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Strategic silence, insider selling and litigation risk ☆

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ABSTRACT

Prior work finds that managers beneficially time their purchases, but not sales, prior to forecasts. Focusing on *if* (as opposed to *when*) a forecast is given, we link insider selling to silence in advance of earnings disappointments. This raises the question of whether the absence of incriminating trading drives reductions in litigation risk potentially attributed to warnings. We find that the absence of a warning combined with the presence of selling exacerbates the consequences associated with the individual behaviors. Yet, selling prior to a warning typically does not offset all of the warning's benefit. In so doing, we supply the first robust evidence of a litigation benefit associated with warning.

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1. Introduction

Skinner (1994) finds that 25% of firms facing large, negative earnings news voluntarily warn of the bad news, compared to 6% of the firms facing large, positive news.[1] He argues that these findings result from managers' fear of legal liability. Empirical evidence in support of this theory is mixed (Healy and Palepu, 2001), with some recent work finding that bad news warnings do not trigger litigation and may potentially deter certain types of litigation (Field et al., 2005) but still other work arguing that warnings prompt lawsuit filings (Johnson et al., 2007). In the event of a lawsuit, warnings do appear to play a role in lowering settlement costs (Skinner, 1997). If managers can indeed lower litigation costs by warning, why do most managers remain silent when facing earnings disappointment? In Skinner (1994)'s sample of firms facing large, negative news, 75% of managers elected not to warn. Studying a more recent time frame, we find remarkably similar rates of silence: our evidence indicates that 74% of firms facing impending negative news fail to warn. Further, when we narrow our

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[1] Managers voluntarily warn of negative news via their earnings guidance (as captured in either an earnings forecast or an earnings preannouncement). In this paper, we use the terms "disclosure" and "guidance" interchangeably.

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focus to firms with a recent history of supplying guidance, the rate of silence only falls to 52%. In this paper, we investigate whether managers who remain silent in the face of earnings disappointment engage in insider selling to exploit knowledge of the impending shortfall and, if so, how this opportunism affects firms' litigation risk.

Prior research connects insider trading with opportunistic disclosure behavior. In early work, Penman (1982) provides evidence that managers benefit from timing their trades around their forecasts of annual earnings. Noe (1999) builds on this finding to show that managers' opportunistic trading occurs after, but not before, they deliver a forecast. In more recent work, Cheng and Lo (2006) provide evidence that managers opportunistically adjust their forecasting activity when they purchase shares. Yet, they find no evidence to suggest that managers strategically adjust either the frequency or the timing of their earnings guidance when they sell shares, conjecturing that litigation concerns likely cause managers to avoid selling shares prior to issuing bad news forecasts. Also consistent with a reluctance to engage in blatant opportunism, Huddart et al. (2007) find that insiders abstain from profitable trade immediately prior to earnings announcements and, instead, trade heavily after earnings announcements (but prior to the filing of the formal report) during a time when the legal risks associated with insider trading are lower. Thus, evidence indicates that managers time both their trades and forecasts to exploit information asymmetries, but that legal fears constrain overt opportunism associated with insider selling immediately prior to the delivery of negative earnings news.

Building upon these findings, we investigate the link between insider selling and the decision to warn in the face of impending negative earnings news. In contrast to prior work that links the timing of a forecast to insider purchasing, we connect strategic silence (i.e., the absence of a warning) to insider selling. In so doing, we shift attention from *when* forecasts are given to *if* a forecast is given when there is increased incentive to do so. Focusing on the quarterly decision to supply earnings guidance, we document a link between the failure to warn of impending earnings disappointment and insider selling. Consequently, we supply evidence that speaks to the question of why managers may fail to warn even if it is in the firm's best interest for them to do so.

As mentioned, prior work typically examines trading behavior conditional upon the presence of a forecast—i.e., prior work begins with a sample of forecasts and examines the timing of a trade in relation to the timing of a forecast. Our research design, however, acknowledges the evolving disclosure and trading environment that managers now confront. In particular, we conduct our analysis at the firm-quarter level and focus on whether a forecast is given (as opposed to the timing/frequency of forecasts) for two main reasons. First, the overwhelming majority of guidance now arrives bundled with a quarterly earnings release. Over our sample period, approximately 80% of all forecasts are bundled and, in later years, the proportion climbs above 90%. Accordingly, the decision to guide increasingly appears to be made on a quarterly (as opposed to a day-to-day) basis. Second, company-level regulation of insider trading generally precludes trading prior to earnings announcements and typically encourages insiders to concentrate their trade in the days shortly after earnings announcements.[2] As a result, managers increasingly make disclosure and trading decisions on a quarterly basis and in temporal proximity. These trends reduce managers' control over the timing of both forecasts and trades. Yet, managers can and do control whether or not they issue a forecast. Thus, because we expect that managers now have less power to time their trades or their forecasts, we turn our attention to the question of whether trading incentives help to explain whether managers choose to warn or to remain silent in the face of impending bad news.

We examine an initial sample of 107,307 quarterly earnings announcements made during the decade since Regulation Fair Disclosure ("Reg FD") took effect in October 2000. We focus on the firm-quarter observations in which managers face impending negative news, as measured by the delivery of disappointing earnings news in the next quarter. Because it is not possible to cleanly identify the point at which managers learn of negative earnings news, this approach to measuring impending negative earnings news categorizes all managers of firms that report negative earnings news *next* quarter as possessing this knowledge on or before the earnings announcement associated with the *current* quarter. The measurement error associated with this approach likely reduces our ability to detect significant relations in the data: if managers do not possess the negative news yet, then they do not have an incentive to sell and, thus, their selling behavior should not correlate with their decision to warn of this yet-to-be-learned news.[3] Consequently, our empirical tests investigate whether trading considerations appear to factor into the decision to "bundle" a bad news warning with the current quarter's earnings announcement (or, alternatively, the decision to remain silent) for managers who face impending earnings disappointment next quarter.

We find that managers who disappoint investors with negative earnings news next quarter are less likely to bundle negative earnings guidance with the current quarter's earnings news when they sell more shares in the two-week trading

[2] Bettis et al. (2000) document that over 92% of their sample firms have a policy in place to regulate insider trading, with 78% of firms having explicit blackout periods in place to preclude insider trades. Examining the specifics of the policies, they note that "[t]he single most common policy disallows trading by insiders at all times except during a trading window that is open during the period 3 through 12 trading days after the quarterly earnings announcement." (Page 192) Consistent with the notion that increased jeopardy accompanies trades that occur during blackout periods, Huddart et al. (2007) find that insiders disproportionately concentrate their trade in the days immediately following quarterly earnings releases.

[3] A wealth of prior literature provides evidence that managers trade in the quarters leading up to important information releases, including dividend announcements (John and Lang, 1991), repurchases of stock (Lee et al., 1992), equity offerings (Karpoff and Lee, 1991), bankruptcy filings (Seyhun and Bradley, 1997), and 10-Q/10-K filings (Huddart et al., 2007). Further, focusing specifically on trading in advance of earnings disappointment, Ke et al. (2003) find insider selling increases up to nine quarters prior to a break in a string of consecutive increases in quarterly earnings, while Hugon and Lee (2014) find that insiders' 10b5-1 sales predict weakening earnings performance many quarters in advance, which is consistent with earlier evidence in Jagolinzer (2009).

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