INTERIM REPORT NO. 18

THE ADVERSE DOMINATION OF THE GOVERNMENT OF THE CITY OF SAN DIEGO

REPORT OF THE

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30 August 2007

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I.
INTRODUCTION

The City of San Diego ("City") is in the throes of one of the most daunting political and financial crises in its history. The City is currently facing a funding debt in excess of $2 billion in its pension system as a result of a number of governmental decisions including, but not limited to, the creation of illegal retirement benefits.

The granting of these benefits is the result of two contingent, *quid pro quo* arrangements between the San Diego City Council ("City Council") and the San Diego City Employees' Retirement System ("SDCERS"). The first of the deals, commonly referred to as Manager's Proposal 1 ("MP 1"), occurred in 1996 and was comprised of an agreement by the SDCERS Board of Trustees ("Board") to relieve the City from making its required payments to the pension fund. In return, the City granted retroactive retirement benefits for City employees. The second deal, called Manager's Proposal 2 ("MP 2"), took place in 2002. According to MP 2, the SDCERS Board allowed the City to pay less than actuarially required into the pension system while the City again increased pension benefits for retirees.

Ironically, throughout the late 1990s and early 2000s, the City was being honored nationwide as an example of well-managed municipalities. Meanwhile, beneath the surface the financial stability of the City was crumbling under the burden of the massive debt created by granting retroactive retirement benefits and the City's failure to pay the full actuarially required amount into the pension fund – a direct result of the MP 1 and MP 2 deals between SDCERS and the City.

City officials and high-level managers engaged in a pattern designed to conceal the debt created by MP 1 and MP 2. That pattern of concealment, as to the nature of the debt, commenced the day the first enhancements to retirement benefits were created as part of MP 1 in 1996. This pattern of concealment is still active today.

The City officials who engaged in these unlawful acts cannot be expected to police themselves and undo their own unlawful acts. Today, the City Council has four members who took part in the acts that form the basis of the wrongdoing identified herein. Thus, the government of the City of San Diego has been adversely dominated by those who engaged in this unlawful conduct and who have worked in concert with each other to frustrate all efforts to set aside the unlawful pension benefits in further violation of their fiduciary duties to the citizens of the City of San Diego.

This report explains how City officials violated their fiduciary duties to the City in granting certain pension and retiree health care benefits in violation of local and state law. This report also explains how the City has been adversely dominated by the wrongdoing of City officials, with such wrongdoing interfering and obstructing the ability of the City to set aside the illegal pension and retiree health debt. This report also shows how City officials wasted millions of dollars in attorneys and consulting fees in the effort to escape responsibility for their unlawful behavior.

Finally, this report recommends a course of action by which the City can continue to initiate appropriate action to protect taxpayers and to fulfill fundamental legal duties owed to the people of the City of San Diego.

II.
BACKGROUND

Unlawful conduct by City officials has caused the City of San Diego to suffer a staggering debt in excess of $2 billion. This debt was created when City officials and employees used unlawful means to enrich themselves with hundreds of millions of dollars of pension and retiree health care benefits in breach of their fiduciary duty to the City and the people of San Diego. In creating this debt, these officials and employees did not follow the procedures prescribed by the San Diego City Charter ("Charter") and the California State Constitution. What is worse, City officials who participated in the unlawful conduct have remained in control of the City government and have used their control to frustrate all efforts directed at repairing the damage.

As a result, the City of San Diego faces the worst financial crisis since the City was forced to declare bankruptcy in 1852.[1] As a consequence, the City's roads and streets are in disrepair,[2] City libraries and recreation centers operate at reduced schedules, neighborhood centers have closed, and capital improvements on city buildings have been postponed. It is estimated that the City's deferred maintenance and capital needs, excluding water and wastewater, is at least $800 to $900 million.[3]

On 5 September 2003, SDCERS Trustee Diann Shipione sent an e-mail to SDCERS' Administrator Lawrence Grissom warning that bond offering documents being used by the City of San Diego to sell sewer bonds were inaccurate.[4] Ms. Shipione called special attention to the statements made in the disclosure document that the SDCERS actuary had determined that the funding method being used by the City in its pension plan was "an excellent method for the City and it will be superior to the PUC method." In fact, the funding method being used was not an approved method for funding a pension

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[1] The City of San Diego operated in trusteeship under the supervision of the State of California from 25 March 1852 until 1886. See, Heilbron, Carl H. History of San Diego County (The San Diego Press Club, San Diego 1936) pp. 254-80, attached as Exhibit 1.

[2] Industry standards state that 75% of City streets should be in acceptable condition. In San Diego, however, 63% of the streets are below the national standard and are classified as being in fair or poor condition. See 2 May 2007 Mayoral Fact Sheet, Exhibit 2.

[3] 29 November 2006 City of San Diego General Fund Five-Year Financial Outlook 2008-2012 p. 25. (Exhibit 4.)

[4] 5 September 2003 e-mail from Diann Shipione, SDCERS Board Trustee, to Lawrence Grissom, administrator with SDCERS. Subject: "Incorrect Pension Materials in Bond Solicitation Circular." (Exhibit 5.)

system and was being used to hide hundreds of millions of dollars of pension benefits that had been illegally created by City officials.

