

Do Hedge Funds Exploit Material Nonpublic Information? Evidence from Corporate Bankruptcies

Wei Wang Yan Yang Jingyu Zhang

Smith School of Business
Queen's University

ABFER
May 22, 2023

Hedge funds are prominent participants in corporate financial distress

Hedge funds are prominent participants in corporate financial distress

- Involvement in nearly 90% of large U.S. bankruptcy cases.(Jiang et al., 2012)

Hedge funds are prominent participants in corporate financial distress

- Involvement in nearly 90% of large U.S. bankruptcy cases.(Jiang et al., 2012)
- Efficiency gains and positive impact during corporate restructurings:

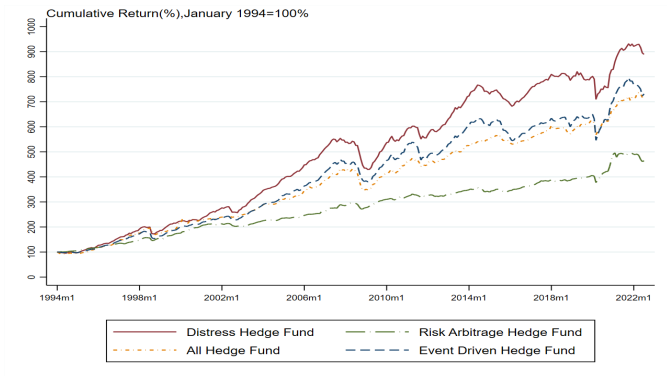
Hedge funds are prominent participants in corporate financial distress

- Involvement in nearly 90% of large U.S. bankruptcy cases.(Jiang et al., 2012)
- Efficiency gains and positive impact during corporate restructurings:
 - ↑ Prepackaged bankruptcies, ↓ restructuring duration, and ↑ debt reduction.(Lim, 2015)

Hedge funds are prominent participants in corporate financial distress

- Involvement in nearly 90% of large U.S. bankruptcy cases.(Jiang et al., 2012)
- Efficiency gains and positive impact during corporate restructurings:
 - ↑ Prepackaged bankruptcies, ↓ restructuring duration, and ↑ debt reduction.(Lim, 2015)
 - ↑ Creditor recoveries and ↓ managerial self-dealing.(Elias, 2016)

Cumulative Returns to Distressed Hedge Funds and Other Hedge Fund Indices



Data Source: The Lipper Hedge Fund Database (TASS)

Hedge funds obtain material nonpublic information from the unsecured creditors' committee

- A typical entry point for hedge funds in Chapter 11 bankruptcies: invest in unsecured debt and join the unsecured creditors' committee (UCC).

Hedge funds obtain material nonpublic information from the unsecured creditors' committee

- A typical entry point for hedge funds in Chapter 11 bankruptcies: invest in unsecured debt and join the unsecured creditors' committee (UCC).
- **the unsecured creditors' committee (UCC):**

Hedge funds obtain material nonpublic information from the unsecured creditors' committee

- A typical entry point for hedge funds in Chapter 11 bankruptcies: invest in unsecured debt and join the unsecured creditors' committee (UCC).
- **the unsecured creditors' committee (UCC):**
 - Holders of the seven largest unsecured debt claims.

Hedge funds obtain material nonpublic information from the unsecured creditors' committee

- A typical entry point for hedge funds in Chapter 11 bankruptcies: invest in unsecured debt and join the unsecured creditors' committee (UCC).
- **the unsecured creditors' committee (UCC):**
 - Holders of the seven largest unsecured debt claims.
 - Fiduciary duty to all unsecured creditors.

Hedge funds obtain material nonpublic information from the unsecured creditors' committee

- A typical entry point for hedge funds in Chapter 11 bankruptcies: invest in unsecured debt and join the unsecured creditors' committee (UCC).
- **the unsecured creditors' committee (UCC):**
 - Holders of the seven largest unsecured debt claims.
 - Fiduciary duty to all unsecured creditors.
 - Access to material nonpublic information. [▶ Bankruptcy Code](#)

Hedge funds obtain material nonpublic information from the unsecured creditors' committee

- A typical entry point for hedge funds in Chapter 11 bankruptcies: invest in unsecured debt and join the unsecured creditors' committee (UCC).
- **the unsecured creditors' committee (UCC):**
 - Holders of the seven largest unsecured debt claims.
 - Fiduciary duty to all unsecured creditors.
 - Access to material nonpublic information. [▶ Bankruptcy Code](#)
 - Restrictions on trading securities of the bankrupt firm.

