownership structure is prone to breed tunneling behavior, which results in a decrease in company value, damage to the interests of minority shareholders, and a reduction in market efficiency. This paper, through the study of relevant literature, summarized the behaviors of controlling shareholders' asset-stripping companies that harmed people's interests, listed different methods used by controlling shareholders for asset stripping, explored the causes of controlling shareholders' asset-stripping behavior, and examined the consequences of controlling shareholders' asset stripping methods.

Keywords: Controlling shareholder, asset stripping, tunneling behavior.

1. Introduction

China's capital market is experiencing rapid development; however, it also faces various issues, and one of them is the problem of tunneling behavior. Due to the incomplete construction of the rule of law, weak mechanisms for protecting small shareholders, and deficiencies in both internal and external governance of companies, controlling shareholders, who hold a high proportion of shares and possess significant influence and control over decision-making, can exploit their position to manipulate corporate decisions. This creates a breeding ground for asset stripping by controlling shareholders, who continue to engage in covert activities to encroach upon company interests. The adverse effects of such behavior include a decline in company value, damage to the interests of small shareholders, and disruption of market order.

Therefore, it is crucial to prevent and identify tunneling. This paper conducted an in-depth analysis of tunneling behavior and identified the underlying causes. Additionally, to guide regulatory agencies in formulating actions, this study evaluated the internal and external deficiencies that lead to tunnels. Regulatory agencies can strengthen policy measures to prevent asset stripping by controlling shareholders. Furthermore, to prevent such behavior, regulatory authorities can enhance external supervision, conduct rigorous pre-checks, and impose severe penalties afterward.

2. Tunneling Strategies

Referring to the researches of domestic and foreign scholars on the tunneling practices of controlling shareholders, the main ways of tunneling practices were illegal guarantees and related party transactions.

2.1. Illicit Guarantees

Wang Quanzai (2018) [1] found in his research that in listed companies, controlling shareholders usually abused the rights of listed companies, made use of the assets of listed companies, and sought private gains through illegal external guarantees through informal processes, this led to an increased risk burden on the company. When the guaranteed payment is due, the listed company is forced to repay the debt in turn, which increases the unnecessary expenditure of the listed company and increases the financial risk of the company. Yi Zhihong et al. (2021) [2] analyzed the empirical

evidence of A-share listed companies and believed that the credit risk of enterprises would be increased if there were illegal guarantees.

2.2. Embezzlement of Funds

The occupation of a listed company's funds can also be one of the more direct means through which major shareholders achieve tunneling.

In the study by Fan Yu (2022) [3], it is explained that in the practice and research of China's capital markets, the non-operational occupation of funds by controlling shareholders within corporate groups is the most common form of tunneling. Although, within corporate groups, listed companies may have a creditor-debtor relationship with major shareholders, due to the absolute decision-making power held by these controlling shareholders, it is often challenging for listed companies to recover funds from them in a timely manner. Extensive fund occupation inevitably harms the normal operational capacity of the listed company, and if this occupation cannot be reclaimed over an extended period, it may eventually result in the recognition of bad debt provisions through accounts receivable write-offs.

The actual data is derived from Yan Wei's research on Kangde Xin (2022) [4]. In January 2019, Kangde Xin faced significant market scrutiny when it was revealed that despite having 1.22 billion yuan in cash on its books, it couldn't meet its maturing debt obligations of 1.5 billion yuan. Upon closer examination, the root cause was traced to a cash management agreement between Kangde Group and the Xidan branch of a bank. Under this agreement, Kangde Group was able to surreptitiously occupy funds while maintaining the appearance of ample cash flow in Kangde Xin's accounts. These funds were then used for self-interest purposes, ultimately leading to the unscrupulous tunneling of Kangde Xin.

2.3. Related Party Transactions

Related party transactions first emerged in the 18th and 19th centuries. The early purposes of related party transactions included resource consolidation, risk diversification, and tax advantages. Qin Shunyi (2019) [5] found that in the past, tunneling was primarily conducted by fictitiously allocating funds. However, a new method of tunneling emerged, whereby inflated contracts were signed with suppliers through related party transactions to extract benefits. Loans were obtained from the listed companies in the name of suppliers for personal expenses. Related-party transactions are a commonly employed method of tunneling.

