Behind New Jersey's Tobacco Bond Bailout, A Hedge Fund's $100 Million Payday

When New Jersey decided to bail out some of its tobacco bonds, the state gave up $400 million in future revenues to pocket $9: million immediately, an arrangement that also helped one savvy investor cash in on a big bet.

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New Jersey Treasurer Andrew Sidamon-Eristoff's office raised $92 million through a deal that bailed out two bond issues headed for default. But a hedge fund made more money from its big bet on the rescued bonds than the state's taxpayers. (Peter Foley/Bloomberg via Getty Images)

TRENTON, N.J. – When state Treasurer Andrew Sidamon-Eristoff briefed lawmakers on New Jersey's ailing budget in April, he brought good news. His office had just raised a welcome $92 million thanks to a deal that bailed out two bond issues headed for default.

New Jersey had no legal obligation to make good on the debts, which were backed by payments from a national settlement with the nation's leading tobacco companies. But Sidamon-Eristoff said the bailout was a "no brainer" because it protected the state's reputation with lenders and raised badly needed cash.

An examination of this transaction by ProPublica shows that the argument for the deal was far from clear cut. As it bailed out bond investors, New Jersey traded away an estimated $400 million in future tobacco revenues that would have flowed into state coffers starting in 2017.

One undeniable winner, however, was Claren Road Asset Management, a New York

hedge fund that walked off with more than $100 million in profits from its investment in the debt, according to interviews with deal participants, an analysis of the bonds' trading data and previously undisclosed public records.

Records and interviews show that Claren Road bought up the bonds when they were heavily discounted and sold them after the bailout substantially raised their value.

A spokesman for Washington D.C.-based Carlyle Group, the majority owner of Claren Road's management company, declined to comment on the profit estimate.

How could a hedge fund make more money from the bailed-out debt than New Jersey's taxpayers?

It's eminently possible in the tangled world of tobacco bonds, where dozens of states and municipalities borrowed heavily against future proceeds from the landmark 1998 tobacco settlement.

The money was intended to reimburse state governments for the past and future costs of smoking. In exchange for immediate cash, governments sold bonds that entitled investors to collect some or all of their annual settlement payments, often promising huge lump-sum payouts decades from the date of issue.

Now, nearly all of those bonds are careening toward default because of a steeper-than-expected drop in smoking. The tobacco settlement payments to governments are tied to cigarette sales, so there is not enough money to pay off the vast amounts promised on the bonds.

New Jersey's case illustrates the difficult choices the governments now face. If they let the bonds default, investors are entitled to keep collecting the tobacco payments they were promised until the debt is satisfied. The alternative is to cut new deals with bondholders, which also comes at a cost.

In recent months, two New York counties completed bailouts that gave bondholders more money than went to the governments. Iowa and Virginia have also been pitched rescues, while Rhode Island has put a deal with Claren Road on hold after another bondholder filed a lawsuit opposing the plan.

New Jersey's is the biggest rescue to date and remarkable for its novel structure – a two-step refinancing engineered by bankers from Barclays Capital. The bankers brought the deal to the treasurer's office and reaped

How the Deals Worked

Here's how Claren Road made more than $100 million from its venture into New Jersey's junkiest tobacco bonds.

January 2007: As part of a $3.6 billion bond issue, New Jersey issued two capital appreciation bonds, or CABs, backed by its share of the 1998 tobacco settlement. Investors who buy CABs do not get paid cash interest over time. Instead, their investment compounds into a big amount due at maturity. In New Jersey's case:

- The 1B CAB raised $126 million from investors and promised to repay $855 million at maturity in 2041
- The 1C CAB raised $60 million from investors and promised to repay $426 million at maturity in 2041

Series 2007-1B CABs:

February 2011: Starting in 2011, Claren Road Asset Management bought up 95 percent of the 1Bs, or about $809 million of the amount due on the Series 2007-1B CABs at maturity. Trading data indicates it paid on average about 5 percent of the maturity value. That includes a $615 million it bought in February 2011 for about 3.8 percent of maturity value.

March 2014: New Jersey decided to enhance the CABs with a pledge of additional money. Claren Road sold its holdings of the 1Bs to the state for about 15 percent of the $809 maturity value it held, producing a profit of about $80 million. Then, after the state enhanced the bonds, Claren Road bought them back at around 21 percent and resold them in the open market for about 24 percent, netting close to $28 million in additional profit.

