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INSIDER TRADING PRIOR TO HOSPITALITY ACQUISITION PAYMENT TYPE ANNOUNCEMENTS

Seonghee Oak
and
William Andrew

ABSTRACT

This study examines evidence of whether hospitality insiders use personal private information to maximize their private benefits prior to hospitality acquisition payment type announcements. The findings of this study, with few exceptions, do not support the hypothesis that hospitality insiders undertake abnormal insider trading using inside information about the true value of the acquiring firm when an acquisition payment type is announced. For hospitality acquiring firms using stock or cash financing to pay for the acquisition, the level of abnormal insider transactions in the four quarters prior to an acquisition payment announcement was not significant. However, for hospitality acquirers using mixed financing (cash and stock), abnormal insider sales were positive and significant in the four quarters prior to the announcement. The lack of significant results for the all cash or stock payment announcements may reflect legal constraint on insider trading, managerial control or compensation issues.

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Introduction

This study examines the effect of information asymmetry on insider trading activities in hospitality firms when the firms announce a particular type of payment for acquisition. In modern hospitality corporations, managers and shareholders may have different information about the true value of their firm (Brealy & Myers, 2000). This results in information asymmetry between the hospitality firm's managers and the firm's investors that may allow the managers to obtain abnormal trading profits (at the expense of investors) through purchases or sales of their firm's stock based on the manager's private information (Rozeff & Zaman, 1998; Yook, Gangopadhyay & McCabe, 1999; Lakonishok & Lee, 2001; Jenter, 2005).

In the case of a hospitality acquisition, the decision of how to finance the acquisition may reveal the manager's true perception of the value of their firm's shares (Shleifer & Vishny, 2005). In addition, rational behavior would be expected to encourage a hospitality manager to exploit such information asymmetry (especially where there are no other constraints, such as insider trading laws). In this situation, when managers of an acquiring hospitality firm perceive the shares of their firm to be overvalued, they may use those shares to pay for the acquisition and also sell their own (overvalued) personal shares before the acquisition payment announcement is made (Seyhun, 1990). When the managers of acquiring hospitality firms perceive their shares to be undervalued, they may avoid using the firm's shares to finance the acquisition and instead finance the acquisition with cash (Seyhun, 1990). In this situation, to take advantage of their prior knowledge of the firm's true value, they would buy shares of their firm before the acquisition payment announcement. When managers of acquiring hospitality firms perceive their shares to be fairly valued (all other factors being equal), they may be indifferent to using stock or cash to finance an acquisition and thus may be more inclined to use a mix of stock and cash as payment. In this situation, there should be no abnormal buying or selling on the manager's personal account before the acquisition payment announcement is made.

These various theoretical transactions by insiders in response to private information about the true valuation of their hospitality firm presuppose that hospitality managers are subject to no other influences on their behavior. However, securities law requires managers to report their transactions to the SEC in a timely fashion in order to prevent illegal insider trading around acquisitions (Meulbroek 1992; Ke, Huddart & Petroni 2003). Hence, the results of this study may be influenced by how well the regulation of insider trading deters the acquiring firm's informed managerial trading prior to the hospitality acquisition payment announcement.

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This study empirically examines insider trading prior to acquisition payment type announcements and represents the first formal examination of this subject in the hospitality literature. Despite persistent debate over the level of market efficiency in the financial markets and the importance of information asymmetry, none of the research in hospitality has so far addressed the process of insider trading around hospitality corporate events. In addition, previous hospitality research related to hospitality acquisitions has

utilized an event study methodology where share price abnormal returns are calculated for the acquiring firms and targets (Kwansa, F., 1994; Sheel & Nagpal, 2000; Canina, 2001). Since insider trading prior to acquisition payment type announcements has not been examined in the hospitality literature, this study should help to define its importance in a hospitality framework and may also offer insight as to the effects of such announcement and related insider trading on hospitality firm shareholder value. Finally, since hospitality firms tend to need to raise significant amounts of capital to finance their operations, it is important that investors in hospitality firms have confidence that the managers of these firms do not exploit their inside knowledge of the firm's prospects at the expense of the firm's investors. This study should help to clarify this issue.

Literature Review

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Several authors in the hospitality literature (Sheel & Nagpal, 2000; Canina, 2001) have examined consolidation and acquisition activity by hospitality firms. Explanations such as valuation, expense reduction, increased market power, increased economies of scale and scope, reduced earnings volatility, reducing agency problems, and tax savings have been suggested as reasons for such activity. Empirically, these studies have measured market gains/losses around the acquisition announcement to test the effect of the acquisition and consolidation activity on firm value. Using an event study methodology, the studies showed positive short-term abnormal returns for both acquiring firms and the target (Kwansa, 1994; Canina, 2001) but negative long-term cumulative abnormal returns for the acquiring firms (Sheel & Nagpal, 2000). In contrast, this study examines the behavior, prior to the date of the actual acquisition (payment type) announcement, of hospitality managers with potential inside information. The methodology includes comparing managerial buying/selling of their personal shares in the period prior to the announcement with a three year base period established for control purposes four years before the announcement. This different approach should help to supplement the existing hospitality literature and offer another perspective on the hospitality acquisition process (for comparison purposes, a long term event study analysis of the acquiring firm's performance by acquisition payment type has been included in Appendix A).

