



The Impact of Management and Outside Blockholder's Ownership on Capital Structure

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Abstract

The happening of Asia Financial Crisis highlighted incomplete corporate governance system of companies. The financial crisis not only damaged the benefits of investors but also seriously affected confidence of the public and stability of international financial markets. Healthy corporate governance would benefit business a lot and enhance confidence of investors.

In order to be more competitive in the market, the company will introduce professional managers to enable more efficient business operation upon separation of ownership and management. The separation of ownership and management has led to agency issue. Company should choose between benefits and agency cost in order to make decision best for the company.

The purpose of this study is to investigate the relationship between ownership structure and capital structure from corporate governance perspective, in which the ownership structure is measured by blockholder and manager's shareholding. Our sample is Taiwan listed companies during the period of 1990-2011 excluding financial firms.

We found that blockholder's ownership, manager's ownership and their product-term report different effect on corporate debt. Manager's ownership reports no effect on leverage while blockholder's ownership reports positive and significant effect on leverage, lastly the relationship between external blockholder's ownership and leverage is not affected by the ownership of managers. The result implies that blockholder's ownership provides incentive for active monitoring, which induces high leverage for providing additional outside monitoring.

Key words: *Ownership Structure, Capital Structure, Corporate Governance, Leverage, External Blockholder*

INTRODUCTION

According to 1997 Asia Financial Crisis, it had pointed out that the incompleteness management of Asian corporate governance. Afterward, a series of financial crisis such as Taiwan's financial crisis in 1998 which triggered unstable bear market in Taiwan financial industry, and 2001 when Enron went bankrupted, and Tyco faced serious financial



problem, and came after World Com and Xerox, etc. In particular, the outbreak of the subprime mortgage happened in USA in 2007, coupled with the rise of international oil and commodity prices, resulted in deterioration of inflation, triggered a series of financial crisis at the investment bank. Lehman Brothers declared bankruptcy, furthermore the financial crisis in banking & automobile industries worsened worldwide economy.

With all of these results and problems, they have outstood and criticize the importance of corporate governance and the risk mitigation that corporate governance can leverage, and how it maximize the profit for stakeholders. As a result, an amount of scholars have proposed on this topic and believed that enhancing corporate governance is the most effective way to fight against financial crisis. Corporate governance will not only reduce the cost for monitoring, but also increase the profit and productivity of the company, and drive both the country and corporate to a better future.

Jensen and Meckling (1976) believe in the model where ownership and operation concession are separated, can result in agency problem and cost, and furthermore, interest conflict, and the professional management team could damage corporate profits and degrade its value when it happens. For corporate to increase their market competence, basically, they will engage with professional agencies such as professional managers to manage the company and separate the ownership of the company to maximize investors and stakeholders profit. This will increase the gap between ownership and operation concession, and could cause a serious affect if professional managers became selfish, and cause potential interest conflict. Whenever this occurs, a balance/tradeoff between ownership and operation concession become important.

If a company has a better corporate governance strategy, contrary, it will have more advantage and be easier to raise fund, and increase profit on proposals. Back in 1958, the MM theory concluded that capital structure will affect company value, and increase company value by combing capital structure, however, the pitfall is that it might track financial crisis if the debt ratio is high. We can conclude that corporate governance has impact on capital structure, and capital structure is also part of corporate governance, and a well corporate governance can enhance company performance and increase company value.

Obedience to good principles of corporate governance by the company has gradually become an important factor that determines investors whether to invest or not, the company governance enables reasonable and fair treatment to business investors and people of related interests, while such idea is applied to the company, which helps



enhance decision quality, reduce operation risk and improve business performance effectively.

Agency problems occur as a consequence of divisions between enterprise ownership and managerial authority. This study investigates how agency problems can be resolved using ownership structure and elucidates the effects of various ownership structures on the capital structure of an enterprise. This study examines the correlation between ownership and capital structure from a corporate governance perspective. Ownership structure is investigated to determine whether the shareholding proportion of large external shareholders and managers affects the influence of capital structure on corporate debt. To understand the role and effects of corporate governance on an enterprise, debt ratios are used as proxy variables to determine if different shareholding proportions influence the capital structure of an enterprise. According to previous research background and motivations, the objectives of this study are to examine the following: 1. The relationship between managerial shareholding and the proportion of corporate debt. 2. The relationship between external shareholders and the proportion of corporate debt. 3. The joint influence of large external shareholders and managerial shareholding on corporate debt.

