

# Long-Term Performance of ESOPs and Optimal Managerial Control

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## Introduction

Our paper examines the interaction between managerial control and ownership in firms with employee stock ownership plans (ESOPs) to determine whether there is evidence of entrenchment in such firms. An increase in executive ownership in a firm gives managers greater control over the firm, but makes them significant shareholders, so their incentives are more aligned with other shareholders. However, a compensation plan that provides executive effective control over a large block of shares without the counterbalancing executive ownership could permit executives to entrench themselves at the cost of the other shareholders. ESOPs are plans like this, and they allow for separation between ownership and control by enabling the board to influence the distribution of unallocated shares from the ESOP. Such a separation could lead to managerial entrenchment.

As noted by the National Center for Employee Ownership, the use of ESOPs in both publicly traded and privately held firms has grown dramatically over the past three decades, with a total of about \$400 billion in assets under management as of 2002. Privately held firms operate the majority of ESOPs, presumably with a tax-motivated intent of transferring shares from the original owners to employees (Bailey 2002). There are over 10,000 plans, but the large majority of these are in private or small firms. We focus on a smaller number of publicly traded ESOPs.

An ESOP allocates shares of stock to a pool at initiation. Over time, these shares are distributed to employees of the firm as a form of incentive pay. Unlike many other plans, the shares are not targeted primarily at executives but rather are allocated more broadly. Because of this structure, managers of firms with ESOPs effectively control more shares than they own since management and the Board (the executives) choose who will direct the ESOP. Because managers have significant influence on the voting behavior of the firm managing unallocated ESOP shares, a wedge is driven between the number of shares owned by a firm's managers and the number of shares those managers control. Managers are able to own a smaller number of shares personally, so that their interests are not as well aligned with shareholders. At the same time, due to the shares that they control through the ESOP, the managers are able to entrench themselves at the expense of shareholders. Some authors (Dhillon and Ramirez 1994) have examined the size of the ESOP wedge. However they ignore its interaction with prior managerial ownership. Managers owning a significant portion of the firm's equity are unlikely to entrench regardless of the ESOP size. We extend their analysis of managerial ownership and the ESOP wedge, allowing for a clearer picture of the issues involved in ESOP performance.

While theory suggests that ESOPs could lead to greater agency costs in the firm, others argue that an ESOP should create shareholder value. Some literature (Gordon and Pound 1990; Dhillon and Ramirez 1994) suggests that the primary source of shareholder value results from the increased managerial control accompanying an ESOP. Managers increase control by

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retaining the voting rights of the ESOP shares until the vestment period is expired, which is typically seven years.<sup>1</sup> Pugh, Oswald, and Jahera (2000) used 183 firms' data to exam eight financial ratios. Their study found the strong relations between managers and employees led to greater shareholder value. According to this theory, the increased managerial control enables managers to focus their attention on creating value for shareholders. If ESOPs create shareholder value, employees benefit directly, simply because they own shares in their firms. In a related manner, other papers (Iqbal and Hamid 2000) find that the operating performance of an ESOP firm improves subsequent to a large stock price increase. Given the two conflicting theories of ESOPs, and the mixed results to date, there remain important questions about the overall benefit of ESOPs for employees and/or shareholders.

In order to evaluate the actual performance of the firms that use ESOPs, we analyze the long-term stock performance of ESOPs and its relation to managerial control. It is useful to examine ESOPs, not only because many public firms still use and/or initiate ESOPs, but also because ESOPs create a separation between ownership and control for executives.

We use a careful analysis of firm stock performance over five years following the ESOP compared to managerial control of the firm. By decomposing the levels of managerial ownership and control, we are able to determine whether an optimal level of managerial ownership exists which maximizes shareholder value. While our results are mixed, we generally find that the use of an ESOP by firms has no impact on the long-run performance of those firms.

## **Prior Research**

Presumably, a firm should need to justify to shareholders shifting a significant proportion of its equity to its employees. A typical justification for ESOPs is that they increase employee productivity, because employees are also then owners. Two measures of productivity (performance) have been used in the ESOP literature as indicators of corporate performance.