The SEC litigation release on the misuse of material nonpublic information obtained from UCC



U.S. SECURITIES AND EXCHANGE COMMISSION

Litigation Release No. 20132 / May 30, 2007

SEC v. Barclays Bank PLC and Steven J. Landzberg, 07-CV-04427
(S.D.N.Y.)

Barclays Bank Pays \$10.9 Million to Settle Charges of Insider
Trading on Bankruptcy Creditor Committee Information

Barclays' Former Head Trader of Distressed Debt Also Pays
\$750,000

"Barclays and Landzberg illegally traded millions of dollars of bond securities over eighteen months, while aware of material nonpublic information received through six creditors committees." — Litigation Release No. 20132

The SEC litigation release on the misuse of material nonpublic information obtained from UCC



U.S. SECURITIES AND EXCHANGE COMMISSION

Litigation Release No. 20132 / May 30, 2007

SEC v. Barclays Bank PLC and Steven J. Landzberg, 07-CV-04427
(S.D.N.Y.)

Barclays Bank Pays \$10.9 Million to Settle Charges of Insider
Trading on Bankruptcy Creditor Committee Information

Barclays' Former Head Trader of Distressed Debt Also Pays
\$750,000

"Barclays and Landzberg illegally traded millions of dollars of bond securities over eighteen months, while aware of material nonpublic information received through six creditors committees." — Litigation Release No. 20132

A (bankrupt) firm does not operate in vacuum and UCC hedge funds trade public equities at the same time...

Research Question

Do hedge funds exploit material nonpublic information acquired on the unsecured creditors' committee (UCC) of a bankrupt firm to trade equities of nonbankrupt firms?

Hedge funds make abnormal tradings on stocks of nonbankrupt firms after joining UCC of a bankrupt firm

- Trading intensity with UCC information access:

Hedge funds make abnormal tradings on stocks of nonbankrupt firms after joining UCC of a bankrupt firm

- Trading intensity with UCC information access:
 - High turnover \uparrow 30.49%

Hedge funds make abnormal tradings on stocks of nonbankrupt firms after joining UCC of a bankrupt firm

- Trading intensity with UCC information access:
 - High turnover \uparrow 30.49%
 - Large trade \uparrow 18.96%

Hedge funds make abnormal tradings on stocks of nonbankrupt firms after joining UCC of a bankrupt firm

- Trading intensity with UCC information access:
 - High turnover \uparrow 30.49%
 - Large trade \uparrow 18.96%
 - Results robust to different event windows and subsamples

Hedge funds make abnormal tradings on stocks of nonbankrupt firms after joining UCC of a bankrupt firm

- Trading intensity with UCC information access:
 - High turnover \uparrow 30.49%
 - Large trade \uparrow 18.96%
 - Results robust to different event windows and subsamples
- Additional (Placebo) tests:

Hedge funds make abnormal tradings on stocks of nonbankrupt firms after joining UCC of a bankrupt firm

- Trading intensity with UCC information access:
 - High turnover \uparrow 30.49%
 - Large trade \uparrow 18.96%
 - Results robust to different event windows and subsamples
- Additional (Placebo) tests:
 - Bankruptcies without UCC appointment

Hedge funds make abnormal tradings on stocks of nonbankrupt firms after joining UCC of a bankrupt firm

- Trading intensity with UCC information access:
 - High turnover \uparrow 30.49%
 - Large trade \uparrow 18.96%
 - Results robust to different event windows and subsamples
- Additional (Placebo) tests:
 - Bankruptcies without UCC appointment
 - Pseudo UCC

Hedge funds make abnormal tradings on stocks of nonbankrupt firms after joining UCC of a bankrupt firm

- Trading intensity with UCC information access:
 - High turnover \uparrow 30.49%
 - Large trade \uparrow 18.96%
 - Results robust to different event windows and subsamples
- Additional (Placebo) tests:
 - Bankruptcies without UCC appointment
 - Pseudo UCC
 - UCC without hedge funds members

Hedge funds make abnormal tradings on stocks of nonbankrupt firms after joining UCC of a bankrupt firm

