Insider trading and stock market perception of bankruptcy

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Abstract

There is evidence that the stock market’s first perception of a bankruptcy, indicated by a decrease in the mean of stock returns, may occur in advance of the actual filing date. In this paper, we examine insider transactions around the month when the market anticipates the bankruptcy and then around the month when the bankruptcy filing is announced. Our results show that the insiders sell their shareholdings prior to the anticipation of the bankruptcy by the investors. We also find that insiders do not sell around the filing month for firms that are perceived to be bankrupt well in advance.

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1. Introduction

Empirical studies by Clark and Weinstein (1983), Bradley and Rosenzweig (1992), and Seyhun and Bradley (1997) provide evidence that the stock prices of bankrupt firms decline over several years preceding the filing date. Ramaswami (1987) contends that a significant decrease in stock price results when the stock market first perceives that the firm may file for bankruptcy. His findings indicate that the market’s perception of a bankruptcy occurs several months prior to the actual filing date. Dugan and Forsyth (1995) show that such perception of an upcoming bankruptcy occurs in close proximity to the release of unfavorable information.
about the firm. In sum, the evidence presented in these studies suggests that financial distress begins well before the actual bankruptcy filing and that the share prices adjust in anticipation of the filing.

Although Seyhun and Bradley (1997) observe significant insider sales in the months and even years before a bankruptcy filing, little is known about insider trading behavior around the point at which a bankruptcy might be perceived by the stockholders. Extant empirical evidence confirms that insiders possess valuable information about the future price of their firms’ securities and that they use private information to trade stocks of their own firms. Insiders tend to purchase stocks prior to the release of favorable news and a corresponding increase in stock price, and they tend to sell prior to the release of unfavorable news and a corresponding decrease in stock price. Given the evidence in prior studies, it would not be surprising to observe significant insider sales prior to the point at which a bankruptcy might be anticipated.

In this study, we examine whether corporate insiders engage in abnormal selling of their firm’s stock around the point at which a bankruptcy filing is first perceived by the stockholders. Significant insider sales will further validate the conclusions drawn by Seyhun and Bradley (1997) that corporate managers do not act in the best interests of the shareholders during periods of financial distress. According to Seyhun and Bradley (1997), managers appear to exhibit self-serving behavior by bailing out on the stockholders long before the actual filing date. That there is such behavior by the managers raises the question of whether they can be relied upon to control the firm’s resources during the bankruptcy process.

We also study insider trading in the months surrounding the formal filing of bankruptcy. An important research question raised here is whether insiders sell their holdings around the filing date when the firm is already perceived to be in financial distress. Our findings will also shed light on the appropriateness of examining insider trading around the filing date. Ramaswami (1987) cautions that because of the cross-sectional difference in stock market lead time in perceiving bankruptcy, using bankruptcy filing as the single event to examine abnormal stock returns (in event type studies) may bias the results. In other words, insider transactions that occur because of anticipation of bankruptcy would go undetected when the intervals between the perception time and the eventual date of bankruptcy differ across firms.

The findings of this study are consonant with our expectations. We observe significant net insider sales within the 12 months prior to the point when the stock market first perceives a potential bankruptcy. This evidence is consistent with the self-serving motives of the insiders. The insiders seem to possess private information about the firm’s potential bankruptcy which they exploit by selling their shareholdings before prices decrease.

In addition, we find no unusual insider sales within the 12 months prior to the filing date when financial distress was perceived long in advance. In contrast, we observe significant insider sales around the filing date for firms whose bankruptcies are first anticipated within the 12 months prior to the filing date. The findings for this latter group of firms are consistent with the evidence presented in Seyhun and Bradley (1997) that intense insider selling occurs in the months immediately preceding the filing date. Our findings also imply that examining insider transactions around the formal filing of bankruptcy may not be appropriate.

The remainder of this paper is organized as follows. The next section describes, the sample and data. The methodology is described in Section 3. In Section 4, the findings of this study are presented and discussed. The concluding remarks are given in Section 5.
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