All of the studies have potential implications for the existence of efficient markets. Fama (1970) first defined the efficient market hypothesis, which is a framework for examining how information influences stock prices. If a financial market is efficient, stock prices will fully reflect all available information and investors cannot consistently beat the market. However, Grossman and Stiglitz (1976, 1980) developed the impossibility of efficient market such that some investors remain uninformed. One can attribute information asymmetry in hospitality acquisitions to a manager's private information about an acquiring firm's economic value (Agrawal, Jaffe & Mandelker, 1992; Loughran & Vijh, 1997). Although managers in acquiring hospitality firms may have information about the future prospects of the combined firms, outside investors do not have access to that information. Thus it is possible that managers of hospitality acquiring firms can use their private information to trade their firms' shares on their personal accounts and that this insider trading can lessen the market value of their firms (Seyhun, 1990; Madison, Roth & Soporoschenko, 2004). In this case, the insider trading

of the acquiring hospitality firm's managers will be gains for the managers and losses for the outside investors.

One can reduce this adverse selection problem with what is known as a "signal," which Spence (1974) defined as a manipulatable attribute or activity that conveys information. Several signals appear prior to acquisitions, and they include insider trading and the type of payment offered to the target. The type of payment—cash, stock or mixed—constitute a signal in an acquisition announcement, reflecting the manager's perception of the overvaluation or undervalution of a firm (Seyhun, 1990). For example, if managers of acquiring firms perceive an overvaluation of their firm's shares, they would be motivated to use stock to pay to the target. When the managers pay with overvalued stock, the cost of acquisition will be reduced by the amount that the shares are overvalued. Thus if a hospitality acquiring firm undertakes an acquisition paying with its own stock, this suggests that its managers perceive the economic value of that stock to be lower than its market value (Brealey & Myers, 2000). The reverse is likely to be true for a cash financed acquisition i.e., if managers perceive an undervaluation of their firm's shares, they would be motivated to pay in cash. Previous (non-hospitality) research does offer indirect support for this idea by showing that the subsequent performance of an acquiring firm is related to the type of payment offered in an acquisition. For example, several studies have shown that a cash offer from an acquiring firm produces a more favorable long-run announcement effect than does a stock-financed offer (Agrawal, Jaffe & Mandelker, 1992; Loghran & Vijh, 1997; Rau & Vermaelen, 1998).

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Private information presents hospitality insiders with opportunities for personal trading (Rozeff & Zaman, 1998; Lakonishok & Lee, 2001; Jenter, 2005). If hospitality insiders have private information, they can use it for their private benefit–namely, to make positive abnormal returns on their investment portfolio. Insider trading by an acquiring hospitality firm's managers can also signal a manager's perception of her firm's performance after the acquisition. In the case of a hospitality acquisition payment type announcement, knowledge of the difference between the market and the economic value of the acquiring hospitality firm prior to the announcement can give insiders an opportunity to trade their own shares advantageously (Seyhun, 1990).

Empirical tests suggest that managers often know their firm's stock price movement in advance and behave proactively. Finnerty (1976) found that during an eleven-month holding period, insider purchases of their firm's shares produced positive excess returns for the insiders while insider sales of their firm's shares enabled them to avoid negative excess returns. Seyhun (1986, 1990) demonstrated that insiders tend to rely on private information to govern their transaction timing. While insiders purchase their firm's stock prior to an abnormal rise in stock prices, they tend to sell it prior to an abnormal decline in stock prices. Seyhun showed that during the 100 days subsequent to the insider trading day, abnormal returns on insider selling portfolios were negative, and abnormal returns on insider buying portfolios were positive. Seyhun also showed that in a takeover, bidder managers make more prior insider purchases when the stock price reaction to the takeover announcement is large and positive than when it is large and negative. Seyhun, therefore, concluded that managers in acquiring firms generally time

their transactions to sell before stock-financed acquisitions and to purchase before cash-financed acquisitions. Likewise, Yook, Gangopadhyay and McCabe (1999) showed that insiders of acquiring firms tend to sell before stock offers relative to before cash offers. In addition, their study reported that cash offers have higher abnormal returns on the acquisition announcement date than stock offers.

More recent insider trading studies support the fact that insiders undertake trading based on their private information of firm's fundamental value and in a manner to avoid legal constraints on their trading. Insider sales increased three to nine quarters prior to announcements that earnings in the current quarter were less that earnings for the same quarter of the previous year (Ke, Huddart, Petroni, 2003). Ke's study also showed that insiders have timely trading strategies for avoiding civil and criminal liability. For example, in bank mergers, the targeted bank insiders significantly decreased both insider sales and insider purchases one year prior to the merger announcement (Madison, Roth & Saporoschenko, 2004). Insiders may also, in general, time their purchases and sales to their perception of the value of the company even in the absence of significant corporate events. Insiders in low valuation firms (value firms) may buy their shares and insiders in high valuation firms (growth firms) may see advantages in selling their shares (Rozeff & Zaman, 1998; Lakonishok & Lee, 2001; Piotroski & Roulston, 2003; Jenter 2005). This general insider trading has been shown to be consistent with the subsequent market movement of the firm's share price (Lakonishok & Lee, 2001).

All of these studies imply that there may be a tendency for hospitality managers who have knowledge about the true valuation of their firm's shares to trade the shares for their own personal benefit prior to acquisition payment type announcements. This study will offer evidence as to whether this may be the case and under what circumstances such trading occurs.

Insider Trading Regulation

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Although the government regulates insider trading to keep private information from penalizing the uninformed investor, insider trading can still adversely influence stock prices in the financial market. While economists Calton and Fischel (1983) long ago defined insider trading as "a transaction by those better informed than their trading partners," insider trading in a legal sense is "a transaction within a six-month period prior to corporate events based on material information held by insiders or their tippers (Calton & Fischel, 1983)". Material information means that "reasonable investors would consider the information important to their investment decisions (Meulbroek, 1992)." Until 1980, neither the corporation nor an investor trading on the opposite side of an insider transaction had any legal remedies against the insider. Only common law rules allowed suits against insiders for trading, and "the strictures of contract law applied only if the plaintiff could prove such special facts as misrepresentation of the security value (Calton & Fischel, 1983)."