- Trading intensity with UCC information access:
 - High turnover \uparrow 30.49%
 - Large trade \uparrow 18.96%
 - Results robust to different event windows and subsamples
- Additional (Placebo) tests:
 - Bankruptcies without UCC appointment
 - Pseudo UCC
 - UCC without hedge funds members
 - Other institutional investors

Hedge funds make abnormal tradings on stocks of nonbankrupt firms after joining UCC of a bankrupt firm

- Trading intensity with UCC information access:
 - High turnover \uparrow 30.49%
 - Large trade \uparrow 18.96%
 - Results robust to different event windows and subsamples
- Additional (Placebo) tests:
 - Bankruptcies without UCC appointment
 - Pseudo UCC
 - UCC without hedge funds members
 - Other institutional investors
- Abnormal trades concentrate in nonbankrupt firms that have close economic linkages with the bankrupt firm.

Hedge funds make abnormal tradings on stocks of nonbankrupt firms after joining UCC of a bankrupt firm

- Trading intensity with UCC information access:
 - High turnover \uparrow 30.49%
 - Large trade \uparrow 18.96%
 - Results robust to different event windows and subsamples
- Additional (Placebo) tests:
 - Bankruptcies without UCC appointment
 - Pseudo UCC
 - UCC without hedge funds members
 - Other institutional investors
- Abnormal trades concentrate in nonbankrupt firms that have close economic linkages with the bankrupt firm.
- Large trades are profitable.

Contribution

- Hedge funds' informed equity trading: syndicated loan market (Massoud et al., 2011), private meetings with senior management (Solomon and Soltes, 2015), and connections with lobbyists (Gao and Huang, 2016) and prime brokers (Kumar et al., 2020).
 - Direct evidence: exploit material nonpublic information
 - Nuanced channel: UCC
- Nonbank institutional investors' presence on the debt market and its influence on the equity market (Bushman et al., 2010, Jiang et al., 2010, Ivashina and Sun, 2011, Massoud et al., 2011, Kumar et al., 2020).
 - Distressed debt market and equity trading
- Raise concerns on potential “insider trading in a gray zone”.

Data

Novel dataset on UCC members of bankrupt firms:

- The Florida-UCLA-LoPucki Bankruptcy Research Database (BRD):
 - All Chapter 11 bankruptcies filed by large public US firms from 1996 to 2019
- The Public Access to Court Electronic Records (PACER) and BankruptcyData.com (NGR):
 - Members of UCC from court dockets
 - UCC Notice [▶ SunEdison, Inc.](#)

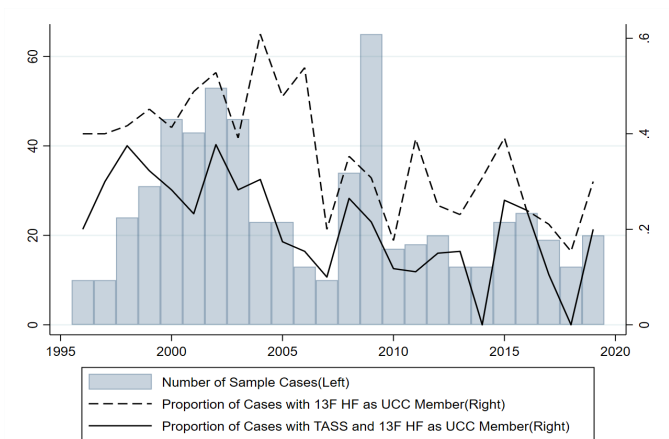
Data

- SEC filings, institutions' official websites, and industry directories and publications (e.g., Barron's):
 - Identify Hedge Funds and Other Institutional Investors among UCC Members (Jiang et al., 2012).
- The Thomson Reuters Institutional Holdings Database (13F):
 - Stock holdings of institutional investors.
- The Lipper Hedge Fund Database (TASS):
 - Hedge fund characteristics: fund size, AUM, and rate of return.
- Compustat and Capital IQ:
 - firm-level financial information.