Ms. Shipione's e-mail caused the City's bond offering to be halted. On 27 January 2004 the City was required to disclose to its current bond investors hundreds of millions of dollars of debt not properly disclosed by the City previously. These disclosures prompted an investigation by the U.S. Securities and Exchange Commission beginning in February 2004. On 14 November 2006, the SEC issued a cease and desist order against the City of San Diego finding that City officials had engaged in securities fraud. However, the SEC has not brought charges against any individuals as of 30 August 2007.

City officials and employees withheld from taxpayers and investors in the City's municipal bonds the massive and growing debt they caused the City to incur in order to enrich themselves. The United States Securities & Exchange Commission (SEC) after investigating the conduct of these City officials and employees found that City officials violated "the antifraud provisions of the federal securities laws."[5] The SEC made numerous findings regarding the conduct of City officials:

- The SEC found that the City of San Diego faced a "financial crisis," and in failing to disclose critical facts about its pension and retiree health care debt violated "the antifraud provisions of the federal securities laws in connection with the offer and sale of over $260 million in municipal bonds in 2002 and 2003. At the time of these offerings, City officials knew that the City faced severe difficulty funding its future pension and health care obligations unless new revenues were obtained, pension and health care benefits were reduced, or City services were cut."[6] (emphasis added.)

- The SEC found the "City's looming financial crisis resulted from (1) the City's intentional under-funding of its pension plan since fiscal year 1997; (2) the City's granting of additional retroactive pension benefits since fiscal year 1980; (3) the City's use of the pension fund's assets to pay for the additional pension and retiree health care benefits since fiscal year 1980; and (4) the pension plan's less than anticipated earnings on its investments in fiscal years 2001 through 2003."[7] (emphasis added.)

- The SEC found City officials did not disclose the "gravity of the City's financial problems" including that the "City's unfunded liability to its pension plan was expected to dramatically increase, growing from $284 million at the beginning of

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[5] 14 November 2006 SEC Cease and Desist Order p. 2 ("SEC Cease & Desist Order"). (Exhibit 6.)

[6] SEC Cease and Desist Order p. 2, attached as Exhibit 6.

[7] SEC Cease and Desist Order p. 2. (Exhibit 6.)

fiscal year 2002 and $720 million at the beginning of fiscal year 2003 to an estimated $2 billion at the beginning of fiscal year 2009." Also not disclosed was the fact that the City's "projected annual pension contribution would continue to grow, from $51 million in 2002 to $248 million in 2009." Also not disclosed was the fact that the "estimated present value of the City's liability for retiree health benefits was $1.1 billion."[8]

- The SEC found that the City has used the discredited practice of applying "surplus earnings—i.e., earnings above the actuarially projected 8% return rate -- to fund an ever-increasing amount of additional benefits for San Diego City Employees' Retirement System members."[9]

- The SEC found that in "fiscal year 1996, the City agreed to increase significantly and retroactively all employees' pension benefits. The City, however, could not afford to fund the cost of the benefit increases. The City, therefore, made the pension benefit increases contingent on CERS's agreement to the City's under-funding of its annual contribution to CERS."[10] (emphasis added.)

- The SEC found that in "March 2000, the City again retroactively increased pension benefits. Specifically, the City and CERS settled a class action lawsuit brought by CERS members, with Corbett as the named class plaintiff. Under the Corbett settlement, the City retroactively gave increased pension benefits to both current and retired City employees, increasing CERS's liabilities."[11]

- The SEC found that in "April 2002, the City received a warning that the City's pension and retiree health care liabilities would continue to grow and that the City was not adequately planning to meet those liabilities." The warning, according to the SEC, came in the form of a report from "the City's Blue Ribbon Committee to the City Council."[12]

- The SEC found that in "fiscal year 2003, the City again increased its pension liability by granting additional retroactive benefits, used additional CERS assets to pay for additional pension and retiree health care benefits and an increased

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[8] SEC Cease and Desist Order pp. 2-3. (Exhibit 6.)

[9] SEC Cease and Desist Order pp. 6-7. (Exhibit 6.)

[10] SEC Cease and Desist Order p.7. (Exhibit 6.)

[11] SEC Cease and Desist Order pp. 7-8. (Exhibit 6.)

[12] SEC Cease and Desist Order p. 9. (Exhibit 6.)

portion of the employees' contribution, and obtained additional time to underfund its annual CERS contribution."[13]

- The SEC found that the City received two reports from CER's actuary that provided "the City with negative information regarding the present and projected status of CER's funded ratio and the City's unfunded liability to CERS." According to the SEC, one report showed that the pension had "suffered an actuarial loss of $364.8 million and that as of the end of fiscal year 2002, CER's funded ratio was 77.3% and the City's unfunded liability to CERS was $720 million."[14] The second report, according to the SEC, showed that the "City's contribution rate was projected to more than quadruple-9.83% of payroll in fiscal year 2002 ($51 million) to 35.27% of payroll in fiscal year 2009 ($248 million)."[15]