LITERATURE REVIEW

Capital Structure Literature

Titman and Wessels (1988) research aimed to verify the capital structure theory. Research covered 469 listed companies from 1972 to 1982, the conclusions are: there was negative correlation between the uniqueness of company's products and its debt levels. It had negative correlation in the short-term debt ratio and firm size. It tends to more short-term liabilities for small-scale companies considered the higher cost. It met Myers pecking order theory that company profitability and capital structure is negatively correlated.

Baskin (1989) research to pick Compustat 378 companies in line with Fortune 500 companies set in 1960 in the period 1960-1972. It concluded to be positive correlation among dividend payment rate, company growth and debt levels by using regression analysis. The company profit ability and debt levels were negatively correlated. It caused higher debt ratio due to more borrowers, consequently, there was positive correlation in dividend payment of attainment and liabilities ratio.

Jensen, Solberg and Zorn (1992) carried out a study on the relationship between the company's employees shareholding to the liability of the company. Their research



was based on the data collected from Compustat covering the period from 1982 to 1987. Their final analysis was based on 565 sample companies from 1982 and 632 sample companies from 1987. The result analysis shows that: there is an adverse relationship between the management shareholding against the leverage of the company. The same relationship was also noted on profitability and leverage. However the scale of the company will directly determine the leverage of the company.

Frank and Goyal(2003) verified the possibility of establish & explanations for the pecking order theory. Research came to results that small companies do not meet the pecking order theory, while the large-scale companies are more in line with the pecking order theory than the former. It became more important for equity financing than debt financing in recent years. The large-scale companies closely met the pecking order theory than small-scale companies did

Billett et al. (2007) adopt 15,000 bonds issued from 1960 to 2003 as subjects, and find that without protections from debt contract, company's growth opportunity and debt ratio share negative correlation. By if taking the influence posted by debt contract into consideration, company's growth opportunity shares positive correlation with debt ratio. Meanwhile, high-growth rate companies' better future performance persuades institutional owners choose them as investment option.

Ownership Structure Literature

Jensen and Meckling proposed "interest convergence hypothesis" in 1976. This hypothesis advocates that the operator holding a positive correlation ratio between shares proportion and the value of the entity. Jensen and Ruback (1983) proposed that when the administrator's holding shares ratio increases, insiders or majority will tend to control of corporate decision-making based on personal profits, because managers possess sufficient voting rights so that their effectiveness greatly technology. Fama (1980) proposed that ownership structure is irrelevant to company value.

Shleifer and Vishny (1986) thought the largest shareholder is the largest supervisor, so the equity is more concentrated. The greater the supervision strength of major shareholders, managers made to the decision-making will be inclined to pursue shareholder wealth maximization. Morck, Shleifer and Vishny (1988) applied piecewise linear regression model to study the correlation between company's performance and management shareholding. When the management shareholding ratio is in the range of 0% ~ 5%, there is a positive correlation between management shareholding and company's performance. However when the shareholding ratio falls in between 5%~25%, there is a negative correlation on the two variables.



Tong and Ning(2004)discover deep connection between owners and company's capital structure. They also find out the relation among owners' share-holding, short-term debt ratio, business size, share return and sales growth rate. Therefore, with agency theory, moderate monitor from institutional owners can minimize agency cost, while share prices can be maximized through the influence from financing decision to capital structure. Joher et al.(2006) consider the ownership plays a vital role in company's operation, which possesses effective controlling mechanism on management and debt-financing decision. Agency conflicts can be decreased as well.

METHODOLOGY

Hypothesis and Model

The tests involve three stages. First, to test for a non-linear relation between managerial ownership and capital structure. Managerial share ownership has been suggested as a mechanism that reduces agency conflicts through the alignment of interests between management and shareholders. However, the precise relation between managerial share ownership and corporate debt is complex. At high levels of managerial ownership, substantial risk from the pursuit of self-interest arises due to management's large exposure to the firm. Hence, at high levels of managerial share ownership there are incentives to decrease debt levels than would otherwise be the case. Corporate debt itself is an internal control mechanism that can reduce agency conflicts. Specifically, the obligations associated with debt reduce management's discretionary control over the firm's cash flow and their incentives to engage in non-optimal activities. At high levels of managerial share ownership, the alignments of interests between managers and shareholders may be so strong that there exist few agency-related benefits to be obtained from the increased use of debt. In either case, a potential relation between managerial share ownership and corporate debt levels is a nonlinear inverted U-shape. The managerial share ownership variable and the square of managerial share ownership variable are included in the regression model together with the control variables:

$$D/E_{it} = \alpha_0 + \beta_0 MO_{it} + \beta_1 (MO)_{it}^2 + \beta_2 SIZE_{it} + \beta_3 IND_{it} + \beta_4 VOLTY_{it} + \beta_5 GROWTH_{it} \quad (1) \\ + \beta_6 PROF_{it} + \beta_7 FCF_{it} + \beta_8 INTA_{it} + \beta_9 NDTS_{it} + \beta_{10} DIV_{it} + \varepsilon_{it}$$

The square of MO is used to test for the quadratic form such that if the earlier arguments hold, a negative sign on MO² will produce a maximum point, given that MO



and D/E must be non-negative by construction. Hence, a positive sign should be observed on β_0 .