▶ Sample Construction

Sample Overview

▶ Summary Statistics



Most Active Hedge Funds on UCC

Hedge Fund UCC Member	Cases Involved
Angelo, Gordon & Co. L.P.	8
Cerberus Capital Management	8
Loomis, Sayles & Co. L.P.	8
Magten Asset Management	8
Aegon Asset Management	7
Appaloosa Management. L.P.	7
AQR Capital Management	7
Elliott Investment Management	6
Highland Capital Management. L.P.	5
York Capital Management	5

Hedge funds can not predict an UCC event

- Investing in large quantities of distressed debt of a portfolio of firms.
- Highly illiquid distressed bond market. (Longstaff et al., 2005, Chen et al., 2007)

Arrival of UCC events:

$$I(UCCEvents)_{j,t} = \Phi' X_{j,t-1} + \delta_j + \theta_t + \epsilon_{j,t}$$

- $I(UCCEvents)_{j,t}$: Dummy variables to capture the level and the intensity of UCC events for hedge fund j in year-quarter t .
- $X_{j,t-1}$: Lagged fund-level characteristics.
- δ_j : Fund fixed effect.
- θ_t : Time fixed effect.

Hedge funds can not predict an UCC event

	(1) UCC	(2) Multiple UCC	(3) Num. UCC	(4) Ln(1 + Num. UCC)
Lag HF Size	0.002 (0.572)	0.001 (0.403)	0.003 (0.576)	0.002 (0.575)
Lag HF Flow	0.000 (-0.982)	0.000 (-0.395)	0.000 (-0.957)	0.000 (-0.982)
Lag HF Return	0.000 (-0.332)	0.000 (0.045)	0.000 (-0.042)	0.000 (-0.179)
Fund Comp. FE	Y	Y	Y	Y
Year Quarter FE	Y	Y	Y	Y
Standard Errors	Double Clustered	Double Clustered	Double Clustered	Double Clustered
Observations	3,056	3,056	3,056	3,056
Adj. R-squared	0.043	0.018	0.045	0.045

Empirical Strategy

Main specification:

$$I(\text{AbnormalTrading})_{j,t} = \beta(\text{InformationIndicator})_{j,t} + \Phi'X_{j,t-1} + \delta_j + \theta_t + \epsilon_{j,t}$$

- $I(\text{AbnormalTrading})_{j,t}$: Dummy variables to capture the abnormal tradings by hedge fund j in year-quarter t .
- $(\text{InformationIndicator})_{j,t}$: Dummy variables for year-quarters when hedge fund or other institutional investors j have access to UCC private information or the bankruptcy information.
- $X_{j,t-1}$: Lagged fund-level characteristics.
- δ_j : Fund fixed effect.
- θ_t : Time fixed effect.

Hedge fund trading upon UCC events: High Turnover

	(1) High Turnover	(2) High Turnover	(3) High Turnover Buy	(4) High Turnover Sell
UCC Information	0.160*** (6.381)	0.136*** (3.843)	0.124*** (3.892)	0.131*** (3.926)
Covariates	N	Y	Y	Y
Fund Comp. FE	N	Y	Y	Y
Year Quarter FE	N	Y	Y	Y
Standard Errors	Robust	Double Clustered	Double Clustered	Double Clustered
Observations	3,144	3,056	3,056	3,056
Adj. R-squared	0.012	0.495	0.472	0.466

Hedge fund trading upon UCC events: Large Trade

	(1) Large Trade	(2) Large Trade	(3) ln(#Large Trade)	(4) ln(#Large Trade)
UCC Information	0.138*** (5.806)	0.109*** (2.882)	0.378*** (4.155)	0.345*** (3.282)
Covariates	N	Y	N	Y
Fund Comp. FE	N	Y	N	Y
Year Quarter FE	N	Y	N	Y
Standard Errors	Robust	Double Clustered	Robust	Double Clustered
Observations	3,144	3,056	3,144	3,056
Adj. R-squared	0.009	0.546	0.005	0.670

No abnormal trading: placebo periods

	(1) High Turnover	(2) High Turnover Buy	(3) High Turnover Sell	(4) Large Trade	(5) ln(# Large Trade)
UCC Shift	0.026 (0.543)	0.029 (0.538)	0.049 (0.998)	-0.058 (-1.209)	-0.108 (-0.828)
Covariates	Y	Y	Y	Y	Y
Fund Comp. FE	Y	Y	Y	Y	Y
Year Quarter FE	Y	Y	Y	Y	Y
Standard Errors	Y	Y	Y	Y	Y
Observations	3,056	3,056	3,056	3,056	3,056
Adj. R-squared	0.496	0.472	0.468	0.550	0.673