Insider trading regulation became much stricter by statute after 1980, and anyone with material and confidential information about a firm could no longer trade its securities prior to corporate informational events. The Insider Trading and Securities

The Sample of Acquiring Hospitality Firms

Fraud Enforcement Act (ITSFEA) created a reward program to insider trading informants, made top managers bear responsible for employee's illegal trading, and raised criminal penalties (Ke, Huddart & Petroni, 2003). But despite the strict regulation of insider trading since 1980, there is little evidence that the increased enforcement of insider trading sanctions has actually deterred insider trading (Seyhun, 1992). This failure in the statutes appears to reflect a lack of congressional oversight, high insider trading frequency, diverse insider trading schemes that escape legal definition, and the high legal costs of proving insider trading. In addition, "safe harbor" rules that enable insiders to avoid any risk of insider trading liability, allows employees to file selling plans with the SEC and to sell their stocks regularly on a set date. This arrangement enables insiders to sell their stock legally prior to corporate informational events (Shell, 2001). The study presented here does not distinguish illegal trading from legal trading prior to acquisition payment announcements in the hospitality industry. Rather, it analyzes all insider trading at least one year before the public acquisition payment announcement.

Data

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This study examines payment type announcements by acquiring hospitality firms which bought either public or private hospitality firms. To identify those acquiring firms with a public hospitality target, the authors first identified target hospitality firms delisted from a stock exchange and then searched to find the matching acquiring firms. The authors used the Center for Research in Security Prices (CRSP) tapes for all NYSE, AMEX, and Nasdaq hospitality firms (SIC industry codes: hotel 7011, restaurant 5812, casino 7999, and cruise 4481) delisted during the 1983-1999 period. The CRSP tapes assign firms that are delisted because of being acquired a delisting code between 200 and 203. After identifying the delisted firms (targets), the authors consulted the Wall Street Journal Index to determine the acquiring firms.

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To collect acquiring firm data where the target was a private hospitality firm, trade magazines like Hotel & Motel Management and National Restaurant News were used. In addition to these sources, the Mergerstat Review and the Merger Yearbook was used to identify additional acquisitions in the hospitality industry not found in the other sources. The search for acquiring hospitality firms buying either private or public hospitality target firms produced a total of 111 observations between 1983 and 1999. The authors divided this sample of acquiring firms into three subsets based on the acquisition payment type (cash, stock and mixed) as reported in the Dow Jones News Service (DJNS). If the payment type for the observation was unknown, the acquisition was excluded from this study. This reduced the sample size from 111 announcements to 80 (the time period of acquisition announcements in the reduced sample ranged from 1988 to 1999). The first sample subset consisted of the stock-payment group (where only the acquirer's common stock was used to pay for the acquisition) and contained 35 of the 80 observations. The second sample subset consisted of the cash-payment group (where only cash was used to pay for the acquisition) and included 20 of the 80 observations. The last sample subset consisted of the mixed-payment group (where both cash and stock were used to pay for the acquisition) and contained 25 of the 80 observations (see

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Insider Trading Data

Appendix B). The event date for the acquisition payment type announcement was taken as the first date of the acquisition payment announcement on the DJNS (Ahn, Cao & Choe 2001). The event date for majority of sample (75 of the 80 observations) was the same day as that of the first public announcement of the acquisition.

The authors obtained insider trading data on the 80 observations in the sample from First Call Insider Research for the period 1984 to 1999 (although the empirical sample period starts in 1988, it is necessary to have the data four years prior to establish an initial control period. See page 13 for specific details). First Call Insider Research compiled the information from the original SEC filings. The SEC defines an insider as an executive, officer, director, or any individual in a policy-making position or a beneficial owner (holder of 10 percent or more of the stock). This study excluded beneficial owners, a measure consistent with previous insider trading studies (Kahle, 2000; Clarke, Dunbar & Kahle, 2001). This is also supported by Seyhun (1986) who suggested that trades by principal shareholders who are neither officers nor directors convey comparatively little information.

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A time lag occurs between insider transactions and when insiders report their transactions to the SEC. Several previous studies used the day of filing insider transactions to the SEC as the insider trading day (see, for example, Clarke, Dunbar & Kahle, 2001). In this study, however, we use the actual trading date of the insider transaction, consistent with Seyhun (1990). Using the actual trading date may reduce errors attributable to delayed reporting since managers may use the delayed disclosure provision to unload shares when they foresee bad news (Cheng, Nagar & Rajan, 2003). Under Section 16 of the Securities and Exchange Act of 1934, insiders are required to report any transaction to the SEC on Form 4 by the tenth of the month following the trade (Cheng, Nagar & Rajan, 2003). Those insiders who have had exempt transactions and have not reported on Form 4 are required to file annually through Form 5 (Cheng, Nagar & Rajan, 2003).

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This study used data on hospitality officers' and directors' trading during the period prior to an acquisition payment announcement. Abnormal insider trading was calculated by comparing insider trades in the study period (four quarters prior to the announcement) with insider trades in a control period of 36 months (beginning 48 months prior to the acquisition payment announcement and ending 12 months prior to the announcement). In addition, this study used only open-market stock transactions to determine insider sales and insider purchases (Kahle, 2000; Clarke, Dunbar & Kahle, 2001). The other types of transactions excluded from this study (such as exercising options and selling warrants) generally account for only 10 percent of total insider transactions (Meulbroek, 1992) and may also be influenced by the firm's compensation policy (Madison, Roth & Saporoschenko, 2004).