One productivity measure, as employed by (Dunbar and Kumbhakar 1992; Beatty 1995), uses production functions like Cobb-Douglas to explain output based on the labor and capital inputs. Production not explained by the level of labor or capital is assumed to result from increased productivity. Unfortunately, other exogenous factors also fall into the residual of the production function, making the use of the residual problematic.

The other approach for measuring productivity is to consider the stock price reaction to ESOP announcement. Although the reaction describes the wealth effects of the ESOP, it does not provide a clear measure of employee productivity (Beatty 1995). It is possible that any particular ESOP is being used for all cited reasons (tax, entrenchment, and incentive), yet the stock price can only provide an aggregate effect. For example, Gordon and Pound (1990) and Park and Song (1995), find a negative effect from using an ESOP as an anti-takeover device.

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<sup>1</sup> Managers maintain some control over employees even after the vestment period, because of the threat of termination. This threat is presumably greater for employees in ESOP firms than non-ESOP firms, because their human capital is less diversified and they risk losing the future value of the ESOP shares. Note that we do not take into account the presumed negative impact on employees' ability to diversify their portfolios.

The stock price reaction also does not provide information about the timing of efficiency. A positive stock price reaction could indicate a relatively large initial impact of an ESOP with benefits tapering off over time, or it could indicate a steady, constant increase in productivity over time. There may be a delay (Jones and Kato 1995) in increased productivity of 2–3 years after an ESOP is adopted. ESOP data from Japan suggests that productivity decreases immediately around the ESOP introduction. The productivity measures do not become significantly positive until about three years after the ESOP is enacted. Their evidence suggests that examining the timing of the benefits to ESOPs in the United States may be informative.

Surveys of the literature on ESOPs (Rosen 1990; Scholes and Wolfson 1990) during the 1980s when more public firms initiated ESOPs also examined these productivity measures. They also report mixed evidence for ESOPs improving the performance of the firm.

ESOPs may also indirectly motivate employees by giving them a stake in the financial health of the firm. Theory suggests that corporations adopting salary-deferral programs for employees do so to align the interests of employees and shareholders. Aligning interests, in turn, will reduce agency costs in the corporation and may lead to more efficient use of resources. However, empirical results to date suggest that the strength of the alignment is minimal and is subject to free-rider problems. Conte and Kruse (1991) find that each worker gains only 2.2 cents for an additional dollar of return per employee, presumably not enough for motivation.

In addition to employee motivation, both managerial entrenchment and tax effects have been advanced as reasons for the use of ESOPs. Chaplinsky and Niehaus (1994) discuss the impact of voting rules on an ESOP. If shares have been allocated in a publicly traded corporation, employees must be able to vote their shares. However, all other shares (as well as employee shares without voting directions) are typically voted by the ESOP trustee. Although the trustee is theoretically independent, the practice is rather different. As Chang and Mayers (1992) note, the trustee is typically appointed by management to run an ESOP. This might allow managers to wield the power to vote these shares to entrench.

Given the problems of these performance measures, we use a third measure of corporate performance, the long-term stock price performance after adoption of the ESOP. Long-term stock price performance can be measured over time and be used as a measure of productivity. Indeed, this measure of productivity is at least intuitive as an economic production function and is the most relevant measure of performance for shareholders, including the employees who participate in the ESOP.

The long-term stock price performance, naturally, does not measure employee productivity perfectly either. It is an ex-post realization and therefore subject to exogenous shifts and noise. And it combines the actual information about increases in performance with market expectations of future performance. However, we pair the sample corporations with control firms. This matching technique limits potential problems with the ex-post realizations. Also, innovations in market expectations should be correlated with changes in performance; so long-term stock prices can alleviate the problem of the uncertainty of the time pattern of the impact.

The prior literature using long-term stock returns is somewhat less common, but has also provided mixed results. Although some papers (Park and Song 1995) find some support for long-term gains to the firms that adopt ESOPs, others (Robinson 1997) argue that ESOP firms suffer from severe long-term underperformance. Indeed, using the bootstrap technique Ikenberry, Lakonishok and Vermaelen (1995), find that the mean three-year buy-and-hold return for the ESOP sample is significantly negative.

