Clients&FriendsMemo

Illinois Judge Holds That Courts Cannot Rule Retroactively on Validity of State Debt

September 5, 2019

On August 29, 2019, an Illinois court denied a petition by a political activist and a hedge fund seeking leave to file a lawsuit claiming that approximately $16 billion of Illinois's general obligation bonds ("***GO Bonds***") were issued in violation of the state constitution.[1] Judge Jack D. Davis, II, sitting in a circuit court in the state capital of Springfield, held that the challenged bonds did not violate a provision of the Illinois Constitution requiring long-term debt to be for a "specific purpose," because the legislation authorizing the issuances had, in fact, "stated with reasonable detail the specific purposes for the issuance of the bonds."[2] Judge Davis also held more broadly that the validity of the bond issuances constituted "a non-justiciable political question" such that for a court to rule on the issue "would be improper and would violate the separation of powers."[3] Given the breadth of the ruling, it seems likely that Judge Davis wanted to preclude similar debt invalidation challenges in the future, thereby shielding Illinois and the bond markets more generally from the destabilizing effects of legal challenges to already-issued public debt.[4]

Background

Under Illinois law, private citizens have standing to bring actions in their capacity as taxpayers to enjoin the disbursement of public funds for improper purposes. *See* 735 ILCS 5/11-303. Before bringing such an action, however, a private citizen first must file a petition seeking leave from a court. *Id.*

On July 1, 2019, a prominent political activist, John Tillman ("***Tillman***"), filed such a petition in his capacity as an Illinois taxpayer. The proposed complaint attached to the petition also identified New York-based hedge fund Warlander Asset Management, L.P. ("***Warlander***") as a plaintiff in the

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[1] *Tillman v. Pritzker*, Case No. 2019-CH-000235 (Cir. Ct. Sangamon Cnty., Ill. Aug. 29, 2019).

[2] *Id.*

[3] *Id.*

[4] Judge Davis also was aware that the hedge fund that helped bring the challenge held credit default swaps ("***CDS***") that would pay off upon a default on the challenged bonds, which may have provided an "ulterior purpose" for the fund's participation in the litigation.

proposed action. The complaint primarily alleged that Illinois's 2003 and 2017 GO Bond issuances violated two interrelated provisions of the Illinois Constitution, one of which requires long-term debt to be for a "specific purpose" (Il. Const. art. IX, § 9) and one of which mandates a balanced budget by providing that appropriations may not exceed available funds (Il. Const. art. VIII, § 2).

"Specific Purposes" Requirement (Il. Const. art. IX, § 9)

Article IX, Section 9 of the Illinois Constitution authorizes the incurrence of long-term debt upon either (i) a three-fifths vote of the members of each house of the Illinois General Assembly or (ii) approval by the "majority of the electors" voting in a general election, but in either case requires that such long-term debt be for a "specific purpose." *See* Il. Const. art. IX, § 9(b). Specifically, Section 9(b) of Article IX provides: "Any law providing for the incurring or guaranteeing of debt shall set forth the specific purposes and the manner of repayment." *Id.*

The central issue in the litigation, therefore, was the meaning of the phrase "specific purposes." The complaint initially alleged that "specific purposes" include only "specific projects in the nature of capital improvements, including roads, buildings, and bridges." *See* Complaint § 27. The complaint further alleged that the 2003 issuance of "Pension Funding Bonds" failed to satisfy this "specific purposes" requirement, because it allocated bond proceeds to be used to reimburse the State's General Fund for past contributions to the State's retirement systems and to effectively pre-fund the State's future contributions to the State's retirement systems, which otherwise would have been payable from the General Fund. *See* Complaint § 56. The complaint similarly alleged that the 2017 issuance of "Income Tax Proceed Bonds" failed to satisfy this "specific purposes" requirement because it allocated bond proceeds to be used to pay past due bills related to general operating expenses. *See* Complaint § 19.