- The SEC found the City's financial adviser gave City officials "additional information regarding the projected growth of its future pension liabilities and the possible negative effect those liabilities would have on the City's credit rating and ability to issue municipal securities." According to the SEC, in April 2003, the financial adviser informed City officials that the "City's unfunded liability to CERS would grow to $1.9 billion at the end of fiscal year 2009 and to $2.9 billion at the end of fiscal year 2021, and CERS's funded ratio would fall to 66.5% at the end of fiscal year 2009 and would be 67% at the end of fiscal year 2021."[16]

- The SEC found that the "City, through certain of its officials, knew that its Disclosures were misleading. The Mayor and Council were responsible for approving the issuance of the bonds and notes, including issuance of the preliminary official statements and official statements."[17]

Numerous public officials were involved in the above described unlawful conduct. Between 1996 and 2002, 2 Mayors, 13 City Council members, 3 City Managers, 2 City auditors, 1 Assistant City Manager and numerous pension board members violated their fiduciary duties by creating and covering up the unlawful debt. These city officials did not follow the prescribed manner for creating city pension and retiree health care debt. *See President and Trustees of City of San Diego v. San Diego and Los* Angeles Co., 44 Cal. 106 (1872).

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[13] SEC Cease and Desist Order p. 9. (Exhibit 6.)

[14] SEC Cease and Desist Order p. 10. (Exhibit 6.)

[15] SEC Cease and Desist Order p. 10. (Exhibit 6.)

[16] SEC Cease and Desist Order pp. 13-14. (Exhibit 6.)

[17] SEC Cease and Desist Order p. 17. (Exhibit 6.)

III.
THE CREATION OF THE PENSION CRISIS

Public officials offered and received increased benefits in exchange for allowing the City to underfund the pension plan in violation of San Diego City Charter ("Charter") § 94 and Government Code § 1090. In 1996 City officials intentionally failed to pay or to require the payment of pension debt[18] in violation of Charter § 143[19] and the California State Constitution Article 16 §17,[20] increased pension and retiree health care debt without providing a means of payment in violation of the debt limit law of the California State Constitution Article 16 § 18[21] and Charter § 99.[22]

Included in the unfunded pension benefits was the DROP program that allowed City officials to receive their retirement payment while continuing to receive their salary.[23] Also included was the Purchase of Service Credit program which allowed City officials to buy up to five years of service credits.[24] Also included in these benefits was the granting of the unfunded retroactive benefits.[25]

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[18] 23 July 1996 memorandum from Larry Grissom, retirement administrator, to Cathy Lexin, labor relations manager; Subject: "*CITY MANAGER'S RETIREMENT PROPOSAL*". (Exhibit 7)

[19] San Diego City Charter §143 – Contributions. (Exhibit 8)

[20] California Constitution: Article 16 § 17 – Public Finances. (Exhibit 9)

[21] California Constitution: Article 16 § 18 – Public Finances. (Exhibit 9)

[22] San Diego City Charter § 99 – Continuing Contracts. (Exhibit 10)

[23] 4 June 1996; City Employees Retirement System (POA); "Proposal"; p.5. Management Proposal to POA – Changes to Retirement System. 4 June 1996; City Employees Retirement System (MEA); "Proposal"; p. 5. 4 June 1996; City Employees Retirement System (Local 145); "Proposal"; p. 5. (Exhibit 11)

[24] 4 June 1996; City Employees Retirement System (POA); "Proposal"; p.2. Management Proposal to POA – Changes to Retirement System. 4 June 1996; City Employees Retirement System (MEA); "Proposal"; p. 2. 4 June 1996; City Employees Retirement System (Local 145); "Proposal"; p. 2. (Exhibit 11)

[25] 4 June 1996; City Employees Retirement System (POA); "Proposal"; p.2-4. Management Proposal to POA – Changes to Retirement System. 4 June 1996; City Employees Retirement System (MEA); "Proposal"; p. 2—4. 4 June 1996; City Employees Retirement System; (Local 145) "Proposal"; p. 2—4. (Exhibit 11)

City officials held financial interests in the pension[26] debt created in 1996[27] in violation of the California Government Code § 1090[28] and Charter § 94.[29] Between 1996 and 2005 City officials priced pension service credits purchased by other City officers and employees substantially and materially below actual cost. As established under MP 1 in 1996, a key provision of the purchase of service program was that it remains cost neutral to the City. In clear violation of this provision, SDCERS Board members ignored repeated warnings from SDCERS staff and the SDCERS actuary between 1999 and 2004 that the price was too low. The SDCERS actuary went so far as to detail the debt created by the reduce pricing on the pension system. City officials, however, knowingly allowed the pricing to remain low in order to allow more employees to purchase at the discounted rate thereby plunging the pension system deeper in debt. More disconcerting is the fact that representatives of the City Council themselves purchased years of service after the SDCERS' actuary warnings.[30]

In 2000 City officials agreed to create additional pension benefits in connection with the settlement of litigation known as "Corbett" without providing a means of payment.[31] The creation of additional benefits without providing a corresponding