### Methodology – Data

Our sample consists of ESOP announcements by publicly traded firms between 1985 and 1995.<sup>2</sup> To compile the sample, we search for all ESOP-related announcements beginning in 1985. The final sample includes all announcements that satisfy the following criteria:

1. The announcing firm was publicly traded at the time of the announcement, and has daily stock returns available from the Center for Research on Security Prices (CRSP) Daily Returns File for at least 255 trading days preceding the ESOP announcement date. Further, no more than five observations can be missing in the 20 day event window
2. The announcement was cited in the *Dow Jones News Retrieval* or in *Lexis-Nexis* and there were no conflicting news announcements for the day preceding through the day following the ESOP announcement.
3. Financial information for the firm is available from COMPUSTAT for the fiscal year of the announcement and managerial ownership information is available from Proxy statements for at least one year following the ESOP announcement.
4. The ESOP firms can be matched, (Barber and Lyon 1997), to non-ESOP firms that also have the requisite data. There must be no more than 60 days per year missing for at least three years after the event period.
5. The firm can have no other ESOP announcement within one year of the initial announcement to allow for calculation of long-term returns.
6. Financial and regulated firms were removed.

ESOP announcements for 236 firms were identified during the sample period. Applying the above criteria reduces the final sample to 62 ESOPs, along with 61 matching firms.<sup>3</sup>

We use a (Barber and Lyon 1997) matching methodology to estimate long-run abnormal returns, and then regress these returns on the managerial control variables. This should provide a picture of whether ESOP ownership or control levels lead to managerial entrenchment, greater or increased shareholder value. We compare the difference in holding period returns between our sample firms and a set of matched firms. The matching is one-to-one and proceeds by selecting the firm with the closest book-to-market (B/M) ratio from a set of non-ESOP firms within a 70–130% range of the sample firm's size (SIZE), calculated as stock price/share multiplied by shares outstanding.

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<sup>2</sup> The search for ESOPs is terminated in the mid-1990s because we require at least three years of post-announcement financial data and because there are relatively few ESOP announcements following 1995.

<sup>3</sup> One firm announced ESOP initiations twice during the sample period. While this number of firms yields a relatively small sample size, it is consistent with other studies of ESOP firms. Iqbal and Hamid (2000), for instance, have a sample size of 76 ESOP firms.

Barber and Lyon (1997) use holding period abnormal yields (HPYs) calculated as buy and hold returns to the sample firm over the long-term period chosen, net of similar buy and hold returns to a control firm. Control firms are chosen by matching firms by size and book-to-market. The framework exploits the (Fama and French 1992) results that size and book-to-market are strongly associated with common stock returns. In effect, instead of using the "standard" measure of risk such as beta for benchmarking comparative firm performance, the matching procedure compares firms with similar characteristics at a point in time and then calculates differences in the buy-and-hold stock returns to a specified later date. Since size and the book-to-market ratio serve as the measure of firm risk, these returns are automatically adjusted on a firm-by-firm basis for risk.

### Results – Descriptive Statistics

Descriptive statistics for the 61 firms initiating 62 ESOP announcements from 1986 to 1995 are presented in Table I, Panel A. The average size of the firms during the issue year approaches \$5 Billion, with the median slightly below \$2 Billion, indicating that the sample firms are in the mid-cap range. The average (median) book-to-market ratio (B/M) of 0.66 (0.62) indicates that the ESOP firms tend to be growth firms, given the interpretation of Smith and Watts (1992) that high MV/BV proxies for growth (investment) opportunities. Corporate executives own 7.7% of the firm's shares on average, although median ownership is only 2.1%.

Institutional ownership averages 8.7%, but median institutional ownership approaches 0%. Finally, the ESOPs own 5.4% of the firm's common shares on average during the initial year of the ESOP, though the median ownership is 0%. The maximum holding period yields may appear inflated (e.g., a maximum five-year cumulative holding period return of 924% for the ESOP firms). However these high returns are due to one firm, Home Depot, experiencing extraordinarily good performance. The related firm characteristics for the match non-ESOP firms are presented in Panel B for purposes of comparison. The high standard deviations of holding period returns reported in Table I ensure that mean cumulative yields are not significantly different across the two sets of firms. Median tests also cannot detect significant differences between the holding period yields of the ESOP firms and the non-ESOP control firms listed in Table 1 above.

