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2010

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Stoyu I. Ivanov, *San Jose State University*

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ESOPS AND CORPORATE OFFICERS' COMPENSATION

STOYU I. IVANOV[1]
SAN JOSÉ STATE UNIVERSITY

ABSTRACT

In the literature two major hypotheses have been developed for Employee Stock Ownership Plans used as a takeover defense, the management entrenchment and shareholder interest hypotheses, with the existing research not finding conclusive evidence for either one. In this paper we provide evidence that the entrenchment hypothesis is not supported by finding that Employee Stock Ownership Plan firms pay less to their managers than non-Employee Stock Ownership Plan firms. If managers were truly entrenched they would have been able to expropriate wealth from the existing shareholders, which appears not to be the case for Employee Stock Ownership Plan firms.

INTRODUCTION

In this study we test the hypothesis of Employee Stock Ownership Plans (ESOPs) being used to entrench management by examining management compensation. We study a sample of pooled cross-section and time-series data of manager compensation in the period 1996-2001 to determine how ESOP presence affects managerial entrenchment. We find evidence that the entrenchment hypothesis is not supported by finding that ESOP firms pay less to their managers than non-ESOP firms. If managers were truly entrenched they would have been able to expropriate wealth from the existing shareholders, which appears not to be the case for ESOP firms.

The contribution of our study is that we attempt to fill the void in the literature of managerial compensation by examining ESOP as a form of entrenching managers and destruction of shareholder value. ESOPs are different from the other blockholder types because of their legal structure. ESOPs are structured as defined contribution pension plans that are legally required to hold at least 50% of their investments in the sponsoring firm's stock. The pension plan is managed by a management appointed trustee, who is responsible for voting the unallocated ESOP shares.

HYPOTHESES AND METHODOLOGY

The research in ESOPs has been primarily focused on firm performance (Borstadt and Zwirlein, 1995) and long run value effects to shareholders. Most of these studies find evidence that ESOPs are related to firm value (Chaplinsky and Niehaus,

[1] **Acknowledgments**: I would like to thank two anonymous referees and the journal editor Professor David Tufte for their insightful comments on this project. Any errors are my own.

1994; Pugh, Jahera and Oswald, 1999; Cramton, Mehran and Tracy, 2005 to name a few). This is not surprising considering the high profile cases of creation and destruction of value in firms adopting an ESOP. For example, in 2007 in a highly publicized acquisition Sam Zell, the real estate magnate, acquired the Tribune Company by contributing only 4% of the $8.2 billion price of the company, by designing a deal that involved a tax beneficial ESOP, which preserved current management (Creswell and Bajaj, 2007). In 2008 Tribune Co. filed for bankruptcy.

In this study we approach the problem of value effects to shareholders by examining entrenchment of managers. Two alternative hypotheses have been put forth in the literature with regards to the role of ESOPs as a defensive mechanism: the management entrenchment hypothesis and the shareholder interest hypothesis (also known as the convergence of interests hypothesis).

The first hypothesis suggests that managers expropriate wealth from shareholders after obtaining protection from removal via an entrenchment tool. Entrenchment occurs when managers adopt policies and act in such a way that their removal becomes costly to shareholders (Shleifer and Vishny, 1989). The adoption of antitakeover provisions thus makes the removal of managers costly relative to the alternative, their retention. Chaplinsky and Niehaus (1994) find that ESOPs are a strong deterrent to takeover. The predominant view in the literature, as pointed out by Scholes and Wolfson (1989), is that the takeover defense benefits of ESOPs are the primary motivating factor for establishing ESOPs relative to their tax benefits, improvements in employee productivity and costs. Scholes and Wolfson (1989) suggest that ESOPs can be very costly, considering the share-repurchase obligations towards departing employees. When employees depart the company must repurchase their stock. Considering that the company must refinance at this time, strain on the company finances usually occurs. Additionally, ESOPs can help entrench management. Bebchuk and Cohen (2005) provide evidence for the costs of managerial entrenchment. They study charter-based and bylaws-based staggered boards and their impact on market values and find that charter-based staggered boards are negatively related to market values. Their findings are in support of the hypothesis that entrenchment is negatively related to firm value. Also, Borokhovich, Brunarski and Parrino (1997) find that adoption of antitakover amendments results in managers obtaining and maintaining above market levels of compensation.