External blockholders are argued to reduce the scope of managerial opportunism, resulting in lower direct agency conflicts between management and shareholders. If external blockholders serve as active monitors over the actions of corporate managers, management may not be able to adjust the debt ratio to their own interests as freely if such investors do not exist. Moreover, their voting power and influence also increase, giving blockholders greater ability to control the actions of managers. Hence, corporate debt ratios are likely to be an increasing function of the level of share ownership of external blockholders, *ceteris paribus*. The relation between external block ownership and leverage is examined by regressing D/E against the external block ownership (EBO) and control variables:

$$D/E_{it} = \alpha_0 + \beta_0 EBO_{it} + \beta_1 SIZE_{it} + \beta_2 IND_{it} + \beta_3 VOLTY_{it} + \beta_4 GROWTH_{it} + \beta_5 PROF_{it} + \beta_6 FCF_{it} + \beta_7 INTA_{it} + \beta_8 NDTS_{it} + \beta_9 DIV_{it} + \varepsilon_{it} \quad (2)$$

Finally, at low levels of managerial share ownership, external block ownership plays a significant role in monitoring the behavior of management, resulting in lower managerial opportunism. We propose that in general, the relation between external block ownership and leverage at high levels of managerial share ownership will not be as significant as compared to low levels of managerial share ownership. The main test is to investigate the relation between external block ownership and leverage at different levels of managerial share ownership. Recall that the earlier discussion argued that the relation between external block ownership and debt is conditional on the level of managerial share ownership. A dummy variable Φ , denoting different levels of managerial share ownership is employed where Φ takes the value of 0 if the level of managerial share ownership is less than 20 per cent. When managerial share ownership is 20 per cent or more Φ takes the value of 1. For example, Hermalin and Weisbach (1991) find that the entrenchment effect of managerial share ownership sets in after 20 percent of managerial share ownership. The dependent variable is then regressed against MO, MO², EBO, Φ EBO and the control variables

$$D/E_{it} = \alpha_0 + \beta_0 MO_{it} + \beta_1 (MO)_{it}^2 + \beta_2 EBO_{it} + \beta_3 (\Phi EBO_{it}) + \beta_4 SIZE_{it} + \beta_5 IND_{it} + \beta_6 VOLTY_{it} + \beta_7 GROWTH_{it} + \beta_8 PROF_{it} + \beta_9 FCF_{it} + \beta_{10} INTA_{it} + \beta_{11} NDTS_{it} + \beta_{12} DIV_{it} + \varepsilon_{it} \quad (3)$$



The three variables used to control for risk are: SIZE is natural log of the book value of total assets. IND is zero-one dummy variable for industry classification, where IND = 1 if industrial company and IND = 0 if natural resource company. VOLTY is the standard deviation of the annual percentage change in operating income before interest, taxes and depreciation (Bradley et al., 1984).

The variables used to control for agency costs are: GROWTH is the annual percentage change in total assets. Kim and Sorensen(1986), Titman and Wessels(1988), Jensen et al., (1992) and Mehran(1992) suggest that a firm's growth opportunities are a good proxy for the agency costs of debt. PROF is operating income before interest and taxes scaled by total assets. INTA is total intangible assets scaled by total assets, both measured at year-end book values. NDTS is annual depreciation expense scaled by total assets at year-end. The NDTS variable is used to capture the non-debt tax shield argument put forward by DeAngelo and Masulis(1980). DIV is the weighted average percentage of franked dividends paid in a year as a fraction of total dividends paid. DIV is an attempt to capture the effect of dividend imputation on a firm's financing decisions (Howard and Brown, 1992).

Data

In this study, the data sources are the TEJ database during the sample period ending in 1990-2011. The empirical object is rather special due to the financial industry business content, and accounts definitions and general industry there are differences, net of incomplete information samples and the banking, insurance and securities and other financial companies. 711 company, for a total of 6612 samples of the company.

EMPIRICAL ANALYSIS

Sample characteristic

Table 1 for basic statistical scale longitudinal coordinates the average, median, maximum, minimum, standard deviation, skewness, kurtosis, the observed value.