No abnormal trading: bankruptcies without UCC formation

	(1) High Turnover	(2) High Turnover Buy	(3) High Turnover Sell	(4) Large Trade	(5) ln(#Large Trade)
BK - No UCC	-0.008 (-0.598)	0.018 (1.169)	0.002 (0.107)	0.003 (0.314)	-0.005 (-0.186)
Covariates	Y	Y	Y	Y	Y
Fund Comp. FE	Y	Y	Y	Y	Y
Year Quarter FE	Y	Y	Y	Y	Y
Standard Errors	Y	Y	Y	Y	Y
Observations	3,056	3,056	3,056	3,056	3,056
Adj. R-squared	0.496	0.472	0.467	0.549	0.672

No abnormal trading: UCC Events without HF on UCC

	(1) High Turnover	(2) High Turnover Buy	(3) High Turnover Sell	(4) Large Trade	(5) ln(#Large Trade)
Non-HF UCC	0.006 (0.405)	-0.065** (-2.210)	-0.003 (-0.113)	-0.033** (-2.612)	-0.130** (-2.435)
Covariates	Y	Y	Y	Y	Y
Fund Comp. FE	Y	Y	Y	Y	Y
Year Quarter FE	Y	Y	Y	Y	Y
Standard Errors	Y	Y	Y	Y	Y
Observations	3,056	3,056	3,056	3,056	3,056
Adj. R-squared	0.495	0.473	0.467	0.549	0.672

Do other UCC 13F institutions trade abnormally?

	(1) High Turnover	(2) High Turnover Buy	(3) High Turnover Sell	(4) Large Trade	(5) ln(#Large Trade)
UCC Information	0.026 (1.075)	-0.005 (-0.193)	0.015 (0.711)	-0.019 (-1.397)	0.088 (1.605)
Covariates	Y	Y	Y	Y	Y
Fund Comp. FE	Y	Y	Y	Y	Y
Year Quarter FE	Y	Y	Y	Y	Y
Standard Errors	Y	Y	Y	Y	Y
Observations	8,947	8,947	8,947	8,947	8,947
Adj. R-squared	0.327	0.210	0.224	0.459	0.860

What stocks do UCC hedge funds trade?

	(1)	(2)
	Large Trade	Large Trade
Econ Link FF12Ind	0.0098*** (3.271)	
Econ Link Universal		0.0104*** (3.425)
Fund Comp.-Year Qtr FE	Y	Y
Firm-Year Qtr FE	Y	Y
Observations	223,546	223,546
Adj. R-squared	0.128	0.128

Trading Profitability

Return Horizon	Portfolio: Small Trade	Portfolio: Large Trade	D(Large-Small)	t-stat
1 Qtr	0.0004	0.0064	0.0060	0.650
2 Qtr	-0.0003	0.0096	0.0100*	1.142
3 Qtr	0.0010	0.0128	0.0118**	2.435
4 Qtr	0.0003	0.0167	0.0164***	2.332
5 Qtr	0.0010	0.0192	0.0182***	2.730
6 Qtr	0.0052	0.0165	0.0113**	1.714

Conclusion and Implication

- Abnormal stock trading activities of hedge funds after their presence on UCC, manifested in higher portfolio turnover and larger trades.
- Hedge funds do not trade differently after accessing public information of bankrupt firms, and other institutional investors do not experience abnormal portfolio turnover after joining UCC.
- Hedge funds' large trades concentrate in stocks of nonbankrupt firms that have close economic linkages with the bankrupt firm.
- Hedge funds' strategic trading behavior outside of SEC regulation radar may undermine the integrity of the financial market.

Thank you!

Appendix

Section 1103 of the U.S. Bankruptcy Code

[← Back](#)

"...investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business and the desirability of the continuance of such business, and any other matter relevant to the case or to the formulation of a plan."