$4.5 million in fees, in part for "developing the idea," according to a pitch document.

Claren Road, which has $7.3 billion under management, began buying up New Jersey's riskiest tobacco bonds in 2011. The bonds, called capital appreciation bonds, or CABs, could be bought at a massive discount because they called for a $1.3 billion payment in 2041, an amount that is now improbable given falling cigarette sales.

Enter the rescue plan.

First, Claren Road and a few other investors sold the New Jersey bonds they held back to the state for a premium over market prices. After the state pledged to pay bondholders an estimated $400 million in tobacco revenues, the investors bought the bonds back at a higher price.

The state received $92 million after fees, and Claren Road was then able to flip the improved bonds on the open market for additional profit.

Total estimated profit: about $108 million.

Series 2007-1C CABs

March 2014: Claren Road also owned about $196 million of the $426 million due on the 1C tobacco CABs. It had to pay an above-market price for most of that stake, $176 million, in order to facilitate the enhancement transaction. It sold those $176 million of 1Cs to the state at a loss, much or all of which it recouped by reselling the enhanced 1C bonds into the market for more than it paid the state for them. To be conservative, we're assuming that Claren Road broke even on these bonds, even though it is likely that it showed a small profit on them.

Total estimated profit: $0 (break even)

Grand total: More than $100 million across both series of CABs.

Sources: ProPublica, based on CAB trading data from the Municipal Securities Rulemaking Board, fund holdings data from Morningstar; deal documents obtained under public records requests; and background conversations with people familiar with the transactions.

The New Jersey Treasury said the bailout secured tobacco revenue for the future while preserving the state's standing with investors. Had the bonds defaulted, most of the state's tobacco money from 2041 to 2049 would have gone to make good on the debt, the Treasury said. By repaying early, New Jersey made sure that future settlement payments will flow into its general fund. The state valued the net savings, including the $92 million in immediate cash, at $137 million in today's dollars, a Treasury spokesman said in answer to questions from ProPublica.

Public finance experts consulted by ProPublica, however, cautioned that the projected benefit to New Jersey was unlikely to materialize in the amounts expected. Cigarette sales, for one, have proven notoriously difficult to predict even over a few years, let alone decades.

"Tax policy, health care, incentives, smoking bans ... Smoking demand is hard to forecast even if none of this stuff happened," said Daniel Smith, a professor of public budgeting at New York University, who reviewed the state's cash projections for ProPublica.

Given the uncertainty, some question whether the state really is better off trading away $400 million in near-term tobacco payments to recapture what may be a far weaker revenue stream in nearly 30 years' time.

"It's like trading your new BMW for a Yugo," said Gordon MacInnes, head of the nonpartisan think tank New Jersey Policy Perspective. "The immediate beneficiaries are speculators in junk bonds. The big losers are New Jersey's taxpayers."

'Distinctly Horrible' Bonds

New Jersey, like 45 other states that signed on to the 1998 accord with cigarette manufacturers, was originally going to be a big winner. The settlement meant some $250 million flowing each year to state taxpayers to reimburse them for smoking-related

health care costs.

The windfall touched off a rush of borrowing by states eager to get the cash upfront rather than collect annual payments. To do so, they sold bonds – including the capital appreciation bonds, or CABs, that were at the center of New Jersey's rescue.

These were no ordinary bonds.

Unlike regular bonds, CABs don't make annual cash interest payments, instead letting what's owed add up over years into a hefty tab, often due decades later.

As ProPublica has reported, states, territories and local governments pledged to repay $64 billion of future tobacco money in return for $3 billion they raised using CABs. About $186 million of that was cash New Jersey received by issuing its two series of CABs back in 2007, with a promise to pay a lump sum of $1.3 billion in 2041.

At the April hearing, Sidamon-Eristoff minced no words describing what a bad choice that was.

"CABs are – for good reason – known as a distinctly horrible means of public finance. They are bad policy," said Sidamon-Eristoff, who wasn't treasurer when the CABs were issued. "Everybody knew it then, everybody knows it now. But that's the situation that we've inherited."

Unlike other governments that issued tobacco bonds, however, New Jersey was in a better position. The 2007 CABs were part of a larger, $3.6 billion deal to refinance older tobacco bonds that required the state to pay out 100 percent of its annual settlement money. Refinancing freed the other 24 percent for the budget.

