

Bond Case Briefs

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Investor Behind Illinois Bond Suit Made Short Bet Tied to Case, Funds Claim.

- **Nuveen, AllianceBernstein say Warlander bought default swaps**
- **Warlander filed lawsuit seeking to void Illinois debt in court**

A hedge fund that filed a lawsuit seeking to have \$14.3 billion of Illinois bonds invalidated in court stands to reap enormous profit if the case succeeds and the state defaults on the debt, Nuveen Asset Management LLC and AllianceBernstein LP alleged in a court filing.

New York City-based Warlander Asset Management purchased credit-default swaps that will pay off if the lawsuit causes a default, according to Nuveen and AllianceBernstein, which together own about \$2 billion of Illinois bonds, including those challenged in the case.

“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 AllianceBernstein said in a brief filed Friday in Illinois Circuit Court.

Warlander said in a filing Tuesday that there’s nothing improper about an investment firm having a financial interest in litigation and called the funds’ friend-of-the-court brief an “unjustified attack.” The filing didn’t provide details about the nature of that financial interest.

Warlander and the chief executive officer of the Illinois Policy Institute, a conservative think tank, sued Illinois Governor J.B. Pritzker on July 1, saying the state’s 2003 pension bonds and 2017 debt sold to pay bills were deficit financings prohibited by the state constitution. Both issues were done before Pritzker took office this year.

Warlander, which owns \$25 million of Illinois general-obligation bonds that would be more secure if the firm succeeded in having the other securities invalidated, disclosed in a footnote in its complaint that it also had a “separate financial interest” in the litigation. That separate financial interest involves credit default swaps “well in excess of its nominal \$25 million bond position,” Nuveen and AllianceBernstein said, without providing specific evidence.

Warlander’s financial interest has no bearing on a Thursday hearing in circuit court of Sangamon County on whether John Tillman, the CEO of the Illinois Policy Institute, has standing to file a taxpayer complaint, the hedge fund said in its court filing. Although Warlander is a plaintiff in the case it didn’t petition the court to file a taxpayer complaint.

“Though Warlander’s motives are not an issue, they are of no malice to the state. A complaint can hardly be ‘malicious’ when its goal is both to require the state’s elected officials to act within the bounds of its constitution and to relieve the state of \$20 billion in debt service obligations — which would clearly benefit the state.”

Nuveen and Alliance Bernstein want the court to require Warlander to disclose the nature, terms

and extent of its separate financial interest “so that the court can determine whether the petition is filed not to vindicate the interests of Illinois taxpayers but to allow an out-of-state hedge fund to create a default and profit from the swaps,” Nuveen and AllianceBernstein said.

If Warlander’s true financial interest lies in creating a default so it can profit, then the lawsuit was filed with a “malicious or ulterior purpose” and the court should reject it, Nuveen and AllianceBernstein said.

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.

Credit-default swaps on Illinois general-obligation bonds exceeded \$300 million at the end of June, according to International Swaps and Derivatives Association data. The cost to protect against losses on Illinois bonds for five years has jumped 41 basis points since July 1 to 186.5 basis points, or \$186,500 annually for every \$10 million insured, according to IHS Markit.

The lawsuit has already impaired Illinois bond prices and made it difficult for the state to issue new securities, the funds said.

The spread on Illinois’ 2003 and 2017 general obligation bonds rose to 182 basis points from 134 basis points, and the trading price dropped relative to the broad market, after the Warlander suit was filed, according to Nuveen and AllianceBernstein. Benchmark Illinois bonds are trading with a 3.03% yield, the highest among 20 states tracked by Bloomberg, and about 172 basis points more than top-rated debt, according to Bloomberg data.

Holders of the bonds had a paper loss of \$574 million after the lawsuit was filed, the funds said. Illinois postponed until the fall a general-obligation bond sale to pay more bills.

Warlander’s suit is based on an incorrect reading of the Illinois constitution, Nuveen and AllianceBernstein said. Article nine, section nine of the 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.

A “specific purpose” refers to a description, not a limitation on the power to incur debt, the funds said. The three-fifths vote requirements acts as a limitation on the ability to borrow.

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, Warlander said in its original complaint.

The drafters of Illinois’ 1970 Constitution didn’t intend to allow the state to incur unlimited general obligation debt for any purpose, the hedge fund said.

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