The longitudinal coordinate of Table 2 are all explanatory variables, De is explained variable, with P-Value in brackets to examine whether related coefficient is significant. According to Table 2, the maximum coefficient between GROWTH and PROF is 0.218. Therefore the correlation between explanatory variable and explained variable is low, followed by 0.158 between NDTS and SIZE, in which such a small value indicated no issue of multicollinearity.

Empirical analysis



Table 3 estimates equation(1). We use the panel regression estimates. The estimated result was MO Coefficient -0.753 in negative, the MO*MO Coefficient of 0.005 was positive; both data showed in-significantly. Consequently, Management shares had no influence on the company's liabilities. The size of control coefficient reports a significant positive number (36.266), Titman and Wessels (1988) consider that such condition, compared with multiple-operation of big companies, can lower the risk of bankruptcy. Therefore, company size and debt ratio will show a significant positive correlation. According to these studies, there is a negative relationship between profitability and debt, which meets our expectation. FCF reports a significant positive number (0.002), the more the cash flow, the more the debt, INTA shows a significant negative number (-4.251).

According to Myers (1977), the agency cost caused by intangible asset is higher than that of tangible asset, in which INTA is to measure the effect, the higher the intangible asset, the less the debt and will then normally form a negative relationship with debt, this conforms to our expectation. NDTs shows a significant positive number (0.275), indicating that non-debt tax shield is irrelevant to the debt, DIV reports a significant negative number (-0.001).

Table 4 shows the estimated result of equation (2). According to the outcome of estimate, EBO coefficient reports a significant positive number (0.763). External blockholders serve as active monitors over the actions of corporate managers, management may not be able to adjust the debt ratio to their own interests as freely if such investors do not exist. Moreover, their voting power and influence also increase giving blockholders greater ability to control the actions of managers.

The size coefficient reports a significant positive number (37.517), showing that the bigger the company size, the higher the debt ratio, and therefore meets our expectation. According to these studies, there is a negative relationship between profitability and debt, which meets our expectation. According to Myers(1977), the agency cost caused by intangible asset is higher than that of tangible asset, in which INTA is to measure the effect, the higher the intangible asset, the less the debt and will then normally form a negative relationship with debt, this conforms to our expectation. NDTs shows a significant positive number (0.279), indicating that non-debt tax shield is irrelevant to the debt, DIV reports a significant negative number (-0.001).



Table 2 Correlation Coefficient

Probability	DE	MO	SIZE	VOLTY	GROWTH	PROF	FCF	INTA	NDTS	DIV
MO	-0.058 (0.000)									
SIZE	0.124 (0.000)	-0.115 (0.000)								
VOLTY	0.013 (0.286)	-0.022 (0.072)	0.032 (0.010)							
GROWTH	-0.008 (0.540)	0.032 (0.010)	0.075 (0.000)	0.005 (0.659)						
PROF	-0.218 (0.000)	0.119 (0.000)	0.095 (0.000)	-0.011 (0.365)	0.218 (0.000)					
FCF	0.029 (0.019)	-0.024 (0.054)	0.166 (0.000)	0.000 (0.976)	0.081 (0.000)	0.062 (0.000)				
INTA	-0.020 (0.100)	-0.074 (0.000)	0.139 (0.000)	0.002 (0.867)	-0.027 (0.025)	0.018 (0.139)	0.004 (0.767)			
NDTS	-0.016 (0.181)	0.042 (0.001)	0.158 (0.000)	0.037 (0.003)	-0.114 (0.000)	0.174 (0.000)	0.016 (0.193)	0.064 (0.000)		
DIV	-0.046 (0.000)	0.002 (0.851)	0.391 (0.000)	-0.010 (0.431)	0.003 (0.803)	0.184 (0.000)	0.166 (0.000)	0.062 (0.000)	0.151 (0.000)	
EBO	0.042 (0.001)	-0.198 (0.000)	-0.030 (0.014)	-0.033 (0.008)	-0.034 (0.006)	0.022 (0.070)	0.008 (0.541)	0.041 (0.001)	-0.050 (0.000)	0.056 (0.000)



Table 3 Regression Analysis

	Coefficient	Std. Error	t-Statistic	Prob.
C	-376.164	46.224	-8.138	0.000
MO	-0.753	0.731	-1.029	0.303
MO*MO	0.005	0.010	0.504	0.615
SIZE	36.266	2.782	13.036	0.000***
IND	-64.765	7.740	-8.368	0.000***
VOLTY	0.001	0.002	0.361	0.718
GROWTH	0.443	0.107	4.136	0.000***
PROF	-6.476	0.366	-17.683	0.000***
FCF	0.002	0.001	2.481	0.013**
INTA	-4.251	1.400	-3.036	0.002***
NDTS	0.275	0.233	1.180	0.138
DIV	-0.001	0.0002	-5.454	0.000***