### Results – Long-Run Holding Period Yields (HPYs)

One important question for investors examining a firm is whether ESOPs "pay off" over the longer run? And if they do, does the level of managerial ownership play a role?

We examine the benefits to shareholders, the ultimate test of corporate decision-making in modern finance. In order to examine shareholder gains, we match the ESOP firms in our sample to non-ESOP firms by size and the book-to-market ratio (Barber and Lyon 1997). The general hypothesis is that firms adopting ESOPs outperform the non-ESOP firms. But we are also interested in knowing whether any potential long run "abnormal/excess" returns for ESOP firms are associated with an optimal level of managerial control. The abnormal returns in this case equal the holding period yield (HPY) of the ESOP firm minus the HPY of the matched non-ESOP firm. The intuition is that, for example, if a midrange level of ownership (between 10-

15%) provides an optimal level of managerial control, then those firms within this level of ownership would outperform their matches (the non-ESOP firms). This result would be confirmed by positive and statistically significant estimates for the midrange ownership levels.

In order to examine these HPYs, we perform regressions of one-, three- and five-year holding period yields (HPY) on managerial control and the Cumulative abnormal returns (CARs). The return variable (CARs) is included in order to determine whether the initial market response is associated with long-term firm performance. We use as managerial control variable three different control measures. The first measure is the size of the ESOP or proportion of the firm's shares allocated to the ESOP. This ESOP size should be an indicator of the relative ability of managers to entrench. The next measure is executive control of shares before the ESOP. It includes all shares reported as beneficially owned by senior executives and board members. This measures the wealth the executives have at risk in the firm. Greater levels of share ownership would tend to alleviate any agency costs by forcing executives to bear a significant proportion of that burden. The third measure is the joint control of managers after the ESOP. It is measured by the size of the ESOP added to the number of shares owned by the managers and indicates the raw voting power controlled by executives.

Table II examines the relation between the size of the ESOP and the long-term performance of the firms and finds no significant evidence that firms with ESOPs outperform non-ESOP firms. There is a marginally significant effect in the 10-15% range for the first year, but that effect disappears over the longer-term. However, if the ESOPs stimulate employee motivation, better performance would be expected over the longer run. As a result, the evidence suggests that ESOPs are either irrelevant, or the positive benefits of an ESOP are balanced out by the negatives. Also, note that there is no significant relation between the short-term performance of an ESOP around its announcement (CAR) and the long-term performance afterwards suggesting there is no over or under reaction.

In Table III, the relation between executive ownership prior to an ESOP and the performance after an ESOP are examined. Consistent with general executive ownership literature, there is an optimal amount of executive ownership at 10-15%, but firm values tend to fall again afterwards. As our numbers are differenced between the ESOP firms and control firms, the significant positive relation suggests that not only might 10-15% be the optimal level of ownership for firms, but that the use of an ESOP is associated with an increase in the gains to such firms. Again there seems to be no relation between the short-term reaction to the ESOP and the long-term performance compared to the control firms.

In Table IV, we combine the shares issued to the ESOP with the executive ownership to develop a measure of the degree of control of the executives after the ESOP initiation. When the ESOP shares are included, the increased performance from an optimal level of executive ownership seems to disappear. It appears that the added ESOP shares tend to wash out any benefits from optimal executive ownership. Further there is some weak evidence for a negative relation between the short-term and long-term performance. Although marginal, this relation suggests that the firm does worse than thought at the time of the ESOP because of the additional ESOP shares controlled by managers

An important question arises as a result of our research. The number of ESOPs announced during the earlier part of the sample period was much larger than announcements in the latter part of the sample period. An obvious question is why there is a decline in the number observations. We randomly selected 50 firms in order to ascertain the percentage of firms which use ESOPs (during 2001 and 2002) through an examination of their 10Ks and Proxy Statements. A total of 8 of the 50 firms use ESOPs. This suggests a 16% use rate of ESOPs by publicly-traded corporations. It appears that many firms still use ESOPs, but because many ESOPs are ongoing plans that are renewed or updated, the announcements of new ESOPs are relatively rare.