The second hypothesis implies that entrenchment has no negative effects on shareholder value. This hypothesis is based on the notion that after obtaining the necessary protection from removal, managers have more time to focus on increasing shareholder value, compared to managers who spend significant amounts of time devising strategies to fend off removal and stay in office. Ultimately, the managers are compensated and retained for performance in terms of maximizing shareholders' value, Almazan and Suarez (2003) argue that a certain level of entrenchment might be beneficial to shareholders.

However, there is no conclusive empirical support for either hypothesis in the literature. The reason for the lack of conclusive support for either hypothesis might be

due to the diverse factors that might affect entrenchment. The presence of a large shareholder, who is involved in the day-to-day management of the firm, and closely monitors or works with the CEO (such as a family, who have long term interests in the performance of the company) might have an impact on the compensation of the CEO, relative to the compensation of the CEO if such a large shareholder is not present. Yet, another variation in CEO compensation might occur when there is a large shareholder who is not actively involved in the management of the company (such as mutual funds, which predominantly have short term investment objectives). Additionally, the CEO might be the largest shareholder in the company, in which case the compensation might be completely different from the situations discussed above.

Recent studies concur with these implications. Faccio and Lasfer (2000) find that occupational pension funds in the UK do not effectively monitor firms that they are invested in. They find that the pension funds are passive investors that are not actively involved in the management of the firm contrary to expectations. Core, Holthausen and Larcker (1999) find that CEO compensation is a decreasing function of the existence of an external stakeholder with more than 5% ownership and the stake owned by the CEO. They also find that firms that exhibit internally weaker boards have greater agency problems, and the CEOs in these firms are compensated excessively, and perform worse. In a recent article Hartzell and Starks (2003) empirically show that higher institutional ownership concentration is positively associated with the pay-for-performance sensitivity of the executives' compensation and negatively associated with the level of the executive compensation. Almazan, Hartzell and Starks (2005) study the relationship between executive compensation and institutional monitoring, in terms of monitoring costs of the institutions. They consider potentially active and potentially passive institutions, their concentration and monitoring costs and find that pay-for-performance of executives is positively related to active institutions concentration and not related to the passive institutions concentration. In another recent study Cronqvist and Fahlenbrach (2006) study 13 different types of outside blockholders. They find that the corporate policies in a firm – investment, financial, operational, and executive compensation – are determined to a large extent by the type of large shareholder. However, the authors focus on outside blockholders and ignore managerial, affiliated and ESOP types of insider block ownership in their analysis. Chang (1990) finds that the adoption of ESOPs supports both shareholder interest and managerial entrenchment interests hypotheses depending on whether an ESOP is announced to be implemented for employee compensation or take-over defense purpose. The reason for the conflicting evidence might be due to the ambiguity of entrenchment. In general, entrenchment has a negative connotation and is usually associated with a "bad" manager resisting dismissal by the owners of the firm. At the same time, however, entrenchment can be beneficial to the owners of the firm, because a "good" manager will be protected from incurring costs of influencing the decision makers in terms of potential dismissal and focusing on maximizing shareholder value instead (Milgrom, 1988).

We contribute to the finance literature by examining ESOP as a form of entrenching managers and destroying shareholder value. The finance literature has not conclusively determined whether ESOPs lead to corporate insiders' entrenchment. We provide a new perspective on the entrenchment of managers by considering an influence

costs framework (Milgrom, 1988). The influence costs framework allows for the development of empirical hypotheses of the influence of ESOPs on the entrenchment of the corporate insiders. The influence costs framework suggests that by creating the ESOP the management has an owner of the firm that is identifiable and understandable to management and as such allows management to assess influence costs more accurately. Of course, this is in relative terms, large blockholders are easily identifiable but more powerful due to the nature of blockownership, of course the type of blockholder will matter too.

