

Controllers Unbound



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Main Points

- We examine the expected effects of the recent relaxation of constraints on controlling shareholders, including through Delaware's SB21 legislation.
- We show that this relaxation should be expected to have large detrimental effects on public investors and the economy.
- Our aim is not to relitigate the debate on SB21:
 - We take the relaxed constraints as given, and aim to analyze the expected adverse consequences.

Main Points (2)

The relaxation of controller constraints should be expected to:

- (i) **provide controllers with substantial private benefits through six channels** that we identify and discuss;
- (ii) impose even larger costs on public investors and thereby **generate considerable efficiency costs** and reductions in corporate value;
- (iii) **transform ownership patterns over time**, leading to an increase in the incidence of controlled companies and to a decline in controllers' stakes;
- (iv) **lower the quality of investor protection in U.S. controlled companies** relative to that in other advanced economies; and
- (v) **impose especially large costs on public investors and economic performance** in companies with dual-class with small-minority controllers.

The stakes: The rise of controlled companies

- The incidence of controlled companies, and especially dual-class companies, has been steadily rising. We present evidence that:
 - In the past decade, **about 40%** of the high-tech IPOs had a dual-class structure; and
 - The aggregate market cap of controlled companies currently exceeds **\$13 trillion dollars**.
- Furthermore, as we show, the relaxation of controller constraints should be expected to **increase further the incidence of controlled companies**.

The stakes (2): The importance of Delaware

- We present evidence that the controlled companies that are incorporated in Delaware represent out of the total:
 - 92% by market capitalization; and
 - 76% by number.
- Thus, Delaware law is practically the law that largely governs US controlled companies.
- Furthermore, various other states tend to follow Delaware's law.

(I) Large Gains to Controllers

The relaxation of constraints:

Post SB21, outside the freezeout setting, the cleansing of any conflicted action never requires approval by public investors.

Furthermore, cleansing requirements are further relaxed as follows:

- Two approving independent directors are sufficient;
- The reviewing committee is not required to retain its own advisors;
- Directors are independent if satisfy the exchanges' requirements;
- Any judicial intervention due to equity considerations is explicitly rules out if independent director approval is obtained; and
- Any shareholder challenge would anyway be limited by restrictions on shareholder ability to inspect company books and records.

Key channels of obtaining private benefits

- We analyze in detail six channels through which post-SB21 controllers would be able to obtain considerable private benefits at the expense of public investors.
- We do not argue that controllers could not attempt to use these channels pre-SB21; they could have attempted to do so and face the risks of litigation.
- Our key point is that, for sure, post-SB21 controllers would have expansive ability to use these channels.
- By and large, controllers would largely be able, with adequate professional advice, to get through any conflicted action or value-diversion that they desire.

Channels of opportunism (1): Freedom to radically separate votes and cash flows

- Following the relaxation of constraints, any controller should be able to cash out part of its equity capital, and/or raise additional capital for the company without any weakening of its lock on control.
- This could be done by introducing nonvoting shares:
 - Selling these shares to outsiders to finance any investment.
 - Issuing and distributing nonvoting shares to all shareholders as a pro rata dividend would enable the controller to cash out a large fraction of its equity capital without any reduction in the number of votes it holds.

[Such a move was attempted by Meta in 2016 but was blocked by litigation.]

Channels of opportunism (2): The death of sunsets?

- Many dual-class companies have gone public with sunset provisions, and investors have been keen to have them.
- Following the relaxation of constraints, controllers will be able to remove sunset provisions and perpetuate control.
- Of course, that would not be possible if public investors are required to approve the charter change. But our review of all the charters with sunset provisions found that they commonly lacked any such requirement.

Channels of opportunism (3): Opening the compensation floodgates

- Given the introduction of mega-pay packages by Tesla and Musk, the relaxation of standards should be expected to open widely the compensation floodgates, especially in companies with a small-minority controllers.

[Our prediction: Expect large expansion of the use of mega grants in such companies.]

Channels of opportunism (4): Partial freezeouts?

- Viewing freezeouts with controller-favoring terms as a source of serious concern, SB21 retains strong limitations on freezeouts.
- But what about “partial freezeouts” - sales to the controller of a substantial fraction of the company’s assets (e.g., 40% of revenues) but falls below the threshold of “substantially all assets”?
- Such “partial freezeouts” also present serious concerns, but post- SB21 they will be subject to a lax standard.

Channels of opportunism (5): Related Party Transactions and Allocation of Opportunities

- Controllers will also be freed up to engage in related-party transactions and to allocate to themselves corporate opportunities.
- This is highly relevant in any situation in which the controller has business assets other than the controlled company.

Channels of opportunism (6): Reincorporations

- SB21 made it clear that controllers will generally be able to reincorporate, without approval by disinterested shareholders, whenever doing so would favor their private interests.
- Therefore, it is highly unlikely that Delaware will tighten controller constraints so long as there are other states (e.g., Texas, Nevada) offer lax rules.

