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What to Make of a Diminished Thing: Tobacco Bond Defaults and Restructurings

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"The question that he frames in all but words
Is what to make of a diminished thing."
Robert Frost, "The Oven Bird"

There is little poetry in tobacco bonds these days. Cigarette consumption has declined beyond projections, and the advent of e-cigarettes may exacerbate the decline. Payments under the Master Settlement Agreement (MSA) are down, and turbo redemptions of some tobacco bonds have ceased; ratings on longer-term tobacco bonds have declined as a result of their dependency on the MSA payment cash flow. Arbitrations and litigation over whether a portion of past MSA payments should be refunded to participating manufacturers by states that allegedly failed to diligently enforce qualifying statutes that require compensatory payments from non-participating manufacturers are ongoing, despite seemingly endless skirmishing, casting further uncertainty on future cash flows available to pay tobacco bonds. Reserve funds have been invaded by some issuers to pay current interest. Many expect debt service defaults on some tobacco bonds to occur within the next five years.

Although such defaults have not yet occurred, it is not too early for holders to take a hard look at the applicable bond documents to evaluate their rights and leverage in the restructurings or refinancings that have begun and which may proliferate in the years ahead.

The impact of these adverse developments will likely be felt most strongly by those holders that hold the longer-term maturities (including CABs that are not scheduled to pay interest or principal until maturity) or holders of subordinated maturities. By and large, tobacco settlement securitizations transferred the risk of such cash flow declines to bondholders, and issuers are ostensibly under no legal obligation to provide additional sources of repayment.

It is possible that certain issuers may deem it in their best interest to disregard the absence of any legal duty and to take steps to avoid default and mitigate bondholder losses. But such rescues, usually from external funding sources, are likely to be the exception, not the rule. It is more likely that issuers, underwriters and bondholders will continue to pursue refinancings or restructurings to take advantage of lower prevailing interest rates on portions of outstanding tobacco bonds that appear likely to be repaid from available cash flow and/or to postpone default.

Bondholders may find a review of their tobacco bond documents timely as well as productive as there are significant differences among documents. By way of example, the observations below are based on a review of a sample indenture relating to the Buckeye Tobacco Settlement Financing Authority's Tobacco Settlement Asset-Backed Bonds, Series 2007. The structures and indenture terms for the billions of dollars in outstanding tobacco settlement securitizations of course differ from state to state and from issuer to issuer, and may even vary among different series of bonds issued by the same issuer. Thus, the matters highlighted below are intended as examples of areas to focus upon in the context of potential restructurings of troubled tobacco securitizations, but the particulars of any individual indenture must be reviewed and analyzed to determine the constraints applicable to any specific securities.

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Covenants and Events of Default

Although the Buckeye indenture contains negative covenants restricting the issuance of certain additional debt, asset dispositions, transfers and other transactions that may impair bondholder collateral, it contains no debt service coverage or other financial maintenance covenants. Under similar indentures, there may not be an event of default before actual non-payment of scheduled debt service. By that time, the horse may be out of the barn and on the way to the glue factory.

Moreover, the events of default section is nuanced in that it only triggers an event of default upon the failure to make certain payments (as distinct from any payment), which will require bondholders to be conversant with such nuances and, for example, will determine whether or not a failure to pay subordinate bonds, sinking fund installments, projected turbo redemptions, or similar obligations will constitute a default. Such nuances can also make a significant difference in determining whether or not subordinate bonds are likely to default, whether turbo redemptions are likely, and whether or not the failure to pay pari passu obligations such as interest rate swaps will also trigger a default or is expressly or structurally subordinated.

Remedies

The remedies section of the Buckeye Indenture has very specific rules which limit or condition available remedies, including with respect to acceleration, enforcement of the terms of the bonds, and enforcement of certain covenants made by the State of Ohio under the sale agreement pursuant to which the securitized MSA payments were sold to the issuer. Once again, the existence and nature of any available remedies – or lack thereof – will have a significant bearing on the rights and leverage of bondholders in any proposed restructuring or refinancing.