The 2007 transaction was led by Kym S. Arnone, a banker at Bear Stearns who later moved on to Barclays. Now also the chair of the Municipal Securities Rulemaking Board, the industry's self-regulator, Arnone over the years has become one of the most active bankers in the tobacco sector.

It didn't take long before Arnone came back for New Jersey's remaining 24 percent.

In 2010, she pitched a deal to raise $642 million by selling bonds backed by the remainder. Treasury officials didn't bite, but over the next three years, Barclays pitched nine more ideas to the state and sent along 59 updates on the tobacco market, according to a bank pitch book obtained by ProPublica.

By 2013, an idea finally took root: a rescue of the state's CABs.

A 'Trade Idea'

The temptation behind Barclays' pitch was a logic Wall Street already knew well: If tobacco bonds default, the obligation to repay doesn't go away.

In 2010, traders at Citigroup explained the concept in "trade idea" notes the bank sent to hedge funds. One idea was to buy tobacco bonds because, even in default, bondholders were entitled to tobacco settlement money a government received until the debt was repaid – "no matter how long that takes." Moreover, thanks to falling cigarette sales, the bonds were more likely to default and traded at attractive prices.

Claren Road – which specializes in making bold bets on distressed bonds – started buying up tobacco bonds in 2011, including those sold by New Jersey, according to disclosures from the firm's investors.

The fund eventually built up a position that entitled it to about 95 percent of the $855 million due on one of New Jersey's CABs in 2041, according to interviews and a deal document. Trading data for the debt indicates that Claren Road paid an average of 5 cents on the dollar to amass the stake.

It turned out to be the right bet.

In a December 2013 deal proposal to New Jersey, Barclays identified a "hedge fund" as

the major owner of the debt and said rescuing the CABs might make financial sense both to bondholders and the state.

The two CABs, Barclays warned, would default and turn into a vacuum cleaner for the state's tobacco money. Paying them off would take eight additional years. During that time taxpayers would lose access to $1.6 billion in tobacco settlement revenues that would go to the CABs, Barclays estimated, since they would continue to earn interest of close to 6 percent annually.

"Therefore, the state has a very real economic interest in the potential default status and repayment timing/consequences of the 2007 Bonds," Barclays said.

The solution became what Barclays dubbed a "credit enhancement program." The state would pledge its remaining 24 percent of the tobacco revenues to the owners of the two CABs until they were paid off – an estimated cost of about $400 million over seven years' budgets from 2017 to 2023. For New Jersey's troubles, the bondholders would pay a "program fee" negotiated by Arnone and her team at Barclays.

"While this negotiation process will be delicate, Barclays is confident that, given the current repayment prospects of the 2007 CABs, in the end, the 2007 CAB holders will act reasonably and rationally," Barclays wrote, promising an "acceptable" fee to the state.

Through a Barclays spokesman, Arnone declined to comment or answer written questions about the deal.

'Budget Fix'

With 27 years left until the CABs defaulted, rescuing the debt wasn't an imminent concern.

But the state budget was.

On Feb. 25, when Gov. Chris Christie unveiled a $34.4 billion spending plan for the 2015 fiscal year, the Treasury also disclosed a shortfall in expected 2014 revenues.

By then, a partial offset was also in place: A fund set aside for tobacco settlement cash showed a big jump in anticipation of proceeds from the Barclays' CAB deal. That shrank the shortfall from about $342 million to $250 million.

The bump in income caught the eye of analysts in the state's Office of Legislative Services.

"It was a budget fix," said David Rosen, the group's budget officer. But there wasn't much anyone could do to raise questions. "It was a done deal before we knew about it," he said.

A few days later, on March 5, Treasurer Sidamon-Eristoff convened a meeting of the state's Tobacco Settlement Financing Corporation to formally approve the deal.

The corporation is a special entity New Jersey created to sell its tobacco bonds. According to the bond prospectus, this corporation, not the state of New Jersey, is on the hook if the CABs default. The idea was to legally insulate taxpayers from tobacco debts using a separate entity. In practice, however, the entities are controlled by the governments that created them, which leads to concerns among some officials – including Sidamon-Eristoff – about how a default might effect the state's reputation as a borrower.