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Finally, five observations from original twenty observations in the cash sample were excluded from the analysis because they produced no insider transactions in either the control period or the period one year prior to the acquisition announcement. Thus the

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cash sample size was reduced to 15 observations and the overall sample to 75 observations.

The remaining sample of acquiring firms has the following industry distribution: hotels (20 observations), REITs (14 observations), restaurants (32 observations), casinos (7 observations), cruise lines (1 observation) and country clubs (1 observation). Although it would be interesting, an analysis by each industry segment was not possible due to the small sample sizes.

Using the LexisNexis database, the authors checked whether any insider in the entire sample of acquiring firms has been charged with insider trading by the SEC in a civil or administrative case. There was only one insider trading case among the acquiring firms in the sample. In 1994, the secretary to a Hilton director provided inside information (Hilton's plan of hiring an investment bank to facilitate its expansion plans) to a British man previously charged by the SEC. The secretary paid $10,000 to settle the charges. The British man was charged with a fine of $458,458 (Wall Street Journal 1995).

Methodology

Kahle (2000) suggests that two valid measures of insider trading are the number of times insiders trade (a trade-based measure) and the number of shares traded (a volume-based measure). This study used the number of times hospitality insiders trade their firms' shares, weighting what each insider buys or sells equally, regardless of the number of shares involved. Three reasons account for this choice. First, Clarke, Dunbar and Kahle (2001) reported that the number of times insiders trade (trade-based measure) and the number of shares traded (volume-based measure) produce the same results with regard to insider trading. Second, the optimal size of an information motivated trade may be medium to small if expected legal penalties increase with the size of the trade. Third, share price changes should be related more to the number of insider purchases and sales than to changes in the proportion of the firm held by the managers (Bradford, 1987).

This study used hospitality insider trading in the four quarters before an acquisition announcement to determine insider trading patterns (consistent with Clarke, Dunbar & Kahle (2001)). Annual abnormal sales (purchases) were calculated. They are defined as actual sales (purchases) minus expected sales (purchases) in the given year, where expected sales (purchases) are the mean annual sales (purchases) of that firm in the 36-month period beginning 48 months prior to the acquisition payment announcement. The authors used this procedure to calculate the abnormal number of sales and purchases per firm for the year prior to the acquisition payment announcement.

Since insiders are under some legal constraints in regard to trading on their own account during the six month period prior to an acquisition, the abnormal number of sales and purchases per quarter during the 1 year period prior to the acquisition payment announcement were also calculated for each acquiring firm. Quarterly abnormal sales (purchases) are defined as actual sales (purchases) minus expected sales (purchases) in the given quarter, where expected sales (purchases) are the mean quarterly sales (purchases) of that firm in the 36-month period beginning 48 months prior to the acquisition payment announcement.

T-tests were used to measure the significance of abnormal insider sales and purchases. The level of significance (that actual trading is different from expected

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trading) is reported at the ten-, five-, and one-percent levels. Since the authors intend to measure whether abnormal insider sales and purchases are greater than those in the control period, the p-values are calculated using a one tail test.

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Results

If managers of acquiring hospitality firms feel that their shares are undervalued, they have an incentive to use cash to pay for an acquisition and likewise to purchase their firms' shares on their personal accounts prior to a cash acquisition financing announcement. This would suggest that positive abnormal insider purchases occur prior to cash-financed acquisitions. Our results do not support this. Table 1 shows insider trading results for the period one year prior to the acquisition (quarters -1 to -4) and also for each of the individual four quarters within that year (quarters -1, -2, -3 and -4). During the one year prior to the cash financed acquisition announcement, the t-statistic of abnormal insider purchases is insignificant. This implies that insiders in acquiring firms did not, on average, make an unusual number of purchases in the one year prior to the announcement.

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Table 1 also presents the quarterly abnormal insider purchases for the one year prior to the acquisition payment type announcement. This is important because insider trading may be concentrated from 6 to 12 months prior to the announcement to avoid insider trading legalities. However, the quarterly abnormal insider purchases are negatively significant in the fourth (t-statistics = -1.580, p-value = 0.075) and second quarters (t-statistics = -1.450, p-value = 0.08) prior to the announcement (the other quarters do not show statistically significant differences). The results imply that insider purchases during the pre-acquisition period were less than during the control period which is the opposite implied by the hypothesis that a cash payment offer should be associated with prior increased insider purchases.

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The results for cash-financed acquisitions may be interpreted in several ways. First, the managers of acquiring firms are aware of and adhere to the legal constraints on their trading. Second, it is also possible that cash-financed acquisitions are made for reasons other than a perceived undervaluation of the acquiring firm. If acquiring hospitality firms have cash available after all wealth-enhancing investments have been made, managers may use that cash to undertake transactions to increase their own utility rather than to maximize shareholder wealth. For example, managers may choose to grow their firms through (non-value optimizing) mergers since executive compensation tends to relate positively to firm size (Jensen, 1986; Harford, 1999). In fact, Qiu (2004) reported that even the presence of institutional investors (insurance companies, mutual funds and banks) and managerial ownership did not prevent value-reducing acquisition. A third possibility that might explain our results is that hospitality managers may decide to use cash-financed acquisitions even when the managers consider their stock overvalued because stock-financed acquisitions would dilute their managerial control and power in the newly combined firms (Martin, 1996).