Sample UCC Notice

[◀ Back](#)

**NOTICE OF APPOINTMENT OF OFFICIAL
COMMITTEE OF UNSECURED CREDITORS**

William K. Harrington, United States Trustee for Region 2, pursuant to

Section 1102(a) of title 11, United States Code, hereby appoints the following

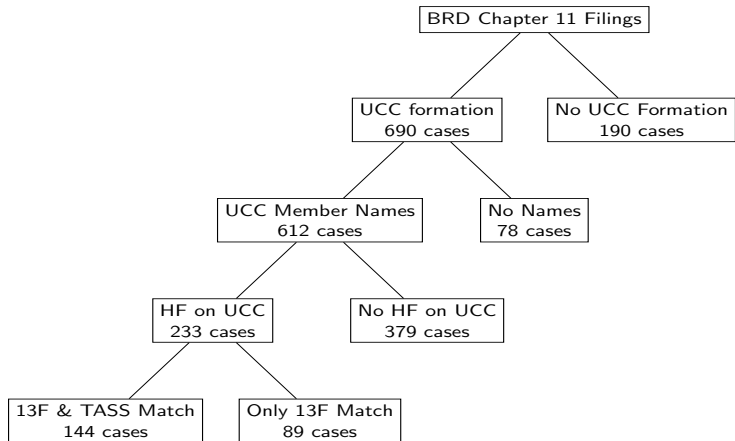
unsecured creditors that are willing to serve on the Official Committee of

Unsecured Creditors of the SunEdison, Inc. and its affiliated debtors-in-possession:

1. BOKF, N.A., as Indenture Trustee
1600 Broadway
3rd Floor
Denver, CO 80202
Contact: George F. Kubin
Telephone: (303) 864-7206
2. AQR DELTA Master Account, L.P.
2 Greenwich Plaza, 4th Floor
Greenwich, CT 06830
Contact: Melinda C. Franek, VP
Telephone: (203) 742-3007
3. Advantage Opportunities Fund, LP
1221 Brickell Ave, Suite 2660
Miami, FL 33131
Contact: Irvin Schlusell
Telephone: (914) 714-0531
4. D.E. Shaw Composite Holdings, LLC
1166 Avenue of the Americas, 9th Floor
New York, NY 10036
Contact: Martin Lebwohl
Telephone: (212) 478-0358
5. Flextronics Industrial, Ltd.
600 Shiloh Road
Plano, TX 75074
Contact: Donald Heap
Telephone: (469) 223-9726
6. Albemarle Corporation
451 Florida Street
Baton Rouge, LA 70801
Contact: Michael Lutgring
Telephone: (225) 388-7236
7. Vivint Solar, Inc.
3301 N. Thanksgiving Way, Suite 500
Lehi, UT 84043
Contact: Jim Lundberg
Telephone: (801) 234-7080

Dated: New York, New York
April 29, 2016

Sample Construction

[◀ Back](#)

Summary Statistics

[◀ Back](#)

	N	Mean	SD	P5	P25	Median	P75	P95
Size:								
Assets	144	10,921	69,834	356	646	1,375	3,728	18,511
Liabilities	144	10,114	66,666	315	579	1,342	3,519	21,967
Sales	143	2,853	7,630	102	502	925	2,436	11,032
Employees	143	8,155	12,550	144	1,650	3,400	8,500	33,500
Performance:								
ROA	134	0.007	0.243	-0.372	-0.015	0.048	0.096	0.208
Tangibility	135	0.416	0.316	0.013	0.177	0.384	0.638	0.859
Leverage	137	0.729	0.557	0.254	0.453	0.636	0.833	1.593
Secured debt/Liabilities	116	0.334	0.449	0.000	0.068	0.246	0.416	0.906
Bankruptcy Characteristics:								
Duration	144	483	485	87	197	379	578	1177
Days BKUCC	141	17	29	6	9	14	16	35

Summary Statistics

[◀ Back](#)

	N	Mean	SD	P5	P25	Median	P75	P95
High Turnover	3144	0.446	0.497	0	0	0	1	1
High Turnover Buy	3144	0.461	0.499	0	0	0	1	1
High Turnover Sell	3144	0.454	0.498	0	0	0	1	1
Large Trade	3144	0.575	0.494	0	0	1	1	1
$\ln(1+\text{Num Large Trade})$	3144	1.702	1.776	0	0	1.386	3.178	4.883
UCC Information	3144	0.144	0.351	0	0	0	0	1
Lag HF Size	3082	19.269	1.918	16.023	17.881	19.397	20.694	22.139
Lag HF Flow	3058	-0.608	4.357	-5.344	-1.829	-0.766	0.410	4.191
Lag HF Return	3082	0.793	3.362	-3.830	-0.300	0.815	1.881	5.410