The preliminary expectations are that the presence of ESOPs enhances the influence of employees (with the exception of the CEO), and is negatively associated with managerial (CEO) compensation and sensitivity. In this study the executive compensation in the firm with a large ESOP block is examined for being different from the compensation in firms without ESOPs. We focus on ESOP as a proxy for entrenchment of management and ignore other entrenchment mechanisms.2 Naturally, the other entrenchment mechanisms might play a role in the determination of CEO compensation; however, as such they will appear in the error term of our model, and are thus accounted for when analyzing in isolation the role of ESOP. The preliminary expectations are based on the idea that the CEO of a firm with a large ESOP block would be able to establish a preferential treatment in terms of compensation due to their increased voting power that would affect the compensation negotiation process. In contrast, in a firm without an ESOP block and thus an increased power of management the CEO would be compensated more. Naturally, the presence of a large affiliated or nonaffiliated blockholder, with at least 5% block ownership, might provide an additional variation on the primary hypothesized relationships between CEO compensation, and ESOP blockholdings.

Therefore, the following hypotheses are tested based on prior literature:

H_0: CEO compensation is unaffected by the presence of ESOPs.
H_A: CEO compensation is affected by the presence of ESOPs.

A regression analysis will help test the stated hypotheses. We use the regression to test for the null hypotheses by studying the relationship of compensation and ESOP ownership and control for other types of ownership as well, such as percentage ownership by the firm's officers and the percentage ownership by outsiders. In this study we examine only public firms, which besides ESOPs, officers and blockholders ownership have also dispersed individual investors' ownership which insures that the sum of the percentage ownership of ESOPs, officers and blockholders does not add up to one:

$$Executive\ Compensation = \beta_0 + \beta_1(\%SUMESOP) + \beta_2(\%SUMOFF) + \beta_3(\%SUMOUT) + \sum_{i=4}^{i=n} \beta_i\,(Control)_i + \varepsilon \quad (1)$$

[2] Other takeover provisions are poison pills, staggered boards, golden parachutes, inside succession, dual position (CEO and chairman, McWilliams and Sen, 1997), managerial tenure, state of incorporation and others.

The rejection of the null hypothesis would suggest that managers are compensated differently in ESOP firms and thus might be expropriating wealth from shareholders dependant on the sign of the coefficient. If the sign is positive the managers' compensation is higher the larger the ESOP block which might indicate expropriation of wealth. If the sign is negative the manager's compensation is less the higher the ESOP holdings and there might be no expropriation of wealth. We control for size directly in the regression by using sales and return-on-assets because additional variation of CEO compensation might be due simply to the size of the firm. We assume no repricing of options and no backdating of options. We also consider compensation as percentage of the firm's sales to control for firm size as well directly in the analysis. The error term of the model, ε, captures any other factors which might influence the determination of the executive compensation such as other entrenchment mechanisms.

DATA

Blockholders Database is used to acquire data on blockholders of publicly traded companies. Dlugosz, Fahlenbrach, Gompers and Metrick (2004) provide a detailed discussion of the data in the Blockholders Database via Wharton Research Database Services (WRDS). The blockholders in the database are classified as officer, director, affiliated entity, ESOPs and outside blockholder. In addition we use EXECUCOMP and COMPUSTAT databases to acquire data on executive compensation and company specific data, respectively.

Executive compensation is comprised of salary, bonus, long term incentive plan payouts, other annual compensation, options and stock awards. Following the Almazan, Hartzell and Starks (2005) methodology we use the following three measures to identify CEO compensation: salary, total compensation for the individual year (TDC1) and pay-for-performance sensitivity (PFPS).