### **Summary and Conclusion**

This paper examines the long-term performance of firms around ESOPs and tries to determine the motivation for managers to adopt these plans. While previous studies have examined long-term performance, our paper is unique in that we: (1) use a matching sample method (Barber and Lyon 1997) to control for risk characteristics, (2) analyze separate measures for managerial ownership and managerial control and at differing levels.

We find evidence firms that adopt ESOPs and have a strong executive ownership level will see improved performance relative to non-adopters. However the size of the ESOP itself does not seem to impact firm value, and combining the ESOP size and executive shares tends to wash out the gain. Of course this could be either a function of ESOPs increasing firm value for these firms, or firms with the greatest potential benefit self-selecting ESOPs.

**Table I – Descriptive Statistics**

Descriptive statistics during the event year for the 62 sample firm announcements are provided below. **SIZE** is the market value of the firm (market value of equity, i.e., the market cap), **Total Assets** is the book-value of the firm's assets, **Net Sales** is the annual revenue, **Total-Long Term Debt** is the book-value of long-term debt, the **Book-to-Market Value** is the book value of equity scaled by the market cap, **Executive Shares** is the percent of total common shares held by all managers and outside directors, **Institutional Ownership** is the percent of total common shares held by non-executive outside blockholders (primarily institutions), and **% ESOP** is percent of total common shares held in the ESOP. Note that the sum of Executive Shares and ESOP shares equals **Joint Shares**. The **HPY** is the 1, 3, and 5 year Holding Period Yields from the ESOP.

<b>Variable</b>	<b>Mean</b>	<b>Median</b>	<b>Std Dev</b>	<b>MIN</b>	<b>MAX</b>
<b>PANEL A – ESOP Firms</b>					
SIZE (\$M)	\$4,794	\$1,787	\$7,130	\$5	\$24,053
Total Assets (\$M)	\$11,639	\$3,052	\$28,585	\$16	\$180,545
Total Long-Term Debt (\$M)	\$2,871	\$799	\$7,314	\$0	\$49,436
Book-to-Market Value	0.66	0.62	0.49	-1.37	1.68
Executive Shares (%)	7.7%	2.1%	10.9%	0.0%	55.2%
ESOP (%)	5.4%	0.0%	8.2%	0.0%	31.3%
Institutional Ownership (%)	8.7%	0.2%	16.0%	0.0%	92.6%
1 Year HPY	5.9%	7.8%	37.8%	-81.9%	91.5%
3 Year HPY	57.5%	37.0%	115.5%	-94.1%	603.2%
5 Year HPY	103.6%	68.2%	174.4%	-87.3%	923.8%
<b>PANEL B – Non-ESOP Firms</b>					
SIZE (\$M)	\$4,570	\$1,616	\$6,854	\$5	\$28,099
Total Assets (\$M)	\$6,169	\$2,112	\$8,904	\$6	\$34,715
Total Long-Term Debt (\$M)	\$1,416	\$419	\$2,152	\$0	\$7,843
Book-to-Market Value	0.63	0.60	0.45	-0.94	1.79
1 Year HPY	10.9%	7.3%	32.2%	-62.5%	98.6%
3 Year HPY	36.2%	32.6%	64.4%	-83.4%	213.4%
5 Year HPY	61.7%	42.19%	79.7%	-75.0%	258.9%

**Table II – Regression of the HPYs on the Size of the ESOP**

The regressions are estimated by ordinary least squares. The dependent variables for the regressions are, respectively, the **One-Year**, **Three-Year** and **Five-Year Holding Period Yields (HPY)** calculated as the *difference* between the sample ESOP HPY and the Control HPY for 62 firms. The explanatory variables for the three regressions are defined as follows: the successive **5% levels of ownership** are dummy variables (equal to 1 if the applicable percentage of shares falls within the level and equal to 0 otherwise) which indicate ownership by the ESOP (the decomposition of ownership proxies for the levels of managerial control); and **CAR** is the cumulative abnormal return, as based upon the corresponding ESOP announcement for the (0,1) window. An \* (\*\*) indicates significance at the 10-percent (5-percent) level; *p*-values are in parentheses below the estimates.