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[26] 1 July 2005; "Amended Interim Report No. 6 Regarding the San Diego City Employees' Retirement System Funding Scheme: Report of the San Diego City Attorney Michael J. Aguirre". (Exhibit 12)

[27] 4 June 1996; City Employees Retirement System; "Proposal"; p.5. The table presented on the bottom of page 7, titled "Employer Contribution Rate Stabilization Plan," contained a table column called "Difference $" which indicated the amount of underfunding of the pension plan that resulted in the approval of the Manager's Proposal. The table indicated that, if approved, the Manager's Proposal would lead to the underfunding of the pension plan by as much as $110.35 million between fiscal year 1996 through fiscal year 2008. (Exhibit 11)

[28] California Government Code § 1090. (Exhibit 13)

[29] San Diego City Charter § 94: Contracts. (Exhibit 14)

[30] 18 September 2006; "Interim Report No. 12: Report on Scheme to Price San Diego City Employees' Retirement System Pension Service Credits Below Cost in Violation of California Law – Report of the San Diego City Attorney Michael J. Aguirre". (Exhibit 15)

[31] 17 May 2000; Superior Court of the Sate of California for the County of San Diego: Order and Judgment Approving Settlement of Class Action; "WILLIAM J. CORBET; DONALD B. ALLEN; LEORNARD LEE MOORHEAD; and GORDON L. WILSON; individually, and on behalf of all others similarly situated, Plaintiffs, v. CITY EMPLOYEES' RETIREMENT SYSTEM; and DOES 1 through 50, inclusive, Defendants. CITY OF SAN DIEGO, Real Party in Interest. (Exhibit 16)

funding source is another in violation of debt limit law contained in the California State Constitution Article 16 § 18 and City Charter § 99.[32]

In 2002 City officials intentionally failed to pay or to require the payment of pension debt[33] in violation of Charter § 143 and the California State Constitution Article 16 §17, increased pension and retiree health care debt without providing a means of payment in violation of debt limit law of the California State Constitution Article 16 § 18 and City Charter § 99, once again attempted to alter the provisions of Charter § 143 by adopting a provision which purportedly allowed the city to avoid mandatory full pension payments set by actuarial determination.[34] City officials also held financial interests in the pension debt created in 1996 in violation of the California Government Code § 1090 and Charter § 94.[35] Also included in these benefits was a provision that allowed the active members to purchase 5 years of pension credits in order to satisfy the 10 year vesting requirement.[36]

IV.
CITY OFFICIALS EDUCATED ON DISCLOSURE DUTY UNDER FEDERAL SECURITIES LAWS

City officials received a thorough explanation of their legal responsibilities to report all liabilities that could be material to investors as set forth by the federal securities

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[32] California Constitution: Article 16 § 18 – Public Finances (*see Exhibit 9*); San Diego City Charter § 99: Continuing Contracts (*see Exhibit 10*).

[33] Minutes of the 18 November 2002 meeting of the San Diego City Council; "Item-133: Two Actions related to Approval of Agreements on SDCERS Board Indemnification & City SDCERS Employer Contributions...Subitem-B (R-2003-661) ADOPTED AS RESOLUTION R-297336 – Authorizing the City to enter into an agreement with the San Diego City Employees' Retirement System regarding employer contributions." 18 November 2002; "Agreement Regarding Employer Contributions Between the City of San Diego and the San Diego City Employees' Retirement System. San Diego City Council Resolution-297336 (Exhibit 17)

[34] 9 February 2005; "Interim Report No. 2 Regarding Possible Abuse, Illegal Acts or Fraud by City of San Diego Officials – Report of the San Diego City Attorney Michael J. Aguirre". (Exhibit 18)

[35] 9 February 2005; "Interim Report No. 2 Regarding Possible Abuse, Illegal Acts or Fraud by City of San Diego Officials – Report of the San Diego City Attorney Michael J. Aguirre". (Exhibit 18)

[36] 9 February 2005; "Interim Report No. 2 Regarding Possible Abuse, Illegal Acts or Fraud by City of San Diego Officials – Report of the San Diego City Attorney Michael J. Aguirre". (Exhibit 18)

disclosure laws. This information was provided to them by lawyers from the Bryan Cave law firm in and around 6 November 2001. The information provided that the Mayor and City Council members were responsible for fully disclosing, under the federal securities laws in connection with the sale of the City's bonds, was set forth in a 29 October 2001 letter.[37] The 29 October 2001 letter to the City Council was signed by Gerald E. Boltz. Mr. Boltz.[38]

The 29 October 2001 Bryan Cave letter, authored by Mr. Boltz, informed the Mayor and City Council members that the purpose of the letter was "to provide an overview of the applicable federal securities laws" in connection with the City's 2001 lease revenue bonds.[39] The letter informed the Mayor and City Council members they "must read" the disclosure documents related to the ballpark bond offering "in light of the application of provisions of the federal securities laws."[40] The letter told Mayor and City Council members that they were required to "ask questions as to any area or matter that may seem unclear or need clarification, actively seek information from the officials of the City or Authority and professionals retained in connection with the proposed offering, and conduct follow-up as to the information supplied."[41]

The letter also clearly stated that municipal bond offerings were "not exempt transactions in municipal securities from the antifraud provisions of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5 promulgated thereunder,"[42] and that the foregoing "provisions prohibit any person, including municipal issuers, from making a false or misleading statement of material fact, or

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[37] 29 October 2001 letter from Bryan Cave law firm to Leslie J. Girard. (Exhibit 19)

[38] Gerald Boltz was a highly-regarded Securities and Exchange Enforcement Division official. Mr. Boltz held several senior positions during his 20-year career at the SEC, retiring in 1979 after seven years as regional administrator of the SEC's Los Angeles Regional Office. Following his government service, Mr. Boltz became a partner in the Santa Monica, California office of Bryan Cave. *See* SEC News Digest Issue 2006-92 12 May 2006. (Exhibit 20).