PFPS is calculated as delta times the number of options held, and the option's delta is calculated as in Burns and Kedia (2006). They calculate delta based on Black-Scholes option pricing model adjusted for dividend payouts:

$$\Delta = e^{-dT}\phi(Z)(0.01) \qquad (2)$$

where Z is computed based on the stock price S, exercise price X, time to maturity T, risk free rate r, dividend yield d, and stock price volatility σ2.3 The fiscal year end stock price S, and the stock price volatility σ2 are obtained from EXECUCOMP (and is measured over 60 months prior to the fiscal year end of the stock price S). The risk free rate r, is obtained from the Federal Reserve at St. Louis, and the natural logarithm of the dividend yield d, is from EXECUCOMP, also, and ϕ, is the standard normal cumulative

[3] Z is computed based on the following equation: $Z = \frac{\ln(\frac{S}{X}) + T(r - d + 0.5 * \sigma^2)}{\sigma\sqrt{T}}$.

distribution function. Burns and Kedia make assumptions about the time to maturity of the option grant T, and the option exercise price X. The time to maturity of unvested options is the time to maturity of the most recent options grant minus one year, and for vested options as the time to maturity of unvested options minus three years. The exercise price X, is assumed to be the stock price at fiscal year end minus the profit per option (where profit per option is calculated as the realizable value per option from EXECUCOMP divided by the number of options at the fiscal year-end). Additionally, the authors calculate deltas and option sensitivities for newly granted options, vested options, and unvested options, which they sum up to obtain total option sensitivity. Burns and Kedia also calculate convexity of the stock option grants, and it represents the rate of change of the option's delta to the stock price, and is as follows:

$$\Gamma = \frac{e^{-dT}\phi(Z)}{S\sigma\sqrt{T}} * 0.01, \qquad (3)$$

where the variables are as defined for the option's delta, and gamma of options is the sum of gammas of newly granted, unvested and vested options. Almazan, Hartzell and Starks use a fourth measure of pay-for-performance sensitivity, which they find to be significantly correlated with the measure PFPS, because of that we consider only the three measures discussed above to identify CEO compensation.

ANALYSIS

To examine whether there is a difference between CEO compensation in ESOP and non-ESOP firms we use three measures of compensation as discussed above and control for profitability and firm size. A summary list of variables used in the analysis, with their respective descriptions, is provided in Table 1.

Summary statistics of data used in the analysis are presented in Table 2. We pool the cross-section of managers' compensation and time-series for the period 1996-2001. We end-up with 15,001 usable manager-year compensation observations. For the calculation of the non-cash compensation, PFPS, we have no data for certain managers causing the elimination of observations resulting in a sample of 12,301 observations. Naturally, the reader might ask whether the truncation might bias our analysis. It is possible that small companies might not have complete data. However, we control for firm size by using sales as a variable in our analysis which will resolve the small company issue. On the other hand, the selection bias imposed by examining only available data cannot be avoided and as such is natural limitation of this study.

TABLE 1
VARIABLE DEFINITIONS

Variable	Definition
SUMOUT	Percentage ownership by nonaffiliated blockholders
SUMESOP	Percentage ownership by the firm's ESOP, but does not include additional shares owned in a non-ESOP 401(k) plans
SUMOFF	Percentage ownership by the firm's officers
SALARY	The dollar value of the base salary (cash and non-cash) earned by the named executive officer during the fiscal year. Units: Thousands of dollars
TDC1	Total compensation for the individual year, comprised of the following: Salary, Bonus, Other Annual, Total Value of Restricted Stock Granted, Total Value of Stock Options Granted (using Black-Scholes), Long-Term Incentive Payouts, and All Other Total. Units: Thousands of dollars
PFPS[4]	The sensitivity of the options part of compensation to the change in the stock price
SALES	Net sales
ROA	Return on assets

TABLE 2
SELECTED SUMMARY STATISTICS ON DEPENDENT VARIABLES

Variables	N	Mean	Standard Deviation	Minimum	Maximum
SALARY	15001	426.53	273.04	0.00	6765.00
TDC1	15001	2784.25	8511.32	0.00	655448.00
PFPS	12301	757.65	21761.79	0.36	1971559.42

SELECTED SUMMARY STATISTICS ON INDEPENDENT VARIABLES

Variables	N	Mean	Standard Deviation	Minimum	Maximum
SUMESOP	15001	1.42	4.07	0.00	36.10
SUMOFF	15001	1.60	5.74	0.00	53.40
SUMOFF	15001	13.37	13.20	0.00	82.64
SALES	15001	6681.90	14237.98	90.54	218529.00
ROA	15001	5.27	6.51	-96.00	57.47