3. Strategies for Mitigating Tunneling

3.1. Internal Management

Insufficient governance systems contribute to the occurrence of tunneling by controlling shareholders. Pan Qidong (2023) [6] conducted an analysis of non-financial companies listed on the A-share market in Shanghai and Shenzhen from 2013 to 2020. The study focused on exploring the inherent relationship between board governance, investor coalitions, and controlling shareholder tunneling. It can be observed that investor coalitions facilitate the occurrence of controlling shareholder tunneling, especially in listed companies with inadequate internal governance systems. Conversely, board governance has a significant inhibitory effect on controlling shareholder tunneling. Chen Jingyi (2022) [7] found that companies can prevent large shareholders' tunneling behavior by establishing a reasonable financial distress early warning mechanism. By proactively informing company management and other stakeholders about potential crises in the company's operations, analyzing potential financial crises and their causes, and intervening in advance to avoid financial distress.

3.2. External Influencing Factors

The government can prevent tunneling behavior by implementing supervision and management measures and promoting employment. Tao Tianxiao et al. (2022) [8] selected data from Chinese A-share listed companies from 2007 to 2019 and found through empirical research that proactive industry policies can reduce the occurrence of tunneling behavior.

On the legal front, preventing tunneling behavior can be achieved by strengthening legal protection and enhancing punitive measures. Chen Shaoyong (2019) [9] found that the relevant legal system needs improvement through the study of controlling shareholders' encroachment on shareholder interests. Huang Zeyue et al. (2022) [10] pointed out that increasing the legal and regulatory measures to protect institutional investors and small investors plays a positive role in restraining tunneling behavior and ensuring market efficiency. The imperfect legal system provides opportunities for controlling shareholders to obtain decision-making power and corresponding resources at minimal risk and cost.

In Li Jiang's study (2019) [11], it is suggested that there is a need to enhance the independence of external regulatory agencies and hold them accountable for providing incomplete or false information through legal regulations. This accountability should serve to increase the accuracy and completeness of their information disclosures. The role of the media should not be underestimated, as some media outlets, driven by the allure of sensational information, may promote companies involved in malicious acts of deception, thereby conveying incorrect information to investors. Under the influence of substantial interests, it is possible that the media may collude with major shareholders to deceive investors.

Therefore, government regulatory bodies should strengthen their guidance and oversight of the media, establishing a media supervision mechanism. This could include the establishment of a credit system for media outlets, where a deduction of credit points occurs upon the dissemination of false information. Additionally, penalties should be imposed based on the economic losses caused by the dissemination of false information by the media. These measures aim to ensure that the media can impartially fulfill their roles in external oversight and information dissemination, reduce the level of information asymmetry between major shareholders and other investors, and alleviate the adverse effects of information asymmetry on minority shareholders and other investors.

4. Consequences of Tunneling

4.1. The Impact on Listed Companies

Firstly, tunneling can deteriorate the financial condition of a company. Transferring company assets to other entities or engaging in fictitious transactions, results in financial losses and capital outflows. Additionally, tunneling can damage the company's reputation and credibility, resulting in decreased investor confidence and even loss of trust, leading to a decline in stock prices and investor withdrawals. According to the research conducted by Yang Chengcheng (2023) [12], it was found that after the self-disclosure of tunneling by the controlling shareholder of ST Daji, the company was subsequently involved in a series of lawsuits and arbitration cases with suppliers and related parties. As of December 31, 2022, ST Daji and its subsidiaries had accumulated a total amount of litigation and arbitration-related expenses, with the total amount of litigation and arbitration expenses incurred by the company and its subsidiaries over the consecutive twelve months reaching approximately 1.002-billion-yuan, accounting for more than 8% of the company's net assets in 2021. The company may even face more severe consequences. According to Sha Wenli(2022) [13]'s research in 2022, since the occurrence of tunneling and misappropriation, the senior management at Kangde Xin has lost confidence in the company's prospects. In order to safeguard their own interests to the maximum extent possible, the senior management at Kangde Xin has chosen to resign, reducing the adverse impact on themselves. For a company, the departure of senior management is a devastating blow to its development strategy. Not only does it render the early strategies and agendas ineffective, but it

also significantly disrupts daily business operations and to some extent dampens employee motivation. Finally, due to the extensive misappropriation of company assets, after numerous disclosures of wrongdoing, the senior management is incarcerated. In order to repay debts, the company's assets are frozen, leading to its delisting.

4.2. The Impact on Stakeholders

The asset-stripping behavior of controlling shareholders can lead to a decrease in the investment value of minority shareholders and result in the dilution of their equity. Rafael La porta Et al. (2002) [14] argued that controlling shareholders had greater discourse and control power through a higher shareholding ratio. Having the opportunity and ability to manipulate the daily business activities of a company for personal gain, is often accompanied by a negative impact on the company. Harm to the interests of individuals and encroachment on the interests of small and medium-sized shareholders. Additionally, it has adverse effects on employees. The mismanagement caused by tunneling can result in poor business performance, operational damages, or even bankruptcy, leading to job losses for employees and there will also be an impact on creditors. Furthermore, the deteriorating financial condition of the company may lead to difficulties in meeting debt obligations, increasing the risk of default. Moreover, tunneling reduces the company's assets available for debt repayment. Some studies pointed out that listed companies often face issues of concentrated shareholding, limiting the voice of minority shareholders and making it difficult for them to protect their own interests. Controlling shareholders tend to encroach upon the legitimate rights and interests of minority shareholders.