<b>Variable</b>	<b>1 Year HPY</b>	<b>3 Year HPY</b>	<b>5 Year HPY</b>
Intercept	-0.085 (0.45)	0.154 (0.57)	0.131 (0.71)
0-5% Ownership	1.981 (0.73)	-3.209 (0.81)	-2.012 (0.91)
5-10% Ownership	0.925 (0.73)	3.784 (0.56)	1.557 (0.87)
10-15% Ownership	2.894* (0.09)	0.330 (0.94)	-3.938 (0.46)
15% + Ownership	0.147 (0.94)	0.965 (0.82)	0.146 (0.98)
CAR	-2.386 (0.45)	-6.435 (0.11)	-2.560 (0.62)
# Observations	62	62	61
F-statistic	0.78	0.70	0.28
Adjusted R <sup>2</sup>	-0.02	-0.02	-0.06

**Table III – Regression of the HPYs on Executive Shareholdings**

The regressions are estimated by ordinary least squares. The dependent variables for the regressions are, respectively, the **One-Year**, **Three-Year** and **Five-Year Holding Period Yields (HPY)** calculated as the *difference* between the sample ESOP HPY and the Control HPY for 62 firms. The explanatory variables for the three regressions are defined as follows: the successive **5% levels of ownership** are dummy variables (equal to 1 if the applicable percentage of shares falls within the level and equal to 0 otherwise) which indicate ownership by Executives (the decomposition of ownership proxies for the levels of managerial control); and **CAR** is the cumulative abnormal return, as based upon the corresponding ESOP announcement for the (0,1) window. An \* (\*\*) [\*\*\*] indicates significance at the 10-percent (5-percent) [1-percent] level; *p*-values are in parentheses below the estimates.

<b>Variable</b>	<b>1 Year HPY</b>	<b>3 Year HPY</b>	<b>5 Year HPY</b>
Intercept	-0.025 (0.79)	0.042 (0.84)	-0.020 (0.95)
0-5% Ownership	-6.512 (0.26)	-11.284 (0.37)	-17.090 (0.34)
5-10% Ownership	5.349 (0.11)	11.523 (0.12)	8.799 (0.39)
10-15% Ownership	2.573* (0.09)	11.221*** (0.001)	9.336* (0.05)
15% + Ownership	-1.210 (0.70)	-2.538 (0.71)	-2.335 (0.81)
CAR	-0.767 (0.62)	-4.302 (0.21)	-1.637 (0.73)
# Observations	62	62	62
F-statistic	2.13*	4.43***	1.69
Adjusted R <sup>2</sup>	0.08	0.22	0.05

**Table IV – Regression of the HPYs on the Total Shares  
Controlled by Management After an ESOP**

The regressions are estimated by ordinary least squares. The dependent variables for the regressions are, respectively, the **One-Year**, **Three-Year** and **Five-Year Holding Period Yields (HPY)** calculated as the *difference* between the sample ESOP HPY and the Control HPY for 62 firms. The explanatory variables for the three regressions are defined as follows: the successive **5% levels of ownership** are dummy variables (equal to 1 if the applicable percentage of shares falls within the level and equal to 0 otherwise) which indicate the total of the ESOP number of shares plus the ownership of the Executives; and **CAR** is the cumulative abnormal return, based upon the corresponding ESOP announcement for the (0,1) window. An \* (\*\*) [\*\*\*] indicates significance at the 10-percent (5-percent) [1-percent] level; *p*-values are in parentheses below the estimates.

<b>Variable</b>	<b>1 Year HPY</b>	<b>3 Year HPY</b>	<b>5 Year HPY</b>
Intercept	0.011 (0.90)	0.303 (0.14)	0.070 (0.79)
0-5% Ownership	-0.341 (0.52)	-2.587** (0.03)	-2.284 (0.15)
5-10% Ownership	-1.207 (0.58)	0.084 (0.99)	3.822 (0.55)
10-15% Ownership	1.019 (0.50)	0.772 (0.82)	0.960 (0.83)
15% + Ownership	0.681 (0.67)	5.398 (0.13)	8.541* (0.07)
CAR	-1.727 (0.30)	-6.845 (0.07)*	-4.749 (0.33)
# Observations	62	62	62
F-statistic	0.49	2.05	1.21
Adjusted R <sup>2</sup>	-0.04	0.08	0.02

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