Table 3 provides information about the number of unique firms with ESOP plans in each year. The number of firms with ESOPs is relatively small compared to the total

[4] PFPS is short for Pay-for-Performance Sensitivity.

sample of firms in the Blockholders database, which is 1500. Considering that there are companies with incomplete data in the six year period that we examine and the fact that there are sometimes more than one blockholder per company the number of observations in this study is not exactly 1500 companies multiplied by six years of data. Nevertheless, the number of ESOP firms is comparable to the overall presence of ESOPs in the economy (Uchitelle, 2007).

TABLE 3
NUMBER OF UNIQUE ESOPs

Year	1996	1997	1998	1999	2000	2001
ESOPs	126	129	128	116	121	115

The correlation among variables plays an important role for the selection of variables to be used in the analysis. The correlations among variables are generally low with the exception of sales, which is highly correlated with market value of the company (results are not reported but are available upon request).5

One might argue that the compensation of managers is highly related to the size of the company and its particular industry. Larger firms tend to pay higher salaries to managers. Another consideration is that we analyze pooled cross-section and time-series sample, in which inflation, particularly in managers' salaries might drive the results. To alleviate these concerns we also scale the dependent variables by sales. Therefore, the scaled dependent compensation variables, Salarys, TDC1s and PFPSs, capture the compensation of the officer relative to the company's size and eliminate any problems arising from company size and inflation.

The regression results are presented in Table 4. The dependent variables are Salary, Salarys, TDC1, TDC1s, PFPS and PFPSs. The results from the multivariate analysis, from both the nominal and scaled compensation variables, suggest that managers in firms with ESOPs are paid differently than managers in non-ESOP firms when salary and bonuses are considered, thus rejecting our null hypothesis. Considering that the coefficient is negative it is reasonable to infer that the compensation of CEOs is less in ESOP firms. For example, if we consider the scaled salary measure of compensation, the marginal relative effect of an increase in ESOP ownership on manager's compensation is a negative 0.26. However, when compensation other than cash is considered ESOP firms seem to have manager compensation similar to firms that do not have ESOPs, the marginal effects are negative but statistically insignificant. We also find that firms with outside blockholders such as families and mutual funds provide lower compensation in terms of salary and bonuses, and that firms with large holdings by officers provide higher compensation to the managers. The marginal effects are statistically significant negative and positive, respectively.6

[5] Therefore, because of multicollinearity we will exclude market capitalization from the analysis.

[6] Regression results for PFPS and the scaled salary, TDC1 and PFPS measures are not reported in Table 4 in the interest of brevity because of poor fit; however, the relation between the scaled dependant variables and independent variables are similar to the non-scaled dependent variables regression results and are available upon request.

TABLE 4
REGRESSION RESULTS, WHOLE SAMPLE

Independent Variables	Dependent Variable for Each Regression	
	Salary	TDC1
Intercept	-375.90 (13.57) ***	-9972.19 (521.27) ***
SUMOFF	-3.06 (0.50) ***	-29.14 (19.12)
SUMESOP	3.65 (0.37) ***	41.40 (14.15) ***
SUMOUT	0.17 (0.16)	8.66 (6.19)
LSALES	100.48 (1.60) ***	1583.71 (61.35) ***
ROA	0.84 (0.32) ***	21.10 (12.30) *
Adjusted R^2	0.2505	0.05027
N	12,301	12,301

Note: Asterisks ***, **, * denote statistical significance at the 1%, 5% or 10% level, respectively

Examining the regression results in their statistical significance in isolation if incomplete, this calls for the interpretation of their economic and financial meaning. For example, salary is statistically affected by the percentage of ownership by ESOP plans in their capital structure, with a statistically significant coefficient of -3.06. The financial interpretation of this coefficient is that the increase in ESOP ownership by one percentage point is associated with $3060 decrease in the CEO direct compensation.