[39] 29 October 2001 Bryan Cave letter. p. 1. (see Exhibit 19).

[40] The lawyers from Bryan Cave noted that allegations were made by ballpark opponents that because of various changes and alternations, the ballpark project should be re-submitted to San Diego City voters (see, 29 October 2001 Bryan Cave letter p. 1). (Exhibit 19).

[41] 29 October 2001 Bryan Cave letter p. 1-2. (Exhibit 19).

[42] *Id.* at p.2.

omitting any material facts necessary to make statements made by that person not misleading, in connection with the offer, purchase or sale of any security."[43]

City officials, however, ignored the advice of Mr. Boltz and disregarded the information presented in the letter.

V.
CITY OFFICIALS CONCEAL DEBT

City officials intentionally concealed the illegally created debt from the people of the City of San Diego. Specifically:

- In 2002, City officials concealed the unlawful conduct by delaying and watering-down the findings of the City's Blue Ribbon Committee report on city finances.[44]

- In 2002, City officials agreed to indemnify pension board members in connection with the unlawful acts in which pension debt was not paid and pension benefit debt was increased without appropriate funding.[45]

- In 2002, SDCERS Board Members, which included City Official Cathy Lexin, conspired with one another to conceal that a special "Presidential Benefit" was given to incumbent union presidents under MP 2, including Ron Saathoff, President of Firefighters Local 145. Notwithstanding that this "Presidential Benefit" was negotiated as part of the retirement benefit enhancements provided for under MP 2, the provisions for the "Presidential Benefit" were omitted from the relevant labor agreements and implementing ordinances. Instead, the incumbent union president benefits were implemented in separate agreements and

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[43] *Id.*

[44] 9 February 2005; "Interim Report No. 2 Regarding Possible Abuse, Illegal Acts or Fraud by City of San Diego Officials – Report of the San Diego City Attorney Michael J. Aguirre". (Exhibit 18)

[45] Minutes of the 18 November 2002 meeting of the San Diego City Council; "Item-133: Two actions related to Approval of Agreements on SDCERS Board Indemnification & City SDCERS Employer Contributions; CITY MANAGER'S RECOMENDATION: Adopt the following resolutions: Subitem-A; (R-2003-390) ADOPTED AS RESOLUTION R-297335: Declaring that the City of San Diego agrees to defend, indemnify and hold harmless the members of the Board of Administration for the San Diego City Employees' Retirement System in performance of their duties. San Diego City Council Resolution R-297335, Adopted on 18 November 2002. (Exhibit 17)

ordinances, in order to conceal that these union presidents were receiving special additional benefits in exchange for their vote or influence to approve MP 2.[46]

- In 2002, City officials made the DROP program permanent despite the requirement set in 1996 that the DROP program could only continue if was cost neutral and despite an actuarial study showing that the DROP program was not neutral.[47]

- In 2002 and 2003, City officials violated the antifraud provisions of the federal securities laws in connection with the offer and sale of over $260 million in municipal bonds.[48] City officials knew that the City faced hundreds of millions of dollars in shortfalls for funding its future pension and health care obligations unless new revenues were obtained, pension and health care benefits were reduced, and/or City services were cut.[49]

- In 2002 and 2003, in furtherance of their unlawful course of action, City officials overrode[50] the recommendation of the City's Pension Reform Committee that the

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[46] 9 February 2005; "Interim Report No. 2 Regarding Possible Abuse, Illegal Acts or Fraud by City of San Diego Officials – Report of the San Diego City Attorney Michael J. Aguirre". (Exhibit 18); San Diego City Council Resolution R-297212, adopted 21 October 2002. (Exhibit 21)

[47] 6 February 2007 City Attorney Report to the Honorable Mayor and City Council – Recommending Amendments to the SDMC Eliminating the DROP. 13 September 1999 memorandum from Rick Roeder, SDCERS actuary, entitled DROP's "Hidden" Liabilities. (Exhibit 22)

[48] 14 November 2006; United States of America before the Securities and Exchange Commission; Administrative Proceeding File No. 3-12478; In the Matter of City of San Diego, California; Order Instituting Cease-And-Desist Proceedings, Making Findings, and Imposing Cease-And-Desist Order Pursuant To Section 8A of the Securities Act of 1933 and Section 21C of the Securities Act of 1934. (Exhibit 6)

