

Bond Case Briefs

Municipal Finance Law Since 1971

Traders Shrug Off Suit Challenging \$14 Billion of Illinois Debt.

- **Citigroup calls the legal challenge by hedge fund unjustified**
- **State bond prices dipped slightly, but then bounced back**

A lawsuit Monday seeking to have \$14.3 billion of Illinois bonds thrown out by a court lit up the phone lines of Wall Street trading desks, where analysts fielded calls from investors worried about the odds their investment in the state's debt could be worthless.

But trading prices show bondholders see little chance that the legal challenge will succeed.

Taxable Illinois debt issued in 2003, which was targeted in the lawsuit, slipped early Tuesday, when a customer sold \$5 million worth for about 103 cents on the dollar, down from an average of 104.5 cents Monday. They swiftly rebounded, however, rising back to 103.8 cents by mid-morning to yield 4.73 percent.

That yield is nearly a full percentage point less than what it was at the start of the year, before Illinois bonds rallied as Democratic Governor J.B. Pritzker paved the way for an income tax increase on the highest earners and ended the political gridlock that dogged his Republican predecessor.

"Illinois had rallied very hard, it was more sensitive to downside recently, but the show of support once it did gap wider also shows the market's lack of belief that this has legs," said Gabe Diederich, municipal-bond fund manager for Wells Fargo Asset Management, which holds Illinois debt among its investments.

Pritzker and Illinois Comptroller Susana Mendoza dismissed the lawsuit as a political tactic by John Tillman, the chief executive officer of the Illinois Policy Institute, a conservative think tank, that will be tossed out of court. The case, also filed by New York hedge fund Warlander Asset Management claims 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.

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.

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. Warlander and Tillman argue that deficit financing isn't a "specific purpose" and doesn't encompass the general purposes for incurring debt discussed in the constitution, such as refinancings or short-term borrowing to paper over temporary cash shortfalls until tax revenue comes in.

Analysts are skeptical. Citigroup Inc.'s Vikram Rai and Jack Muller published a note on the case after the bank was inundated with calls. They said the lawsuit is unjustified because the Illinois Constitution allows debt to be incurred as long as the law details the specific purpose of the debt

and how it will be repaid. Even if it did succeed, they said, the government would likely find a way to repay the debt to avoid being penalized in the bond market.

"The state will not want to pay zero to the bond holders as it was never their intent to harm the investors," Rai and Muller wrote. "They are more likely to want to make the bond holders whole even if that entails amending the constitution."

Jason Appleson, a portfolio manager at PT Asset Management LLC, said he believed market consensus is that the lawsuit was frivolous.

"I was somewhat surprised to see the initial market reaction that spreads widened out, I would have expected the reaction to be a bit more muted," he said.

Appleson attributed the initial widening to "a couple of scared buyers" affecting a light trading day in a slow market. "If this moves forward in court, I think we could see some more widening but if it's shut down we could see a snap-back in spreads given the market conditions."

Bloomberg Markets

By Martin Z Braun and Danielle Moran

July 2, 2019, 10:50 AM PDT

Copyright © 2026 Bond Case Briefs | bondcasebriefs.com