Bond Case Briefs

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NYT: How the Big Tobacco Deal Went Bad.

SAN BERNARDINO, Calif. — WHEN was the last time you saw an anti-smoking ad?

In November 1998, the tobacco industry and 46 states reached what is known as the Tobacco Master Settlement Agreement (four states reached separate settlements). This group deal exempted the industry from legal liability for the harm caused by tobacco use. In return, the tobacco companies agreed to make annual payments, in perpetuity, to the states to fund anti-smoking campaigns and public health programs. The industry guaranteed a minimum of $206 billion over the first 25 years.

While a requirement that the states use these funds as intended was not written into the agreement, it was anticipated that they would do so.

They haven't.

Only a small fraction of the money has gone to tobacco prevention. Instead, the states have used the windfall for various and unrelated expenditures. In Alaska, $3.5 million in settlement money was spent on shipping docks. In Niagara County, N.Y., $700,000 went for a public golf course's sprinkler system, and $24 million for a county jail and an office building. And in North Carolina, in the ultimate irony, $42 million of the settlement funds actually went to tobacco farmers for modernization and marketing.

But that's not all: Nine states — Alaska, California, Iowa, Michigan, New Jersey, New York, Ohio, Rhode Island and West Virginia — and Washington, D.C., Puerto Rico and Guam decided to get as much of those annual payments as fast as they could by mortgaging any future payments as collateral and issuing bonds. They traded their future lifetime income for cash today — at only pennies on the dollar.

A typical bond is like an interest-only loan with a balloon payment in 30 years. But to avoid having to pay yearly interest payments, these 12 chose to issue capital appreciation bonds, deferring all interest payments and repayment for up to 50 years. Then the entire amount is due — with no plans made as to how it will be repaid. By the time these bonds come due, the legislators who approved them will be retired or dead.

Because of the high probability that these bonds will not ever be repaid, they had to be sold at well under their original $1,000 face value in order to attract investors. The 12 issued $22.6 billion in bonds, receiving only $573.2 million in cash. With compounded interest, they will have to repay $67.1 billion. Imagine borrowing $200,000 to buy a house today and your children having to pay back $234 million in 40 or 50 years. That's the scale of this problem. And some of the states went even further: Michigan will have to pay back more than 1,800 times the amount it borrowed.

The ownership of these bonds rests primarily with banks and mutual funds. According to Cezary Podkul, an investigative reporter for ProPublica, who has reported on this story (I helped ProPublica analyze the documents), these institutional investors are betting that the states will step in and bail out these bonds with some combination of all future settlement payments and taxpayer dollars. The idea is that the states won't risk the stigma of a default and will protect their relationships with the institutional investors and the bond brokers who also handle their municipal bonds. They will do this by sticking future taxpayers with the bill.

Looking at the continuing decline in cigarette sales and the corresponding payments, many analysts, including me, believe that defaults will begin to materialize by 2026. If all of the 12 try to stave this off and guarantee their bonds by pledging future tax or bond revenues, the investors will receive a breathtaking profit of 11,708 percent.

This isn't just a "what if" scenario: New Jersey and Rhode Island have already taken steps to reissue bonds with a guarantee of all their future tobacco settlement payments. Rhode Island is now being sued by Oppenheimer Funds to prevent this reissue, claiming that the state intends to divert some $20 million from earlier bondholders, including Oppenheimer. And as a result of New Jersey's guarantee of its bonds, with its implications for the future, its credit rating has been downgraded by Wall Street twice this year, from stable to negative.

The only people making money on these bonds are investment bankers who fooled state politicians into believing that ready money in their state coffers now was more important than any future consequences. The fact that only these 12 issued bonds tells us that a vast majority of states thought this was a dumb idea.

It won't be easy to fix it. The state legislatures are the only ones that can refuse to authorize a bailout or a guarantee of the bonds, and yet despite the ominous examples of Rhode Island and New Jersey, there is still active discussion of guarantees by other states. The only possible solution seems to be direct action by the voters — in the name of future taxpayers — who could call for and pass a referendum prohibiting the issue of new tobacco settlement bonds and stopping the restructuring of existing bonds without voter approval.

And as for those no-smoking ads? Tobacco-Free Kids reports that all together, the states will spend just 1.9 percent of their settlement payments and tobacco taxes on prevention programs this year. So don't hold your breath.

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By JIM ESTES

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