In its objection to the petition, the State of Illinois disputed the plaintiffs' narrow interpretation of the phrase "specific purposes," citing Illinois Supreme Court precedent to the effect that the "specific purposes" requirement merely requires laws authorizing bond issuances to "define *in reasonable detail* how the funds from the sale of bonds are to be expended and the objectives to be accomplished." *See* Objection at 4 (citing *People ex. rel. Ogilvie v. Lewis*, 49 Ill. 2d 476, 484 (1971)). The State rejected the argument that "specific purposes" include only projects in the nature of "capital improvements." *See* Objection at 7.[5]

"Balanced Budget" Requirement (Il. Const. art. VIII, § 2)

The complaint also alleged that the 2003 and 2017 bond issuances violated the "balanced budget requirement" found in Article VIII, Section 2 of the Illinois Constitution, which provides: "Proposed

[5] In addition, the State challenged Warlander's standing to act as a plaintiff on the grounds that Warlander is not an Illinois taxpayer. *See* Objection at 18. The State also asserted defenses based on the plaintiffs' tardiness in challenging the bond issuances, including based on (i) laches (Objection at 11) and (ii) the general five-year statute of limitations for "all civil actions not otherwise provided for" (*see* Objection at 13, citing 735 ILCS 5/13-205).

expenditures shall not exceed funds estimated to be available for the fiscal year as shown in the budget" (§ 2(a)) and "Appropriations for a fiscal year shall not exceed funds estimated by the General Assembly to be available during that year" (§ 2(b)).

The complaint interpreted this "balanced budget" requirement as prohibiting deficit financing to fund general operating expenses, and it viewed the purposes for which the 2003 and 2017 bond proceeds were used as the equivalent of general operating expenses for which deficit financing was prohibited. *See*, *e.g.*, Complaint §§ 34-36, 61.

In response, the State argued in its objection that the plaintiffs' "balanced budget" argument presented a non-justiciable "political question," because Article VIII, Section 2 grants the General Assembly the exclusive authority to estimate funds available for a particular fiscal year and to make appropriations based on those estimates. In the State's view, the Court lacked the authority to interfere with the General Assembly's determination of these issues. *See* Objection at 14-17.

In his reply, Tillman clarified that he was "not asserting a separate violation" of the "balanced budget" clause, and that the proposed complaint mentioned that clause only "as background for interpreting" the "specific purposes" requirement of Article IX, Section 9. *See* Reply at 16. As a result, the plaintiffs' challenge to the validity of the debt ultimately depended entirely on the viability of their "specific purposes" argument.

Allegations regarding "Ulterior Purpose"

It is also worth noting that two holders of challenged bonds, Nuveen Asset Management, LLC and AllianceBernstein, L.P., filed an *amicus* brief in which they alleged that Warlander had an "ulterior purpose" for joining the litigation. Although Warlander's stated basis for its standing in the complaint was that it was a holder of $25 million of non-challenged bonds that the State allegedly would have difficulty paying as a result of its obligation to make payments on the challenged bonds, Warlander acknowledged in a footnote that it also "held a separate financial interest in this litigation" distinct from its bond holdings. In their brief, the *amici* alleged that this "separate financial interest" consisted of "credit default swaps Warlander purchased that will pay off if this action causes Illinois to default" on any of its GO Bonds. Warlander's counsel subsequently acknowledged at a hearing on August 15, 2019, that Warlander did in fact hold CDS.

The Court's Order

In keeping with the plaintiffs' concession that the "specific purposes" requirement effectively formed the exclusive basis for their challenge to the bonds, Judge Davis focused on that issue in his order denying the petition. To assess the 2003 and 2017 bond issuances' compliance with the "specific purposes" requirement, Judge Davis reviewed the legislation authorizing those issuances in light of the Illinois Supreme Court's decision in *Ogilvie v. Lewis*, which the State had discussed prominently in its objection. Based on this precedent, the Court found that the legislation "stated with reasonable detail the specific purposes for the issuance of the bonds . . . as well as the objectives to be accomplished by enactment of the legislation." In the Court's view, the "stated specific purpose" for issuing the 2003 bonds had been "to contribute to funding the State's five pension systems," and the "stated specific purpose" for issuing the 2017 bonds had been "to make good on health insurance vouchers the State promised to pay to vendors." The Court criticized the plaintiffs for attempting to "ignore the plain language of the statutes in question" identifying these "specific purposes." The Court also deplored the fact that the plaintiffs' proposed complaint was "chock-full" of irrelevant conclusory and argumentative statements, adding that the complaint resembled "a political stump speech" more than a "legal pleading." The Court also emphasized that the bond issuances had been approved by the requisite three-fifths majorities in both houses of the state legislature.