(II) The Transformation of Ownership Patterns

Changes in ownership patterns (1)

In the past, even when a company had an initial controller at the IPO stage, it commonly lost control over time as a result of:

- Raising of capital by selling new shares to public;
and /or
- The controller cashing out shares.

Changes in ownership patterns (2):

- Post-SB21, the expected increase in the private benefits of control will strengthen controller incentives to avoid forgoing control.
- Moreover, controllers will be able to avoid doing so with little cost:
 - They can raise new capital by selling nonvoting shares; and
 - They will be able to distribute nonvoting shares to existing shareholders as a pro rata dividend and then sell them to cash out part of their own equity stake.

Change in ownership patterns (3):

As a result:

- (a) The incidence of control blocks should be expected to increase substantially over time; and
- (b) The size of control blocks should be expected to decline over time.

The result: **More controllers, lower stakes** → a large increase in the incidence of small-minority controllers and their costs.

(III) Larger Costs to Public Investors and the Economy

Costs to Investors and the Economy (1):

- Whereas we expect large gains by controllers, **costs to public investors and to corporate value should be expected to be much higher.**

Costs to Investors and the Economy (2):

- The extraction of private benefits will be associated with distortions and efficiency costs (e.g., Bebchuk and Kastiel (2017, 2019)).
- For example:
 - **A decision to retain control** if/when the controller were to stop being the most fitting company leader;
 - **Pursuing related-party transactions** if/when transacting with a non-affiliated entity would be most efficient;
 - **Allocation of a corporate opportunity** if/when the company's itself pursuing this opportunity were value-maximizing;
 - **Reincorporating to a jurisdiction with lax rules** if/when these lax rules would facilitate value-destroying opportunism.

Costs to Investors and the Economy (3): Effects taking the size of control blocks as given

- Consider a controller that owns a fraction α of the cash flows of the company. And consider a corporate action that would reduce the company's market capitalization by ΔV but increase the private benefits of the controller by \$100M.
- The controller will be made better off by the corporate action so long as $\$100M - \alpha\Delta V > 0$.
- For any corporate action providing private benefits, the set of circumstances in which inefficient actions will take place is defined by
$$\Delta V < (1/\alpha) \$100M.$$

The range of inefficient actions that the controller will benefit from pursuing will be larger for small-minority controllers with low α .

* If $\alpha=0.5$, the controller will extract benefits so long as $\Delta V < 200$.

* If $\alpha=0.1$ the controller will benefit as long as $\Delta V < 1,000$ (!).

Costs to Investors and the Economy (4): Effects from Increasing the Incidence of Small-Minority Controllers

- Agency problems and costs increase substantially – and more than in a linear fashion – with reductions in the controller’s fraction of equity capital (Bebchuk et al. (2000); Bebchuk and Kastiel (2019)).
- Because SB21 is likely to substantially increase the incidence of small-minority controllers, this will further raise costs to public investors and corporate value.

(IV) Falling Behind Other Advanced Economies

Falling Behind (1)

- A large literature in financial economics (*see, e.g.*, La Porta, et al., 1997, 2002; Levin, 1999; Dyck & Zingales, 2004) suggests that the quality of investor protection is important for the development of capital markets, and that the success of the U.S. capital markets has been partly due to the quality of U.S. investor protection.
- We show that the relaxation of controller constraints will substantially decrease the quality of investor protection in U.S controlled companies relative to other advanced economies.

Falling Behind (2)

- Djankov et al. (2008) put forward an **anti-self-dealing index** to measure the protection that a jurisdiction provides public investors from controllers. This Index has been used extensively.
- The Index runs from 0 to 1. We estimate that SB21 reduced the score of Delaware law from 0.75 (using conservative assumptions) or 0.9 (under less conservative assumptions) to 0.5, a reduction in the range of 33%-44%.
- Similar results are obtained when we use the scores of the **2020 World Bank update** of the index.

Falling Behind (3)

- According to the results of Djankov et al. (2008), a 0.25 reduction in the Anti-Self-Dealing Index is associated with:
 - a reduction of roughly 24% in the stock-market-cap-to-GDP ratio of affected companies, and
 - an increase of the median control premium by about 5.5%.
- A note of caution: These figures cannot provide a basis for a **precise** quantitative assessment of the costs of the recent unbinding of controllers, but they **do highlight** that these costs are likely to be substantial.

(V) Substitute Protections?

The question

- It might be argued that the costs discussed above could be effectively addressed by “substitute protections” – various market mechanisms that would effectively make up for weak investor protections.

Substitute Protections

Below we consider in turn six substitute protections.

1. Fear that the value of the controller's stake will decline?
2. Fear that the future raising of capital would be impeded?
3. Private ordering by including investor protections in charter provisions?
4. Institutional Investor Oversight?
5. Non-pecuniary operations on independent directors?
6. Reputational and non-pecuniary factors operating on controllers?

