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Hedge Fund Challenges $14 Billion in Illinois Debt as Unconstitutional.

New lawsuit mirrors tactics by Puerto Rico's financial oversight board to drive down public debt

A hedge-fund manager claiming Illinois has piled up more debt than its constitution permits is suing Gov. J.B. Pritzker and other state officials in an effort to wipe out $14.3 billion in municipal bonds.

New York-based Warlander Asset Management LP and John Tillman, chief executive of the conservative Illinois Policy Institute think tank, said Illinois broke a state rule prohibiting deficit financing by selling debt in 2003 to close a pension gap and in 2017 to pay down government vendors.

Warlander, which holds $25 million in other Illinois bonds, said the outstanding portions of the 2003 and 2017 debt sales should be declared "unconstitutional and unenforceable." The Illinois constitution bars the state from taking out long-term debt except for "specific purposes" or to refinance longer-term debt, according to the complaint filed Monday in Sangamon County Circuit Court.

Illinois instead borrowed to bridge deficits and to speculate on financial markets, the lawsuit said, lowering the state's creditworthiness and heightening the likelihood of default.

No U.S. state has failed to pay bondholders since Arkansas in 1933, although the U.S. island territory of Puerto Rico defaulted in 2016 and was later placed under a court-supervised bankruptcy.

Emily Bittner, a spokeswoman for Mr. Pritzker, said the lawsuit "is simply a new tactic from the extreme right to interfere in capital markets." Several layers of bond attorneys and former Attorney General Lisa Madigan signed off on the bond offerings, Ms. Bittner said.

The complaint mirrors ongoing efforts by the board overseeing Puerto Rico's tattered public finances to drive down bondholder claims. In January, the board filed court papers arguing that $6 billion in general obligation bonds should be considered worthless because they layered more debt on Puerto Rico than its constitution allowed.

While no court has ruled on those arguments, a bankruptcy-exit framework proposed by the board last month takes them into account and offers a comparatively lower recovery to investors whose claims have been challenged.

Unlike Puerto Rico, Illinois lacks a bankruptcy mechanism to push bondholders into a centralized court proceeding to hammer out restructuring terms. But the state's finances have been stressed for years, pushing its bond rating to the lowest among U.S. states as pension obligations ballooned and a budget stalemate under former Gov. Bruce Rauner from 2015 to 2017 racked up billions of dollars in unpaid bills.

Illinois Comptroller Susana Mendoza, who was also named as a defendant in Monday's lawsuit, said in a statement that the 2017 bond sale helped pay down vendor bills stemming from the budget stalemate and lowered the state's interest rate on that debt to 3.5% from 12%, saving taxpayers billions of dollars. She said the complaint was meant "to scare investors in the bond market for political ends."

While state and local governments nationwide are grappling with how to cover bond payments, pension benefits and infrastructure needs, few are as strained as Illinois, where state courts have largely barred lawmakers from scaling back retirement obligations.

Illinois has found willing lenders despite its precarious finances, demonstrating how investors' appetite for returns can help governments borrow even with credit ratings teetering on junk territory.

Yet analysts have questioned how long the municipal market will continue lending to Illinois at reasonable rates, especially if the economy dips into recession and the state's tax base shrinks. Warlander said interest and principal payments on the 2003 and 2017 bonds will eat up $20 billion over the next 14 years, roughly half the state's overall scheduled debt service.

"Debt service payments on unconstitutional debt like the challenged bonds are an unconstitutional misuse of public funds that will cause irreparable harm to Illinois taxpayers," the lawsuit said.

The 2003 bond sale, still the largest ever by any city or state, generated $10 billion for the Illinois pension systems but didn't solve their funding problem. The persistent shortfall prompted discussion last year of another pension bond more than 10 times as large, though the proposal didn't gain momentum.

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By Andrew Scurria

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—Gunjan Banerji and Heather Gillers contributed to this article.

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