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Insider Trading Prior to Stock-Financed Acquisition Payment Announcements

If managers of acquiring hospitality firms feel that their shares are overvalued, they have an incentive to use company stock to pay for an acquisition and likewise to sell their firms' shares on their personal accounts prior to a stock financed acquisition payment announcement. This would suggest that positive abnormal insider sales occur prior to stock-financed acquisitions. Our results do not support this. Table 2 presents abnormal insider sales in for one year and on a quarterly basis prior to the stock acquisition payment type announcement. During the one year prior to the acquisition payment announcement, the t-statistic of abnormal insider sales is insignificant (p-value= 0.28). This implies that insiders in hospitality acquiring firms do not, on average, make an unusual number of sales in the one year prior to the announcement of a stock financed acquisition.

In addition, Table 2 shows that quarterly abnormal insider sales are negatively significant (at the 1 percent level) in the three of the four quarters prior to the announcement. This implies that the pre-acquisition period insider sales in the three quarters were less than those during the control period. Again, this is in direct opposition to the hypothesis that abnormal insider sales should increase prior to a stock financed acquisition payment announcement.

These results may have several possible explanations. First, instead of open market sales, hospitality insiders with private information may pursue short-sales transactions to maximize their private benefits. Insiders could try to sell short prior to the acquisition announcement believing that the stock's price will fall and they can then buy the stock back at a lower price after the acquisition payment announcement. These transactions would not show up in the abnormal insider sales transactions. Christophe, Ferri and Angel (2004) provide evidence that abnormal short-sales are significantly related to post-announcement stock returns. Second, a recent study on executive option exercising has shown that insiders sell option acquired shares immediately to reduce their exposure to their firm's stock (Carpenter & Remmers, 2001). This may limit the number of shares that insiders have available to sell when they feel that the firm's shares are over valued.

Insider Trading Prior to Mixed-Financed Hospitality Acquisition Payment Announcements

If managers of acquiring hospitality firms feel that their shares are fairly valued, they should be indifferent, ceterus paribus, to using cash or company stock to pay for an acquisition (and hence may use both) and likewise should lack an incentive to either buy or sell their firms' shares on their personal accounts prior to an acquisition payment announcement. This would suggest that no positive abnormal insider sales or purchases occur prior to mixed financing (cash plus stock) hospitality acquisition announcements. Our results support this for insider purchases. Table 3 presents abnormal insider purchases one year and on a quarterly basis prior to the acquisition payment type announcement. During the entire one year period prior to the announcement, abnormal insider purchases are insignificant (p-value = 0.165). This implies that insiders in

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acquiring hospitality firms did not, on average, make an unusual number of purchases in the one year prior to the announcement. However, it should be noted that for the one quarter period prior to the announcement, abnormal insider purchases are negatively significant (at the 10 percent level), implying that there are fewer insider purchases than during the control period. However, this may simply be due to hospitality insiders avoiding the legal constraints against insider trading during this period.

For insider sales prior to a mixed financing acquisition announcement, we do find significant abnormal insider sales of stock in the one year prior to the payment announcement. In table 4, the p-value for abnormal insider sales is significant (at the 5 percent level) during the one year prior to a mixed acquisition financing announcement. This implies that insiders in acquiring firms did, on average, make an unusual number of sales in the one year prior to the announcement. Examining the quarterly data for that one year period, all quarters except the one quarter prior to the announcement showed a statistically insignificant level of insider abnormal sales. The first quarter prior to the announcement did show a significant level of abnormal sales (at 5 percent level). These may have been planned sales so as not to violate insider sales legal constraints.

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A possible explanation for the statistically significant abnormal insider sales over the one year period prior to the payment type announcement in the mixed purchase sample is that even though the acquiring firm's managers perceive their shares as overvalued, they may still use cash as part of the financing of the acquisition if their firm is particularly cash-rich (Harford, 1999). Martin (1996) also suggests that managers may use some degree of cash financing when their managerial ownership in the acquiring firm is in a range from five to twenty-five percent in order to retain and maximize their managerial control and compensation (Martin, 1996).

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Conclusion and Suggestions for Future Research

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The findings of this research on insider trading do not consistently support the supposition that insiders in hospitality firms invariably use their private information to maximize their private benefits prior to public acquisition payment type announcements. These results may have several explanations, all of which present possible avenues for future research. Securities laws may deter insiders of acquiring firms from exploiting illegal insider trading profits. For example, in hospitality acquiring firms using only stock or cash financing, there were no significant abnormal transactions in the one year period prior to an acquisition payment type announcement. These results suggest that the managers of acquiring firms do not trade on their own account to take advantage of privately held information about the true value of their firms in these circumstances and that one reason may be to avoid the legal constraints on insider trading prior to major information announcements. For hospitality acquirers using mixed financing, abnormal insider sales are positive and significant (although purchases are not). This result may, however, reflect attempts by managers to maximize their managerial control or compensation rather than taking advantage, through personal trading, of private information that they may have. In such a situation, some of these sales may have been planned sales thus avoiding the legal impediments to sales during this period.

Even though the results of this study show a general lack of insider trading prior to an information event like the financing of an acquisition, the study does make an important

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contribution to the hospitality literature related to insider trading. No previous studies have focused on the area of insider trading in relation to hospitality firms. This study offers support for the view, at least in terms of acquisition payment type announcements, that hospitality managers do not use their private information to take unfair advantage of less informed investors in the financial market place. Whether the manager's motives are a result of enforcement of insider trading laws or affected by other considerations such as maintaining managerial ownership and control is a question for further study. In any case, the results of this study should provide assurance to investors in hospitality firms that the managers of their firms do not take unfair advantage of them (at least in the case of acquisition payment type announcements) even when the managers may possess inside information not available to other investors about the true prospects of their firm.