Flow of Funds

The indenture contains a lengthy, complicated and detailed flow of funds regime, both before and after a payment default, which determines the order and priority of payments on bonds of differing rank, the funding and replenishment of various accounts, and how regularly scheduled MSA payments and funds held in debt service, liquidity and other reserve accounts are applied, including limits and priorities on operating expenses, fees to credit enhancers, and any rebate payments required under the Internal Revenue Code. Once again, bondholders need to be familiar with the flow of funds in order to determine when and how much may be available to pay bonds having differing priorities.

For example, after a payment default on senior bond interest or principal payable at maturity, the flow of funds specifies the disposition and priority of all amounts available for debt service on senior bonds, including amounts in the senior liquidity reserve account, and how such amounts are applied to pay current interest on senior bonds and scheduled parity swap payments, as well as the principal and accreted value of senior bonds. The flow of funds then goes on to specify how additional amounts are applied to the payment of subordinate bonds while senior bonds remain outstanding. In the Buckeye Indenture, the flow of funds section specifies that cash flow available for the payment or prepayment of senior bonds following a payment default shall be applied to senior bonds on a pro rata basis, rather than in chronological order of maturities and sinking fund installment dates. Because current interest is payable prior to principal or accreted value, zero coupon senior bonds are effectively subordinated to current interest senior bonds.

Amendments and Restructurings

Given the likely absence of recourse by bondholders to sources other than the MSA payments, the incentive for issuers to restructure tobacco bonds to postpone a payment default or to cure a default may be limited. Nevertheless, there appear to be at least two potential incentives: reputation (some issuers may not want their names associated with defaulted obligations even if they have no further legal responsibility for payment) and self-interest (the restructuring or refinancing to a lower interest rate will increase the likelihood that the issuing state may be able, at some future time, to receive additional MSA payments).

Bondholders likewise may have limited incentives to prompt restructurings that merely reduce or stretch out interest or principal payments on tobacco bonds. But some bondholders, faced with a potential loss if no action is taken, and particularly if they hold a combination of senior and subordinate bonds, may be incentivized to participate in or prompt refinancings or reprioritizations of cash flows that increase aggregate repayments.

The Buckeye indenture contains some provisions that present challenges for restructurings. For example, the indenture contains restrictions on open market purchases using funds in pledged accounts, which may create obstacles to deleveraging through tender offers. In addition, the indenture includes an issuer covenant not to file for bankruptcy. Although an issuer could challenge whether such a covenant is enforceable, it may also have reservations about litigating the issue.

Outside of bankruptcy, any restructuring must comply with the indenture's restrictions on amendments. The Buckeye indenture precludes certain amendments, but permits others with the consent of the holders of a majority in interest of the senior bonds, while the senior bonds remain outstanding, and thereafter a majority in interest of the most senior class of subordinate bonds outstanding. Bondholders must always take into consideration the composition and interests of the other holders.

History suggests that as bonds approach the zone of distress, a likely scenario would be for one or more opportunistic bondholders to accumulate a majority position thought to be sufficient to authorize indenture amendments and/or refinancings that reduce aggregate debt service payable from the pledged revenues and/or produce a timing or priority benefit in their repayment relative to the status quo. A restructuring or refinancing of distressed tobacco bond may not, by itself, generate any tangible financial benefit to the issuer, so part of the challenge may be the inclusion of features that deliver benefits to the issuer sufficient to entice the issuer's participation. Complicating the matter further, if the bondholders view the situation as a zero sum game, any improvement in the issuer's position will be deemed to have occurred at the expense of the bondholders. Thus, any amendments or refinancings involving payments to the issuer are likely to be closely scrutinized and may be contested by minority or subordinated bondholders. In short, those wishing to consummate or assess a potential restructuring will need a thorough knowledge and understanding of how the indenture operates, so as to avoid violating the indenture's terms while incentivizing the necessary parties.

Additional analysis relating to tobacco bonds will appear from time to time on Mintz Levin's public finance blog, Public Finance Matters. Anyone interested in automatically receiving future blogposts can subscribe to the blog here.

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