Bond Case Briefs

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Hedge Fund Seeking to Void Illinois Debt Made Wager on Default.

- **Warlander bought derivatives that would pay if state defaults**
- **Lawyer confirms allegations made by Nuveen, AllianceBernstein**

Warlander Asset Management, the hedge fund seeking to invalidate $14.3 billion of Illinois bonds, bought derivatives that will pay off if the state defaults on the debt.

An attorney for Warlander's co-plaintiff, John Tillman, the chief executive officer of the Illinois Policy Institute, disclosed the firm's derivative wager at a hearing in Springfield on Thursday. That confirms the assertion made by two big bond investors, Nuveen Asset Management LLC and AllianceBernstein, in a brief arguing that the case should be tossed out — saying it raises questions about Warlander's motives.

"Permitting activist investors to litigate against the validity of widely held municipal bonds based on their credit default swap bets could introduce a significant destabilizing force into the municipal markets and harm investors and government entities alike," Nuveen and AllianceBernstin said in their filing on Friday.

The credit default swap market for municipal bonds is thinly traded, given that no state has reneged on its debts since the Great Depression. But the price of those for Illinois have risen since the lawsuit was filed at the start of July: The cost to protect against losses on the state's bonds for five years has jumped by 41 basis points to 186.5 basis points, or $186,500 annually for every $10 million insured, according to IHS Markit.

An Illinois judge Thursday said he needed more time to review Tillman's petition. The complaint claims the state's record pension bond sale in 2003 and debt issued in 2017 were deficit financing prohibited by the state's constitution. Although Warlander is a plaintiff in the case, it didn't petition the court to file a taxpayer complaint.

Illinois taxpayers would save $20 billion in debt service payments if the court finds elected officials violated the constitution, the plaintiffs have said. Warlander has said there's nothing improper about an investment firm having a financial interest in litigation. Warlander previously disclosed they had a financial interest in the case, but didn't provide details about the nature of the interest.

John Thies, Tillman's attorney, didn't disclose the amount of CDS owned by Warlander, and a spokesman for the firm declined to as well.

A credit-default swap contract is similar to insurance on a bond, but the purchaser doesn't need to own any of the underlying debt to buy one. The swap purchaser can buy the bonds after they default and then tender them to the swap seller to get full payment on the contract.

Warlander also owns $25 million of Illinois general-obligation bonds that would be more secure if the firm succeeded in having the other securities invalidated.

Bloomberg Technology

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August 15, 2019, 12:44 PM PDT