Additional research in this area might also look at the issue of free cash flow and managerial acquisition financing decisions. If acquiring firms have significant amounts of free cash flow they may have an incentive to use cash financing in an acquisition regardless of whether the managers perceive the firm's shares to be fairly valued or not. Future studies into whether free cash flow is a significant variable in the acquisition payment choice decision would be helpful.

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Table 1. Abnormal Insider Purchases Prior To Cash-Financed Hospitality Acquisition Payment Announcements

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Pre-acquisition period	Sample size	Mean	standard deviation	t-test t-stat	t-test p-value
Quarters [-1 to -4]	15	-0.860	8.820	-0.360	0.375
Quarter [-4]	15	-0.828	2.097	-1.580	0.075*
Quarter [-3]	15	0.189	2.200	0.330	0.380
Quarter [-2]	15	-0.678	1.807	-1.450	0.080*
Quarter [-1]	15	0.528	3.182	0.640	0.280

*: significant at the 10% levels

Table 2. Abnormal Insider Sales Prior To Stock-Financed Hospitality Acquisition Payment Announcements

Pre-acquisition period	sample size	Mean	Standard deviation	t-stat	t-test p-value
Quarters [-1 to -4]	35	-1.620	15.940	-0.600	0.280
Quarter [-4]	35	-0.200	6.200	-0.190	0.470
Quarter [-3]	35	-1.610	3.648	-2.570	0.012***
Quarter [-2]	35	-0.190	5.597	-0.200	0.460
Quarter [-1]	35	0.210	5.584	0.220	0.420

***: significant at the 1% levels

Table 3. Abnormal Insider Purchases Prior to Mixed-Financed Hospitality Acquisition Payment Announcements

Pre-acquisition period	Sample size	Mean	standard deviation	t-stat	t-test p-value
Quarters [-1 to -4]	25	3.090	15.740	0.860	0.165
Quarter [-4]	25	2.470	11.880	1.000	0.160
Quarter [-3]	25	-0.250	2.982	-0.410	0.350
Quarter [-2]	25	0.257	3.090	0.400	0.360
Quarter [-1]	25	-0.438	1.518	-1.390	0.075*

*: significant at the 10% levels

Table 4. Abnormal Insider Sales Prior to Mixed Financed Hospitality Acquisition Payment Announcements

**: significant at the 5% levels

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Pre-acquisition period	sample size	Mean	Standard deviation	t-stat	t-test p-value
Quarters [-1 to -4]	25	2.860	7.900	1.770	0.045**
Quarter [-4]	25	0.497	1.881	1.290	0.130
Quarter [-3]	25	0.247	2.532	0.480	0.330
Quarter [-2]	25	0.622	2.804	1.090	0.170
Quarter [-1]	25	1.437	3.257	2.210	0.023**

Appendix A

Post-Acquisition Performance of Acquiring firms

If an acquiring firm's managers use stock to pay for an acquisition, previous studies have shown that the acquiring firm has lower long-term abnormal returns than firms that use cash payments (Agrawal, Jaffe & Mandelker, 1992; Loghran & Vijh, 1997). The explanation that has been suggested is that in the long run post acquisition, the market value of overvalued stock converges to its economic value with the consequence that its abnormal returns are more negative than for cash payment offers (which assumes that the shares of acquiring firms making cash payment offers are less overvalued than stock offer firms).

To measure the long-term post-acquisition performance of the acquiring firms, the monthly closing prices of the stock for each acquiring firms is obtained from the CRSP Monthly File. Following Sheel and Nagpal (2000), the sample period is defined as a 36 month period before and after the acquisition payment announcements (total of six years). The event period ranges from six months before to 36 months after the announcement date. The estimation period for measuring the expected return in the market is defined as 36 to seven months before the announcement date.

To measure the long-term performance of acquiring firms, the market model was used (Brown & Warner, 1985; Sheel & Nagpal, 2000). The market model specifies the linear relationship between security j returns and returns on a market portfolio as:

$$R_{jt} = \alpha_j + \beta_j * R_{mt} + \varepsilon_{jt}$$

where R_{jt} = the monthly return on security j over month t

α_j = expected value of (R_{jt} - $\beta_j * R_m$)

β_j = Cov (R_{jt} , R_{mt}) / Var (R_{mt})

R_{mt} = the market return on the CRSP equally-weighted market index over day t

ε_{jt} = random variable.

An estimation period is from trading month t-36 through trading month t - 7, with respect to the acquisition announcement. The abnormal return (A_{jt}) for the security j on month t is defined as the difference between actual observations and estimated returns.

$$A_{jt} = R_{jt} - [\hat{\alpha}_j + \hat{\beta}_j * R_{mt}], \quad \mathbf{t = -6, -5, \ldots 0, 1, \ldots, 36,}$$

where $\hat{\alpha}_j$ and $\hat{\beta}_j$ are estimates of α_j and β_j by regressing R_{jt} on R_{mt} over the estimation period preceding the event window. For the every month in the event period, the abnormal return (A_{jt}) is averaged to make the sample mean

$$AR_{jt} = \frac{\sum_{j=1}^{N} A_{jt}}{N},$$

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where t is defined in trading month relative to the event day. N is the number of securities in the sample. Over the interval of beginning with six months prior to and ending with 36 months after the acquisition announcements, the cumulative abnormal return (CAR_{jt}) is

$$CAR_{jt} = \sum_{t=-6}^{36} AR_{jt} \ .$$

A nonparametric rank test (Corrado, 1989; Nicolau, 2002) is used to test the significance of cumulative average abnormal returns within the event window. The rank test is powerful even under highly nonnormal distributions and corrects the misspecification problem of other parametric tests due to the event-date excess return variance increases (Corrado, 1989). The rank test (Nicolau, 2002) is calculated by:

$$\underline{\mathbf{Z}} = \frac{\frac{1}{N}\sum_{i=1}^{N}\left[K_{i0} - \frac{1}{2}(T+1)\right]}{\sqrt{\frac{1}{T}\sum_{t=1}^{T}\left[\frac{1}{N}\sum_{i=1}^{N}\left[K_{it} - \frac{1}{2}(T+1)\right]\right]^2}}$$

where N = the number of securities, K_{it} = rank of the abnormal returns in the time series estimated for the security i, and T = the total number of months being observed.

