Bond Case Briefs

Municipal Finance Law Since 1971

Hedge Fund Sues Pritzker to Void $14 Billion of State Debt.

• Joins with conservative think tank chief to challenge bonds
• Governor's office sees 'new tactic from the extreme right'

A hedge fund run by a protege of Appaloosa Management's David Tepper and the chief executive officer of a conservative think tank sued Illinois Governor J.B. Pritzker, saying $14.3 billion of bonds should be invalidated because their issuance violated the state constitution.

Warlander Asset Management, a New York-based hedge fund formed by Eric Cole, and John Tillman, the CEO of the Illinois Policy Institute, said the state's record pension bond sale in 2003 and debt issued in 2017 to pay a backlog of unpaid bills were deficit financings prohibited by the constitution. The lawsuit was filed Monday in Sangamon County circuit court.

The goal of the debt limits in the state constitution "was to ensure that the state's elected officials would act in a fiscally responsible manner — that they would cut spending or make structural reforms when needed, rather than continually using deficit financing to 'kick the can down the road' for future generations to resolve," the complaint said.

"The state's elected officials have done just the opposite. They have mortgaged the state's future to pay for the present."

The lawsuit comes two months after the federal board overseeing Puerto Rico's bankruptcy and a group of hedge funds sought to have more than $6 billion of the island's bonds declared null and void and shows how the island's effort to cut its debts is reverberating in the $3.8 trillion U.S. municipal-bond market. The Puerto Rico overseers want to have the debt tossed out on the grounds that it was sold after the territory breached its debt limits, a step that some analysts said could undermine confidence in a market that's seen as a haven.

Illinois officials dismissed the lawsuit, saying it was a politically motivated maneuver by small-government advocates that won't advance in court.

"It was meant to generate headlines to scare investors in the bond market for political ends before the filing is laughed out of court,'' Comptroller Susana Mendoza, who was named in the suit, said in an emailed statement. "The markets should see this as nothing more than garbage.''

Tillman's Illinois Policy Institute has been at the forefront of legal challenges to public employee unions and progressive taxation. The institute backed an Illinois employee named Mark Janus in his challenge to the constitutionality of mandatory union fees. In 2018 the U.S. Supreme Court ruled in Janus's favor, dealing a heavy blow to the labor movement.

In 2014, the institute helped defeat a movement to amend the Illinois Constitution and replace the state's flat income tax with a progressive income tax. Pritzker, a Democrat who took office this year, persuaded lawmakers to put a progressive income tax back on the ballot in 2020.

Several layers of bond counsel and the Attorney General signed off on the 2003 and 2017 bond offerings, Emily Bittner, Pritzker's Deputy Chief of Staff for Communications, said in an email.

"This is simply a new tactic from the extreme right to interfere in capital markets," said Bittner. "We're done with the far right's dangerous financial games to pull Illinois underwater. We saw this repeatedly under Bruce Rauner, who funded and executed on John Tillman's pathological focus to drive Illinois into bankruptcy."

Swelling Debts

In addition to Pritzker, the lawsuit names as defendants state Treasurer Michael Frerichs and Mendoza. Warlander owns $25 million Illinois general-obligation bonds issued in 2001, 2014, 2017 and 2018. Those bonds would be more secure if the firm succeeded in having the other securities invalidated, since there would be more money available to service the debt.

In a statement, Treasurer Frerichs called the suit a "political stunt." The governor and lawmakers passed a budget that begins to undo the financial harm done during Rauner's term, he said.

"I intend to let Attorney General Kwame Raoul do his job and ask the court to reject this absurd request from Mr. Tillman and the Illinois Policy Institute to have the courts entertain the extremist agenda that the legislature and the voting public have already overwhelmingly rejected."

Illinois has struggled for years with its debts and swelling obligations to its employee retirement system even after it sold $10 billion of bonds in 2003 in an ill-fated bid to pay down some of its obligations. Since 2000, the state's unfunded pension liability and bond debt have grown more than 600% to more than $168 billion, according to a copy of the complaint. Its credit rating is one-level above junk by Moody's Investors Service and S&P Global Ratings Inc., the worst among U.S. states.

Matt Fabian, a partner at Municipal Market Analytics, said investors shouldn't trade based on the lawsuit. Some of the pension bonds due in 2033 were little changed Monday, yielding about 4.6 percent, according to data compiled by Bloomberg.

"It's when the issuer wants to invalidate the bonds where things get worrisome," he said. "The last thing the state wants to do is default on bondholders. So even if, post-miracle, this hedge fund wins its lawsuit, the state is most likely going to do right by its lenders so as to preserve market access."

Article nine, section nine of the Illinois Constitution says the state may issue long-term debt only to finance "specific purposes" if approved by three-fifths of the legislature or by popular referendum.

The state may borrow a limited amount in anticipation of revenue or to meet unanticipated shortfalls only through short-term debt, according to the constitution. In addition, the state can refinance higher-cost debt, but only if the refunding debt matures within the term of the debt that's being retired.

In 2003, Illinois used more than $2 billion of the proceeds of its pension bond issue to reimburse the state for its required contributions in 2003 and 2004, which the lawsuit says was "simply a gimmick to mask the fact that the state was using GO bond debt to fill operating deficits."

About $8.85 billion of the pension bonds remain outstanding and they're among the most actively traded Illinois securities. Major owners include Samsung Life Insurance Co., Capital Group Cos. and Dodge & Cox, according to data compiled by Bloomberg. If the state ceases making principal and interest payments on the debt it could contribute an additional $13 billion to its pensions over the next 14 years, according to the complaint.

In 2017, the state issued $6 billion of of general-obligation debt backed by income taxes to pay off a portion of a $15.2 billion backlog of unpaid bills that had accumulated during the previous two years, when then-Governor Bruce Rauner and the legislature failed to pass a budget.

Using bond money to cover general expenses, speculate in the market, or pay past-due bills isn't a "specific purpose" for incurring state debt, but rather another name for deficit financing, the complaint said.

"The burden of servicing this unconstitutional debt fall on the taxpayers of Illinois, including Plaintiff John Tillman" and harms holders of other GO debt like Warlander by reducing the state's ability to service the debt.

Bloomberg Markets

By Martin Z Braun

July 1, 2019, 7:52 AM PDT Updated on July 1, 2019, 3:15 PM PDT

— With assistance by Boris Korby