[49] 14 November 2006; United States of America before the Securities and Exchange Commission; Administrative Proceeding File No. 3-12478; In the Matter of City of San Diego, California; Order Instituting Cease-And-Desist Proceedings, Making Findings, and Imposing Cease-And-Desist Order Pursuant To Section 8A of the Securities Act of 1933 and Section 21C of the Securities Act of 1934. (Exhibit 6)

[50] LaVelle, Phillip; "City Hall pension politics heat up | Plan to scrap board may prove tricky for Murphy"; *San Diego Union-Tribune*; 4 July 2004. Minutes of the 19 July 2004 meeting of the San Diego City Council; LaVelle, Philip; "Measures to fix city pension plan OK'd | New language may force out a trustee"; *San Diego Union-Tribune*; 20 July 2004. "Tawdry Display"; *San Diego Union-Tribune*; 21 July 2004. City of San Diego:

pension board of trustees be "composed of qualified professionals who have no vested interest" in the pension plan.[51]

- In 2004 City officials carried out a plan to discredit a public official whistle blower who alleged that public officials they were engaged in on-going unlawful conduct.[52] Public officials agreed amongst themselves to place the whistle blower under arrest if she attempted to attend meetings of the pension board of which she was a member.[53]

Despite Gerald Boltz and the Bryan Cave firm's candid and straight-forward advice to City officials regarding their responsibilities to ensure the accuracy of financial statements, the City Council approved the issuance of $1.2 billion in eight separate municipal bonds from 14 February 2004 through 26 August 2003, that included false and misleading information. In approving these offerings, the City Council ignored Boltz's advice in the 21 October 2001 letter and approved both the bond offering and the associated financial statements which failed to included information about the growing liability of the pension and retiree health care plans, or the increase in debt to these programs as a result of additional benefit enhancements given to the City's municipal labor groups.

Proposition H: Prop H Amends the City Charter to Change the Composition of the Retirement Board. (Exhibit 23)

[51] 15 September 2005; Final Report of the City of San Diego Pension Reform Committee. *See Recommendation #14.* P. 20 of 74. (Exhibit 24)

[52] Whistle blower Diann Shipione sent a letter and spoke before the Mayor and City Council on 18 November 2002 noting, *inter alia*, that promising a city employee benefit conditioned upon a separate fiduciary's approval of an agreement to reduce already deficient City contributions to its pension plan is ethically questionable, if not blatantly corrupt. Shipione also clearly stated that MP 2 threatened the safety of the retirement plan. Letter from Diann Shipione to Hon. Dick Murphy and City Council, re: Items 50 & 51; re Retirement Benefits, dated 18 November 2002. Cathy Lexin, an SDCERS Board Member and the City's Labor Relations Manager, further perpetuated the concealment of unlawful acts by writing a memorandum on 6 December 2002, under the signature of then Assistant City Manager Lamont Ewell, to the Mayor and City Council responding to each of Shipione's concerns falsely concluding that "there was nothing in the process that was either improper, irregular, or unlawful, and Ms. Shipione's comments are without merit." Memorandum from P. Lamont Ewell to Hon. Mayor and City Council, Subject: SDCERS Benefit Enhancements; Response to Public Comment and Correspondence on Items 50 and 51 Adoptions Agenda, Consent Items, dated 6 December 2002. (Exhibit 25)

[53] Philip J. LaVelle, *Citizen's Arrest of Shipione Weighed*, SAN DIEGO UNION-TRIBUNE, 16 December 2004 <http://www.signonsandiego.com/news/metro/20041216-9999-1n16pension.html>. (Exhibit 26)

After the City Council chose to disregard the advice of Gerald Boltz, a former high ranking SEC official, the Council proceeded to spend millions of dollars on additional former-SEC officials to defend their actions in approving bond offerings and financial statements that failed to contain information about the declining financial stability of the City's pension system and the growing liabilities associated with retiree health care. Former-SEC officials hired by the City to defend the City Council's actions include:

- Paul Maco, the first director of the Securities and Exchange Commission's Office of Municipal Securities;
- Richard Sauer, former assistant director of the Division of Enforcement in the Securities and Exchange Commission;
- Lynn Turner, former chief accountant of the Securities and Exchange Commission;
- Arthur Levitt, former chairman of the United States Securities and Exchange Commission;
- Sean T. Prosser, a former enforcement attorney with the SEC;
- Thomas Zaccaro, former regional trial counsel for the SEC's Pacific Regional office.

The costs of these attorneys and consultants now reaches in the tens of millions of dollar purely for the defense of the City Council members and high ranking City officials. The details of their actions in San Diego are detailed further in this report.

VI.
OBSTRUCTION OF CORRECTIVE EFFORTS THROUGH ADVERSE DOMINATION

With knowledge of the prior wrongdoing from which they or their allies profited, City officials and employees used their control over City government to hamper the efforts to relieve the City and the people of San Diego from the debt. These City officials have blocked corrective action by using their control of City government to "adversely dominate" San Diego City government. See, *City of Oakland v. Carpentier* (1859) 13 Cal. 540; *Beal v. Smith* (1920) 46 Cal. App. 271, 279.