Table 5 shows that the cumulative abnormal returns of stock payment hospitality acquirers (-117.47 %) decline more steeply than those of cash payment hospitality acquirers (-80.11 %). The returns for mixed payment acquirers (-105.28 %) are between those of the cash and stock payment acquirers. This is consistent with previous studies (Agrawal, Jaffe & Mandelker, 1992; Loghran & Vijh, 1997) and supports that the payment type offered in a hospitality acquisition is related to the valuation of acquiring firm. It should also be noted that the event day (day 0) abnormal return sign is consistent with the hypothesis that cash payments indicate undervaluation of the firm's shares and stock payments indicate potential overvaluation of the firm's shares.

Table 5. Cumulative Average Abnormal Returns for the event period

Month	Cash			Mixed			Stock		
	AR t	Rank test Z	CAR	AR t	Rank test Z	CAR	AR t	Rank test Z	CAR
-6	-2.72%	-0.58	-2.72%	-0.59%	0.10	-0.59%	0.12%	0.24	0.12%
-5	-2.45%	-1.07	-5.17%	-6.22%	-0.71	-6.81%	-7.91%	-1.10	-7.79%
-4	3.44%	2.110*	-1.73%	6.96%	2.210*	0.15%	4.30%	1.800$	-3.49%
-3	-2.59%	-1.03	-4.32%	-0.09%	0.31	0.06%	0.20%	0.58	-3.29%
-2	1.14%	0.55	-3.18%	-0.13%	0.50	-0.07%	-0.05%	0.48	-3.34%
-1	-3.95%	-0.85	-7.13%	2.35%	0.97	2.28%	2.91%	1.02	-0.43%
0	**2.48%**	**0.70**	**-4.65%**	**1.69%**	**0.17**	**3.97%**	**-1.33%**	**0.11**	**-1.76%**
1	-3.53%	-0.76	-8.18%	-2.77%	-0.57	1.20%	-1.77%	-0.17	-3.53%
2	-3.49%	-0.92	-11.67%	2.42%	0.68	3.62%	3.42%	0.78	-0.11%
3	1.00%	0.49	-10.67%	-0.56%	0.16	3.06%	-0.55%	0.23	-0.66%
4	0.81%	0.52	-9.86%	-3.78%	-0.92	-0.72%	-3.06%	-0.60	-3.72%
5	2.86%	1.11	-7.00%	-1.23%	-0.03	-1.95%	-0.58%	0.22	-4.30%

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6	-2.98%	-0.62	-9.98%	0.17%	0.52	-1.78%	0.21%	0.59	-4.09%
7	-1.70%	-0.53	-11.68%	-3.25%	-1.03	-5.03%	-5.71%	-1.42	-9.80%
8	0.79%	0.37	-10.89%	1.06%	0.33	-3.97%	-1.09%	-0.03	-10.89%
9	-6.67%	-1.30	-17.56%	-4.54%	-0.75	-8.51%	-5.42%	-0.84	-16.31%
10	-2.63%	-0.67	-20.19%	-7.02%	-2.04	-15.53%	-9.33%	-2.630*	-25.64%
11	-4.10%	-2.01	-24.29%	0.63%	-0.90	-14.90%	1.26%	-0.55	-24.38%
12	-3.83%	-1.12	-28.12%	-4.70%	-1.17	-19.60%	-4.51%	-0.98	-28.89%
13	0.08%	0.64	-28.04%	-5.56%	-1.02	-25.16%	-6.61%	-1.22	-35.50%
14	-0.19%	0.42	-28.23%	-4.51%	-1.15	-29.67%	-3.94%	-1.10	-39.44%
15	-4.31%	-1.25	-32.54%	-3.25%	-0.19	-32.92%	-4.38%	-0.39	-43.82%
16	1.34%	0.67	-31.20%	-2.32%	-0.65	-35.24%	-1.86%	-0.40	-45.68%
17	-3.89%	-0.92	-35.09%	2.55%	0.10	-32.69%	-2.15%	-0.17	-47.83%
18	-7.05%	-2.62	-42.14%	-0.41%	0.27	-33.10%	0.65%	0.31	-47.18%
19	-9.53%	-2.80	-51.67%	-5.05%	-1.01	-38.15%	-3.93%	-0.50	-51.11%
20	0.90%	1.03	-50.77%	-7.27%	-2.61	-45.42%	-9.27%	-2.750**	-60.38%
21	3.22%	1.08	-47.55%	-0.69%	-0.31	-46.11%	-3.51%	-1.04	-63.89%
22	-5.53%	-1.44	-53.08%	1.83%	0.82	-44.28%	2.31%	0.80	-61.58%
23	-7.28%	-1.76	-60.36%	-7.15%	-1.72	-51.43%	-7.80%	-1.990$	-69.38%
24	-5.18%	-1.13	-65.54%	0.46%	-0.02	-50.97%	2.27%	0.44	-67.11%
25	-4.39%	-0.65	-69.93%	-5.48%	-0.98	-56.45%	-7.33%	-1.33	-74.44%
26	-5.47%	-1.42	-75.40%	0.19%	-0.96	-56.26%	2.53%	-0.48	-71.91%
27	-0.58%	0.17	-75.98%	-5.81%	-1.52	-62.07%	-6.53%	-1.53	-78.44%
28	2.10%	-0.30	-73.88%	-0.76%	-0.21	-62.83%	-0.86%	-0.26	-79.30%
29	-1.17%	-0.71	-75.05%	-9.04%	-1.69	-71.87%	-7.29%	-1.10	-86.59%
30	-3.15%	-1.20	-78.20%	-4.09%	-1.34	-75.96%	-0.71%	-0.47	-87.30%
31	0.83%	0.40	-77.37%	-5.13%	-1.07	-81.09%	-3.94%	-0.69	-91.24%
32	-4.06%	-1.15	-81.43%	-6.98%	-1.35	-88.07%	-8.68%	-1.54	-99.92%
33	3.02%	0.38	-78.41%	-7.13%	-2.35	-95.20%	-4.51%	-1.58	-104.43%
34	0.73%	0.46	-77.68%	-9.59%	-2.64	-104.79%	-10.00%	-2.810**	-114.43%
35	-1.03%	-0.31	-78.71%	-2.02%	-0.25	-106.81%	-2.27%	-0.37	-116.70%
36	-1.40%	-0.70	-80.11%	1.53%	0.60	-105.28%	-0.77%	0.02	-117.47%