4.3. The Impact on the Market

The unstable financial condition of a company that holds a significant market position or has close connections with other firms can potentially lead to market instability and impede the development of capital markets. In the study conducted by Xu Tianhang (2019) [15], it was argued that the occurrence of phenomena such as tunneling and transfer of benefits by controlling shareholders in listed companies not only triggered intense public criticism in the capital market but also tarnished the integrity of the Chinese capital market. This, in turn, led to a volatile operation of the capital market and subsequently affected the healthy development of the national economy.

5. Limitations

This literature review provided a comprehensive overview of research on the means, influencing factors, and consequences of controlling shareholder tunneling. With the increasing depth of domestic and international studies on this topic, the related theoretical framework continues to evolve. This review identified the following factors. The relatively concentrated ownership structure of listed companies increased the feasibility of tunneling. Dissatisfaction with normal dividends from listed companies served as a subjective motivation for engaging in tunneling. Within the corporate governance system of listed companies, the dual role of the board of directors and executives promoted the occurrence of tunneling. Conversely, the presence of independent directors can restrain controlling shareholder tunneling. The current legal system lacks robust protection mechanisms for the rights of minority shareholders and imposes lenient punishments for tunneling, contributing to the formation of controlling shareholder tunneling. Blind auditing practices by third-party auditors render them insensitive to controlling shareholder tunneling, thereby fostering such behaviors. The cited references in this paper provided further insights into different perspectives on the topic but they had limitations in terms of comprehensive coverage. Some of them mainly focused on summarizing the conclusions rather than providing detailed explanations. Moreover, although these papers revolved around the central thesis, they were not exhaustive. For instance, the literature mentioned in Section 3.2 regarding relevant legal systems only briefly mentioned the inadequacies of the laws without specifying which laws or provisions were insufficient. Furthermore, in Section 4.3, which discusses

the impact on the market, the literature pertaining to this aspect is mostly similar, lacking significant distinctions. So, we still need to improve the accuracy and comprehensiveness of the literature.

6. Conclusion

This literature review examined various studies on controlling shareholder tunneling and analyzed its consequences. The findings indicated that controlling shareholder tunneling often harms the interests of minority shareholders. Due to their significant ownership and control over resources, controlling shareholders can exploit their positions to transfer assets to other entities, engage in highly-priced mergers and acquisitions, and benefit themselves at the expense of minority shareholders. Controlling shareholder tunneling typically affects a company's performance, leading to resource depletion, governance failures, and a weakened competitiveness and innovation capacity. Tunneling also undermines company value, such as stock price declines, reduced market capitalization, and potential damage to the company's reputation and credibility.

Controlling shareholders have a significant influence on corporate decision-making during the operation of a company, and they possess advantages in accessing information. Therefore, transparency in information disclosure is crucial for external investors. Additionally, due to the inadequate protection mechanisms for external investor rights, it is difficult to effectively control the malicious liquidation-style reduction of holdings by controlling shareholders. Therefore, it is essential to establish a more robust and comprehensive system for information disclosure to better protect the rights of minority shareholders and further facilitate the sustainable development of listed companies.

Furthermore, the China Securities Regulatory Commission (CSRC) has issued various regulations and policies regarding reductions in holdings. However, these regulations are still not comprehensive and have some flaws. For example, the 2017 new regulations on reductions in holdings stipulated that shareholders holding a specific proportion of shares are not allowed to reduce their holdings by more than 1% through auction trading within any consecutive 90-day period, while block trades are limited to a maximum reduction of 2%.

Based on the aforementioned research, this paper concluded that the act of tunneling by controlling shareholders had significant implications for both the company and other related parties. This study also shed light on the detrimental effects of such behavior to company management who may be unaware of its consequences. However, due to the limitations of this research, the present paper did not provide an in-depth analysis of effective preventive measures against tunneling or strategies for mitigating its impact once it occurs. Certainly, it is essential to explore foundational theories related to major shareholder tunneling behavior, such as agency theory and information asymmetry theory. This will enable a more robust explanation of the operational logic behind this behavior in our research. Therefore, future studies should expand the research scope to address these aspects comprehensively.

Authors Contribution

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

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