For example, in 2004, City officials attempted to cover-up their unlawful actions by hiring a law firm to give the false appearance that City officials were investigating their alleged wrongdoing. The firm, Vinson & Elkins, issued a report that, at the City's request, failed to examine key evidence. More importantly, Vinson & Elkins, throughout their engagement, reported to the San Diego City Manager, a position that was hired and fired by the San Diego City Council, the very body that Vinson & Elkins was supposed to investigate. The fact that Vinson & Elkins did not conduct a truly independent investigation caused the City's outside auditor to discount Vinson & Elkins report as insufficient as it did not meet the standards established by the American Institute of

Certified Public Accountants.[54] More alarming, the City Council voted in a closed session meeting on 21 September 2004 to permit Vinson & Elkins to begin settlement negotiations with the SEC. However, the City Council specifically stated that the City and City officials must be part of the same negotiated settlement. In other works, the City Council could not be legally separated from the City of San Diego in any settlement discussion.[55]

In 2005, City officials unlawfully obstructed the City Attorney from naming the attorney for the City's pension plan in violation of Charter § 40 and Municipal Code § 24.0910. Specifically, in 1995, the San Diego City Council adopted a resolution to allow the SDCERS Board appoint its own counsel in an attempt to establish SDCERS as a separate legal entity with interests opposed to those of the City of San Diego. This arrangement permitted the architecture and approval of the now infamous MP 1 and MP 2 deals between SDCERS and the City. These deals led to the Federal Grand Jury indictment of the SDCERS general counsel for fraud in January 2006 and the San Diego District Attorney's indictment of the SDCERS general counsel for conflict of interest and self dealing in May 2005. Despite these charges from the highest legal authorities in the County, which clearly illustrated that the 1995 City Council resolution was a failed policy, the City Council in 2005 repeatedly ignored the City Attorney's request to undo the failed resolution and allow the City Attorney to appoint the general counsel.[56]

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[54] 26 July 2006; "Interim Report No. 9: Report on Breach of Contract, Fiduciary Duties, and Professional Negligence by Vinson & Elkins LLP – Report of the San Diego City Attorney Michael J. Aguirre. (Exhibit 27.)

[55] Vigil, Jennifer; "Council asked for shield in settlement | City told its lawyers to negotiate with SEC"; *San Diego Union-Tribune;* 15 December 2005. Donohue, Andrew; "Council Tries to Settle with SEC in 2004"; *Voice of San Diego*; 14 December 2004. (Exhibit 28.)

[56] 15 December 2004 memorandum from Michael J. Aguirre to Lawrence Grissom, retirement Administrator for SDCERS; Re: "City Attorney As Legal Advisory to Board of Administration Per City of San Diego City Charter Section 40. LaVelle, Philip; "Aguirre asserts control of pension legal affairs"; *San Diego Union-Tribune;* 17 December 2004. 12 January 2005 media release from City Attorney Michael Aguirre titled, "City Attorney Reasserts Role as Chief Legal Advisor to Employees' Retirement System Amidst Allegations of IRS Violations. 22 February 2005 memorandum from City Attorney Michael Aguirre to Honorable Mayor and Members of the City Council; Subject: "Legal Action Plan to Address City's Financial Condition; Hall, Matthew T.; "Aguirre's 'road map' for S.D. | Mayor calls city attorney 'rookie' over legal advice"; *San Diego Union-Tribune;* 23 February 2005. 1 March 2005 media release from City Attorney Michael Aguirre titled, "Mayor and City Council Violate Charter; Attempt to Interfere with City Attorney Authority to Represent City's Retirement Board." (Exhibit 29.)

In 2005, City officials refused to rescind the indemnification of other city officials that purportedly obligated the City to pay for the latter's legal costs incurred in connection with the unlawful failure to pay pension debt and the granting of pension benefits without the required funding.[57]

In 2005, the Mayor refused to calendar before the City Council a discussion on the City Attorney's proposals to set aside unlawful debt created in the MP 1in 1996 and the MP 2 deal in 2002. According to the City's actuary, the removal of the illegal debt could relieve the City of San Diego of more than $500 million from it's over $1 billion pension debt.[58]

In 2006, City officials hired an individual with no pension administration experience to serve as the City's pension plan administrator.[59]

In 2006, City officials attempted to cover up their wrongdoing by employing another law firm and consulting firm to prepare a favorable report for them. However, the report failed to analyze key provisions of California's laws that deal with conflict of interest.[60]

In 2006, City Council President Peters worked with representatives of Kroll to limit questions to be asked of them during their 8 July 2006 presentation of the Kroll report to the San Diego City Council.[61] Specifically, an arrangement was established between Peters and Kroll to allow only questions regarding the contents of the report. This agreement precluded any questions regarding the adequacy and legality of Kroll's billing practices which had been called into question during the period that the company

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[57] 20 May 2005 letter from City Attorney Michael Aguirre to Honorable Mayor and City Council; Subject: "City's Illegal Agreement to Indemnify SDCERS Board Members". Gustafson, Craig; "S.D. to continue covering pension board's legal fees"; *San Diego Union-Tribune*; 19 April 2006; 30 July 2007 San Diego City Attorney Memorandum "Rescission of Resolution R-297335. (Exhibit 30.)