When we analyze only firms with ESOP plans, presented in Table 5, we observe that the combination of ESOP blockholder and outside blockholder results in a reduction in the managers compensation, which is incompletely offset by manager blockholders attempts to increase compensation.7

TABLE 5
REGRESSION RESULTS, ESOP FIRMS ONLY

Independent Variables	Dependent Variable for Each Regression		
	Salary	TDC1	PFPS
Intercept	-296.69 (34.02)***	-7972.01 (971.24)***	-75.59 (186.21)
SUMOFF	10.10 (1.19)***	-0.84 (33.93)	0.99 (6.50)
SUMOUT	-1.32 (0.53)***	-32.12 (15.26)**	-5.08 (2.93)*
LSALES	86.00 (3.84)***	1328.70 (109.56)***	33.60 (21.01)*
ROA	3.92 (1.03)***	10.57 (29.45)	12.99 (5.65)**
Adjusted R^2	0.2502	0.0917	0.0034
N	1638	1638	1638

Note: Asterisks ***, **, * denote statistical significance at the 1%, 5% or 10% level, respectively.

[7] Regression results for the scaled salary, TDC1 and PFPS measures are not reported in Table 5 in the interest of brevity because of poor fit; however, the relation between the scaled dependant variables and independent variables are similar to the non-scaled dependent variables regression results and are available upon request.

Contrast these results to the compensation patterns in firms that do not have ESOP ownership. These results are presented in Table 6. In the firms without ESOP the manager blockholders have a higher nominal compensation regardless if there are outside blockholders or not. When scaled compensation is considered, our data suggests that the presence of large outside owners offset the officer blockholders higher compensation attempts.8

TABLE 6
REGRESSION RESULTS, NON-ESOP FIRMS ONLY

Independent Variables	Dependent Variable for Each Regression		
	Salary	TDC1	PFPS
Intercept	-400.38 (14.79)***	-10356 (583.79)***	-1404.52 (1505.09)
SUMOFF	3.19 (0.39) ***	44.55 (15.36) ***	-7.93 (39.60)
SUMOUT	0.34 (0.17) ***	11.49 (6.72) *	13.08 (17.32)
LSALES	103.60 (1.75) ***	1631.93 (69.20) ***	270.26 (178.35)
ROA	0.57 (0.34) *	20.44 (13.38)	-4.45 (34.49)
Adjusted R^2	0.2542	0.0508	0.0001
N	10663	10663	10663

Note: Asterisks ***, **, * denote statistical significance at the 1%, 5% or 10% level, respectively.

Chow Test results are presented in Table 7. The Chow Test is designed to establish whether there is a structural difference in the parameters of two regression models. The test has a null hypothesis structural similarity among the coefficients. Thus our results suggest in an alternative way that the coefficients of the regression and thus the compensation of managers in terms of salary and TDC1 are different in ESOP and non-ESOP firms. We do not document a difference in the PFPS compensation of managers in the two types of firms.

TABLE 7
CHOW TEST RESULTS

	Salary	TDC1	PFPS
F Value	19.05***	3.21***	0.34
Prob>F	<.0001	0.0067	0.8861

Note: Asterisks ***, **, * denote statistical significance at the 1%, 5% or 10% level, respectively.

CONCLUSION

Employee Stock Ownership Plans (ESOPs) can be used as a tax shelter, to motivate employees, for acquisitions (leveraged ESOPs as in the example of Sam Zell's acquisition of Tribune Co.), and to protect the company from take-over. In the literature

[8] Regression results for the scaled salary, TDC1 and PFPS measures are not reported in Table 6 in the interest of brevity because of poor fit; however, the relation between the scaled dependant variables and independent variables are similar to the non-scaled dependent variables regression results and are available upon request.

two major hypotheses have been developed for ESOPs when they are used as a takeover defense, the management entrenchment and shareholder interest hypotheses, with the existing research not finding conclusive evidence for either one. In this paper we provide evidence that the entrenchment hypotheses is not supported by finding that ESOP firms pay significantly less to their managers than non-ESOP firms. If managers were truly entrenched they would have been able to expropriate wealth from the existing shareholders, which appears not to be the case for ESOP controlled firms.

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