Table 4 Regression Analysis

	Coefficient	Std. Error	t-Statistic	Prob.
C	-422.622	43.637	-9.685	0.000
EBO	0.763	0.297	2.567	0.010***
SIZE	37.517	2.751	13.637	0.000***
IND	-61.043	7.767	-7.859	0.000***
VOLTY	0.001	0.002	0.456	0.649
GROWTH	0.436	0.107	4.070	0.000***
PROF	-6.580	0.363	-18.111	0.000***
FCF	0.002	0.001	2.483	0.013**
INTA	-4.213	1.398	-3.013	0.003***
NDTS	0.279	0.232	1.203	0.136
DIV	-0.001	0.0002	-5.664	0.000***

Table 5 shows the results of equation (3). According to the outcome of estimate, MO coefficient reports an insignificant negative number (-0.768), MO*MO coefficient reports an insignificant positive number (0.007). EBO coefficient reports a significant positive number (0.705); indicating that the more the blockholder shareholding, the more the company debt. PHI*EBO reports an insignificant negative number. When these two



requirements are satisfied, high manager shareholding also represents for negative yet insignificant high external blockholder shareholding and meanwhile, a negative sign of blockholder shareholding on the debt.

There is a negative relationship between profitability and debt, which meets our expectation. The higher the intangible asset, the less the debt and will then normally form a negative relationship with debt, this conforms to our expectation. NDTs shows a significant positive number (0.283), indicating that non-debt tax shield is irrelevant to the debt, DIV reports a significant negative number (-0.001).

Table 5 Regression Analysis

	Coefficient	Std. Error	t-Statistic	Prob.
C	-398.378	47.808	-8.333	0.000
MO	-0.768	0.816	-0.941	0.347
MO*MO	0.007	0.011	0.658	0.511
EBO	0.705	0.325	2.170	0.030***
PHI*EBO	-0.003	0.496	-0.005	0.996
SIZE	36.849	2.794	13.191	0.000***
IND	-62.139	7.823	-7.943	0.000***
VOLTY	0.001	0.002	0.425	0.671
GROWTH	0.440	0.107	4.106	0.000***
PROF	-6.513	0.367	-17.745	0.000***
FCF	0.002	0.001	2.478	0.013**
INTA	-4.309	1.400	-3.078	0.002***
NDTS	0.283	0.233	1.215	0.133
DIV	-0.001	0.0002	-5.620	0.000***

CONCLUSIONS

The paper established 3 models to respective conduct empirical study with estimate conducted on the above-mentioned model upon Panel Regression. We found that blockholder shareholding ratio and manager shareholding ratio and product-term in between all report different level of effect on corporate debt: manager shareholding ratio reports no effect on the debt while blockholder shareholding reports no positive and significant effect on the debt. According to the convergence-of-interest hypothesis, there will be bigger incentive for blockholders to supervise the manager and to boost business performance if major shareholding is in their hands. Therefore, the more centralized the right of ownership, the more the benefits and cost will be converged and hence the



better business performance. Moreover, according to active monitoring hypothesis, there will be incentive for them to supervise manager's investment and to protect interest of their own when there are more external blockholder shareholding, external blockholders will reduce level of opportunism of managers and will lead to a reduction of conflict in direct agency. Lastly a relationship between external blockholders and company debt will not be varied by the number of managers' stock right is found. Fama(1980) has proposed that ownership structure is irrelevant to company value. Fama explained the agency issue of manager from market perspective, when capital market reports efficiency and management of manpower market is imperfect competitive market, the business performance of company this time will be completely reflected on the stock price, pressure will be placed on managers labor force market to urge the company to decide managers' salary upon business performance, therefore managers will be more dedicated in the enhancement of company performance, in his point of view, the performance of the company will be determined by managers labor force market, and is irrelevant to ownership structure.

We also discovered that is a positive correlation is existed among growth rate & company size and debt, Titman and Wessels(1988) also pointed that, a diversified operation will help alleviate bankruptcy risk of large-scale companies, in which diversified companies report lower bankruptcy risk and will be able to bear higher debt, showing that the bigger the company size, the higher the debt ratio, while a negative relationship is existed among intangible asset, profitability, dividend payout ratio and corporate debt.

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