The Court did not separately address the "balanced budget" argument, but did appear to build on the State's "political question" arguments from the briefing on that issue in holding that the plaintiffs were asking the Court "to address a non-justiciable political question and substitute its judgment for the Illinois Legislature some two decades after it occurred." While it is possible that the Court's "political question" holding related only to the "balanced budget" issue, the Court did not explicitly limit its holding to that issue. Therefore, the more plausible reading appears to be that the Court viewed the validity of the debt itself, at least to the extent that it might be challenged under either Article VIII or Article IX of the Illinois Constitution, to be a non-justiciable "political question." By invoking the "political question" doctrine in this expansive manner, Judge Davis appears to have denied the petition on one of the broadest conceivable grounds, thereby leaving little, if any, room for future litigants to attempt to bring a similar debt validity challenge based on the same provisions of the Illinois Constitution.

The Court's order did not directly address the accusations by *amici* regarding Warlander's "ulterior purpose" with respect to its CDS position, but did acknowledge in a footnote that "Warlander . . . has a separate financial interest in this litigation." This remark and Judge Davis's questioning at the August 15 hearing reveal that he was cognizant of the CDS issue, even though it did not play a direct role in his rulings.

On September 3, 2019, Tillman filed a notice of appeal indicating that he intended to pursue an appeal of the Court's order in the Illinois Fourth District Appellate Court.

Conclusion

In modern public finance, the dominant view is that public debt generally cannot be invalidated retroactively once issued. This view makes sense from a policy perspective, because the threat of retroactive invalidation could destabilize the bond markets, increase borrowing costs for government issuers, or even make it impossible for states and municipalities to borrow at all.

The *Tillman* petition initially was viewed as part of a possible trend of new litigation challenging this long-standing policy against retroactive invalidation. If there ever was such a trend, however, the Court's ruling in *Tillman* suggests that it may be short-lived. Although the *Tillman* petition appeared to have some intuitive grounding in the traditional notion that long-term public debt should be issued only for capital improvements and not for general operating expenses, the language of the Illinois Constitution—with its vague reference to "specific purposes"—did not ultimately support the conclusion that long-term debt could be issued *only* for capital improvements. Instead, the Court read the Illinois Constitution's reference to "specific purposes" as being satisfied whenever the legislature identifies in "reasonable detail" the purposes for which bond proceeds are to be used.

The Court's reading of the "specific purposes" requirement accords well with its holding that the validity of the debt constituted a "political question," as well as with the Court's emphasis on the fact that the relevant legislation had passed by three-fifths majorities in both houses of the state legislature. The Court's interpretation of "specific purposes" tends to suggest that the purpose of that requirement is to permit legislators to cast an informed vote on proposed bond legislation, and that taxpayers' primary protection against fiscal irresponsibility lies in the requirement that new debt issuances be approved by legislative supermajorities (or by voter referendum) rather than in any *substantive* limitation on the types of purposes for which debt can be issued. In that regard, the "specific purposes" requirement in the Illinois Constitution is similar to provisions in other state constitutions that are designed to ensure that legislators have clear notice of the contents of the bills on which they are acting, including, for example, constitutional provisions requiring that the subject matter of a bill be identified in its title. By the same token, taxpayers' primary remedy against fiscal irresponsibility is at the ballot box, rather than in the courts, as reflected in the Court's ruling that the validity of debt under the state constitution constitutes a "political question" over which the courts lack jurisdiction.

While the *Tillman* Court's rulings appear sound from both a policy and a legal perspective, the plaintiffs' inability to invalidate a portion of Illinois's debt load through litigation does leave open the question of what measures Illinois or the federal government may need to take in the future to relieve the financial distress of Illinois and similarly debt-burdened states.

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