Substitute Protections (1):

Fear that the value of the controller's stake will decline?

- Extraction of PBC should be expected to become reflected in market prices
 - Might the controller be deterred by the prospect that the value of its block would decline?
- Consider a controller that owns a fraction α of the cash flows of the company and a corporate action that would increase the PBC by ΔB .
- In the case of a “pure transfer” in which the reduction in stock market capitalization (ΔV) would equal the private benefit (ΔB), the action would always be in the controller's interest, because it would bear only a fraction of the former but fully benefit from the latter. So the remaining question is when, due to efficiency costs, the reduction in ΔV is higher than ΔB .

Substitute Protections (1) (Cont.): Fear that the value of the controller's stake will decline?

- In this case, the controller will not be discouraged by the expected decline in the stock price only if

$\$100M - \alpha\Delta V > 0$, which is if and only if:

$\Delta V < (1/\alpha) * \$100M$ or

$\$100M > \alpha\Delta V$.

$\alpha = 0.5 \rightarrow$ A controller with 50% stake will be deterred only if the reduction in cash flows will be more than **twice** of the extracted private benefit.

$\alpha = 0.1 \rightarrow$ A small-minority controller that has 10% stake will be deterred only if the reduction in cash flows will be more than **ten times(!)** the extracted private benefit.

Substitute Protections (2): Fear that the future raising of capital would be impeded?

- But what about the prospect that extraction of private benefits should be expected to make it more difficult to raise capital?
- Suppose that subsequent to the conflicted decision, cash in an amount of C will have to be raised to enable the company's projects.
- In this case, the controller will choose to extract the \$100M in private benefits despite the accompanying cost so long as

$$\$100M - \alpha\Delta V > 0$$

Substitute Protections (2) (cont.): Fear that the future raising of capital would be impeded?

Again:

$\alpha = 0.5 \rightarrow$ A controller with 50% stake will be deterred only if the reduction in cash flows will be more than **twice** the extracted private benefit.

$\alpha = 0.1 \rightarrow$ A small-minority controller in a dual-class company that has 10% of the equity capital will be deterred only if the reduction in cash flows will be more than **ten times** (!) the extracted private benefit.

Substitute Protections (3):

Private ordering by including investor protections in charter provisions?

- Will substitute protections be provided via private ordering?
 - Controllers would have an incentive to include charter provisions in the IPO that would provide effective investor protection in order to maximize the IPO price. Note, however, that:
- This argument is relevant only for companies that will go public in the future; It does not apply to existing public companies.
- Controllers' incentives to provide such protective charter provisions would depend on whether and to what extent the market would price the value of such provisions. Our article might contribute to the market's gaining such an understanding.

Substitute protections (4): Institutional Investor Oversight?

- It might be argued that controllers might be discouraged from taking advantage of relaxed constraints by institutional investors' monitoring.
- Without a controlling shareholder, such investors have considerable power to influence because they potentially have the votes to replace the board.
- However, in controlled companies, institutional investors lack such potential power.
- Indeed, controllers with dual-class structures commonly ignore precatory shareholder proposals to dismantle the dual-class structures that receive support from most institutional investors.

Substitute Protections (5): Non-pecuniary operations on independent directors

- As discussed, independent directors in controlled companies have strong pecuniary incentives to go along with the controller.
- But surely there are individuals who might choose to resist the controller due to fiduciary norms, strong personal convictions on the issue, etc.?

Substitute Protections (5) (Cont.): Non-pecuniary operations on independent directors

- The controller, however, still has the ability to select and reselect directors from a **vast pool** of individuals who would qualify as independent directors.
 - The controller may, at the outset, interview as many candidates as needed to find two who are likely to go along with high probability; and
 - If the individuals initially selected unexpectedly fails to approve an action desired by the controller, the controller can replace them with two other individuals and try again.

[Consequently, independent directors might be reluctant not to approve conflicted actions in the first place]

Substitute Protections (6) : Reputational and non-pecuniary factors operating on controllers

- To be sure, some controllers might elect not to extract private benefits to the fullest possible extent due to internal norms or a desire to avoid negative publicity, but these constraints are hardly binding (especially in the case of the many controlled companies that attract little media interest).

Conclusions

The relaxation of controller constraints should be expected to:

- (i) provide controllers with substantial private benefits through six channels.
- (ii) impose even larger costs on public investors and thereby generate considerable efficiency costs and reductions in corporate value;
- (iii) transform ownership patterns over time
 - More controlled companies.
 - Lower stake by controllers.
- (iv) lower the quality of investor protection in U.S. controlled companies to a level significantly below that observed in other advanced economies.
- (v) impose especially large costs on public investors and economic performance in companies with dual-class and small-minority controllers.