$, *, and ** : significant at the 10%, 5% and 1% levels, respectively at one tail test.

Appendix B.

List of hospitality acquisition by payment types

Cash Payment

Acquirer	Target
Caesars World Inc	Caesars New Jersey
Harrah's Entertainment	Showboat Inc.
Hollywood Park	Casino Magic
Mirage resorts	Boardwalk Casino
HFS	Jackson Hewitt Inc.
Marriott international	Forum group Inc.
Marriott	Renaissance
Collins Foods Unit	Del Taco
CKE restaurant	Advanced Unit
Carrols Corp	PolloTropical Inc
Perkins Family restaurants	Restaurant Co.
Piccadilly Cafeterias Inc	Morrison Restaurants Inc.
Quality Dining	Grady's
LaSalle Hotel Properties	San Diego Princess Resort
Patriot America hospitality	Arcadian international Inc.

Stock Payment

Acquirer	Target
Harrah's Entertainment	Rio Hotel & Casino Inc.
Hollywood Park	Boomtown Inc
MGM Grand	Primadonna
CapStar Hotel Co	American General Hospitality Corp.
HFS inc	Casino & Credit Services Inc.
HFS inc	CUC International
Hilton	Bally's Entertainment
Hilton	Grand Casinos Inc.
Hudson hotels corps	6 limited partnership
prime motor inn	Cindy'a Inc
Prime Hospitality	Homegate Hospitality Inc.
Promus	Double Tree
Doubletree	RFS Inc.
Microtel Franchise	Hudson Hotels Corp.
Apolena Capital Corp.	Casino Creek Holdings
Applebee's international inc	Pub Ventures
Apple South Inc	DF & R
Manhattan Bagel	I & J Bagel
Daka International	Champps Entertainment

Brinker International	Border Café
Brinker International	Northwest Restaurant Inc.
Brinker International	Lettuce Entertain You Enterprise
GB foods	Timber Lodge
Hometown buffet	Buffets
Longhorn Steaks Inc	Bugaboo Creak Steak House
Quality Dining	Brugger's
Servico inc	Impac Hotel Group
Shoney's	TPI Enterprises Inc.
Outback Steakhouse	Lousiana Outback Steakhouse Inc. five Units
Taco Cabana Inc.	Two Pesos Inc.
FelCor Lodging Trust Inc	Bristol Hotel Co
Hotel Investors Corp.	Hotel Properties Inc.
Humphrey hospitality trust	Supertel Hospitality
Patriot America hospitality	Wyndham Hotel
Extended Stay America	Studio Plus Hotels Inc.

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Mixed Payment

Acquirer	Target
Nashville Country Club	Avalon Entertainment
Royal Caribbean International	Celebrity Cruise Lines Inc.
Marriott International	Execustay Corp.
Bristol Hotels	60 properties of Holiday Inn
Doubletree	Red Lion Inns
Wyndham	Clubhouse Hotels Inc.
Apple South Inc	Hops Grill & Bar Restaurants
Boston Chicken Inc	Mid-Atlantic Restaurant Systems LP
Boston Chicken Inc	Progressive Food Concepts Inc.
CKE restaurant	Summit Family Restaurants Inc.
CKE restaurant	Casa Bonita Inc.
Koo Koo Roo Inc	14 properties of Hamlet Restaurant
Laundry's Seafood	Bayport Restaurant
New York Bagel Enterprises	Lots A' Bagels Inc.
Bally Manufacturing Corp.	Golden Nugget Inc.
Chart House Enterprise	Paradise Bakery Inc.
Apple South Inc	McCormick & Schmick's Restaurant
Starwood Lodging trust	HEI
Boykin lodging	Red Lion Inns
Starwood Lodging trust	Westin Hotels & Resorts
Starwood Lodging trust	ITT Corp.
Jameson Inns	Signature Inns Inc.
Meditrust	La Quinta Inns Inc.
Patriot America hospitality	WHG resorts & casinos Inc.
Patriot America hospitality	Interstate Hotels

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