The bailout was not subject to approval by any other arm of state government. Thus, as the Treasurer promised away hundreds of millions of dollars in future revenues, meeting minutes show that only Barclays bankers and a throng of legal advisers looked on.

The next day, with formalities out of the way, Barclays executed the complex deal.

The state bought, for about 15 cents on the dollar, the CAB in which Claren Road held a 95 percent stake, according to people familiar with the transaction. New Jersey then pledged additional tobacco revenues toward repayment of the debt and sold the beefed-

up CAB back to Claren Road at 5.75 cents higher, according to ProPublica calculations based on deal documents. New Jersey gained $46.5 million from the trade, according to a memo summarizing the deal.

The second CAB was rescued in a similar fashion, netting another $50 million from Claren Road and other investors. After paying the fees to Barclays and others, the state cleared its $92 million.

The pledge of additional cash turned what had been bottom-of-the-barrel debt into something valuable. The S&P rating agency upgraded the CABs to the highest level of any of New Jersey's tobacco bonds, and investors bid them up even higher than the roughly 21 cents at which New Jersey had sold them back to investors. That allowed Claren Road to resell at about 24 cents on the dollar, adding to the profits.

Although S&P saw the rescued CABs as more creditworthy, the deal actually put a dent in the state's credit rating. On April 9, a draft credit rating downgrade from S&P landed in the Treasury's inbox. It cited a "trend of structurally unbalanced budgets" and "reliance on one-time measures" – like the tobacco deal – as the cause.

Emails obtained through a public records request show the notice was promptly forwarded to Lou Goetting, then a top Christie adviser, who seemed puzzled. "Obviously questionable decision and timing in light of all of our steps to improve fiscal condition," Goetting responded to other Christie aides. Asked about the email exchange, Goetting said it speaks for itself.

Nor did the $92 million do much to mend the state's budget. By May, the revenue gap widened by another $1 billion. Christie eventually was forced to slash a planned pension payment, retreating from a promise to make the "largest pension contribution ever" in 2014.

Making those pension payments will become a bit harder in 2017, when some $50 million to $60 million a year in tobacco payments will skip the general fund until the CABs are repaid, which is expected to happen in 2023.

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State Takes On The Risk

In defending the deal, the Treasury said budget woes weren't the motive. Instead, the state wanted to maintain "integrity in the markets" and avoid tarnishing its reputation with creditors, the Treasury said in its written response to ProPublica.

It is unclear how upset the bond market would be if the CABs had defaulted. New Jersey

had clearly warned buyers that its tobacco bonds were payable only from the settlement payments, not from general state funds. Still, at the April hearing, Treasurer Sidamon-Eristoff said the debt is "clearly associated with the state" and so default was not an option.

Goetting Downgrade Email

The Treasury also believes that future savings "far outweigh" the estimated $400 million in relinquished revenue. That's because repaying the debt early avoids much larger payments due from the settlement revenue under default.

ProPublica shared the state's math with public finance experts at three universities. All agreed that the claimed benefit hinges on iffy long-term forecasts of cigarette sales and settlement income.

When New Jersey sold its CABs in 2007, IHS Global, a consulting firm hired to predict cigarette sales, said Americans would buy 199 billion cigarettes in 2041. That meant an annual payment of about $440 million due to New Jersey.

This year, IHS slashed its 2041 forecast to 118 billion cigarettes. Based on the reduced forecasts, Barclays bankers estimated the state will now get a payment of $274 million in 2041.

The falling forecasts suggest that projected savings from the bailout could easily disappear, said Daniel Bergstresser, a finance professor at Brandeis University who reviewed the deal for ProPublica.

"In the past, forecasts of cigarette sales have been extremely unreliable," Bergstresser said. "If that happens again, then the cost of this deal for New Jersey will turn out to be large."

That uncertainty about declining payments is why Iowa recently opted not to bail out its CABs.

Two weeks after Barclays submitted its proposal to New Jersey last December, it sent Iowa similar pitch. The bank said Iowa could avoid losing $815 million in future tobacco revenues from 2047 to 2063 if it signed over some of its unpledged tobacco money to repay two CABs starting next year.

Stefanie Devin, the state's deputy treasurer, found Barclays' math unconvincing.

"The reason we sold the bonds in the first place was to shift the risk to investors," Devin said. "We really didn't see any reason to take any of that back."

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