THE WALL STREET JOURNAL.
WSJ.com

BUSINESS | MAY 24, 2011

School District, Bank in Swap Clash

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State College Area School District in Pennsylvania several years ago abandoned plans to build a new high school. This month, it received a notice that it owes $10 million to Royal Bank of Canada for skipping an interest payment on money it never borrowed for a school it didn't build.

The notice was the latest step in a legal battle over what the district calls a "naked swap" and what RBC describes as a binding legal agreement. The conflict is an example of how cities, states, schools and other public entities are second-guessing financial deals they made in recent years, pitting them against their own bankers and advisers.

Many of the regrets revolve around interest-rate swaps that became popular as a way for municipal borrowers to guard against jumps in rates. Typically under these contracts, a borrower pays a bank interest with a fixed rate and the bank pays interest with a floating rate in return. When interest rates declined, swaps proved costly to many borrowers.

The State College case has an unusual twist. The school agreed to swap interest rates before it borrowed the money; it filed a lawsuit in a U.S. district court saying this fact makes the contract void. This month it skipped its first payment—for $978,000. RBC says the school authorized the debt—even if it never borrowed money for the project—and that the swap is valid.

Since Pennsylvania passed a law in 2003 allowing municipalities to use swaps, more than 700 deals were done, according to documents filed with Pennsylvania Department of Community and Economic Development. Many entities had losses, says Jack Wagner, auditor general for Pennsylvania.

Paul Chaplin / The Patriot-New

Royal Bank of Canada structured swaps for a State College, Pa., school district and on debt tied to this Harrisburg incinerator.

Now, he and several state legislators are pushing to ban municipal swaps. "Swaps are nothing more than a gamble with taxpayer money," Mr. Wagner says.

Bankers who have done swaps around the country say they inform clients that their payments could increase if interest rates move opposite to what they predicted. Clients also are generally aware that termination fees hinge on interest rates and can run into the millions of dollars. Bankers and some government officials say many clients have benefited from the deals.

RBC is the biggest municipal-bond underwriter in Pennsylvania, according to Thomson Reuters data; it also is a leading swaps dealer in the state. RBC was behind 88 Pennsylvania swaps, the bank says.

RBC became a force in Pennsylvania partly through acquisitions of other financial firms; it also has employees with a track record in the state. James Losty, a managing director in Philadelphia, has long done work for the capital city of Harrisburg, where he helped structure swaps on part of $280 million in debt tied to a troubled incinerator project.

Mr. Losty declined to comment. RBC spokesman Kevin Foster said the transactions resulted in low-cost financing.

The State College saga began in 2006. The district was planning to build a school the following year and wanted to take advantage of low interest rates. After making some other deals in anticipation of the project, in April 2006 it consulted about financing with its adviser, Louis Verdelli, who worked for Public Financial Management Inc. It then signed a deal for a swap with RBC.

Shortly after the swap was signed, Mr. Verdelli went to work for RBC. Mr. Foster said the district was "well served" by Mr. Verdelli on the matter and his job move "is not uncommon in the industry."

The school district agreed to pay RBC a fixed rate of 3.884% on about $58 million beginning in 2007. The bank would pay the district a floating rate.

In 2007, the district canceled the project after bids came in over budget and the elected board had turnover. The district maintained the swap so the new board could evaluate the project.

The price to get out of the swap, meanwhile, to about $2 million by October 2007, from $168,000 in June, as interest rates fluctuated.

The school in late 2007 deferred the start date of the swap under a new deal with a higher rate on less debt. The school was to begin making payments this month, through 2028.

To hedge the deal, RBC entered contracts with other parties, it says. Now, it is obligated to pay those investors.

By February 2010, the district's termination fee had escalated to $5.5 million. The school sued, claiming the swap was illegal because it wasn't tied to debt. It also says that when it amended the contract, the deal lacked a new so-called interest-rate-management plan required by law.

"How can we make interest payments on debt that doesn't exist?" asks Louis Moffa, an attorney for the district. "It's a naked swap. That's not even allowed under state law."

RBC says in legal papers that the swap was tied to anticipated debt. "We entered into a binding, legal agreement with the District, which it now wishes to disregard by way of a meritless lawsuit which never specified that RBC had done anything wrong," the bank said in a statement. It blames "a local political issue" that drove the board to "renege."

If the district believes the deal was illegal, it should blame other professionals, RBC has said. "The board was advised by its own professional adviser, including lawyers as well as PFM," RBC said in a recent letter to the district, referring to Mr. Verdelli's former employer, Public Financial Management. A spokeswoman for PFM didn't comment.

"Notably, however, the district has not sued those advisers," the letter said, "even though the board, through its lawsuit against RBC, has called their advice into question."

This month, RBC moved to assert third-party claims against Rhoads & Sinon, bond counsel on the swap, and the district's solicitor, then called Miller, Kistler, Campbell, Miller, Williams & Benson Inc.

Representatives of both firms declined to comment.

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