[58] 22 February 2005 City Attorney memorandum "Legal Action Plan to Address City's Financial Condition, Exhibit 31.

[59] 26 September 2006 Deposition of David B. Wescoe pp. 47-48, (Exhibit 32.)

[60] 9 February 2005; "Interim Report No. 2 Regarding Possible Abuse, Illegal Acts or Fraud by City of San Diego Officials – Report of the San Diego City Attorney Michael J. Aguirre". (See Exhibit 8) 13 April 2006; "Interim Report No. 8 Report on Kroll's Breach of Legal Duties Owed to the City of San Diego, Exhibit 33.

[61] Matthew T. Hall, *Kroll Report, Quarreling Both Have Early Start: Details of 8a.m. Meeting Next Week Upset Leaders*, SAN DIEGO UNION-TRIBUNE, 3August 2006. (Exhibit 34.)

worked on the report. This agreement also precluded any questions regarding the investigative methods and techniques used by Kroll to ensure they met standards established by the American Institute of Certified Public Accountants.[62]

In 2006, the Council President refused to calendar a discussion before the City Council on the City Attorney's proposal for setting aside the unlawful debt.

In 2006, the San Diego City Employees' Retirement System pension actuary refused to answer questions regarding his actuarial report which contained questionable assumptions that had the effect of understating the sums due.[63] This is crucial because, at this time, the City was on notice that it was under investigation by the U.S. Securities and Exchange Commission. In short, while being investigated, the SDCERS general counsel, with the assistance of City Council President Scott Peters, precluded a due diligence questioning of the adequacy of the financial information to ensure that the accurate financial information was being issued to the public and to investors in San Diego bonds.

In 2007, despite a mandatory vote of the people of San Diego,[64] the SDCERS board decided to use a 20-year amortization period rather than the voter mandated period of 15 years.[65] Despite the clear voice of the people, the Mayor's appointee on the board

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[62] It is worth noting that the City of San Diego has received detailed billings from Kroll to audit the work and ensure that the City was not over billed for work or that the City was billed for work that was not completed.

[63] Jennifer Vigil, *Pension Board Rejects Aguirre's Questions*, SAN DIEGO UNION-TRIBUNE, 20 May 2006; Craig Gustafson, *Council Panel Questioning Actuary on Pension Gap*, SAN DIEGO UNION-TRIBUNE, 15 June 2006, Exhibit 36.

[64] On 2 November 2004, 53.41% of San Diego voters approved Proposition G to enforce certain changes on the amortization schedule for paying of liabilities for the San Diego City Employees' Retirement System. The ballot language of Proposition G stated, "This proposition would preclude the ability of the City of San Diego to negotiate multi-year delays of full actuarial funding of the Retirement System. Additionally, the basis upon which new retirement benefits are amortized would be limited to no more than a five-year schedule and the basis upon which net accumulated actuarial losses are amortized would be limited to no more than a fifteen-year schedule." (Exhibit 23.)

[65] Vigil, Jennifer, "Payment span set on pension debt," *San Diego Union-Tribune,* 17 March 2007. (Exhibit 37.)

voted in favor of this provision.[66] As a result, the City officials violated the San Diego Charter.[67]

Council President Scott Peters further illustrated his unwillingness to comply with the rule of law established by the SEC Cease-and-Desist Order when he issued a letter on 2 August 2007 to Mayor Sanders seeking certain changes to the City's financial statements. Most disconcerting is that the some of the changes include glaring misstatements of facts that Mr. Peters of issues that he is aware of. Specifically, Peters asked that the new CAFR include information that the voters approved a 15-year amortization schedule for the unfunded liability of the pension debt.[68] Peters made this suggested after he was aware that the SDCERS Board voted to implement a 20-year amortization schedule for the debt.

In 2007, City officials and employees agreed to carry out a false and misleading campaign to pressure the City Attorney to drop the City's legal actions to set aside the unlawful debt.[69]

In 2007, the San Diego City pension actuary refused to answer questions regarding his actual report which contained questionable assumptions that had the effect of understating the sums due.[70]

In 2007, City Councilmember Toni Atkins blocked discussion of the need to correct the underlying unlawful conduct by withdrawing from the San Diego City Audit Committee thereby depriving the Audit Committee of a quorum.[71]

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[66] Vigil, Jennifer, "Payment span set on pension debt," *San Diego Union-Tribune,* 17 March 2007. The article stated, "The pension board approved the 20-year time frame on a 9-3 vote, with three representatives of employee unions dissenting…." (Exhibit 37.)

[67] San Diego City Charter § 143 (see Exhibit 8.)

[68] 2 August 2007 letter from Council president Scott Peters to Mayor Jerry Sanders. Subject: "2004 Comprehensive Annual financial Reports". (Exhibit 38.)

[69] 6 August 2007 email from Debbie Quinones; Subject: "Urgent Message From MEA." (Exhibit 39.)

[70] 12 April 2007 City Attorney Media Advisory City Attorney Responds to City Council President's Action to Suppress Public's Right to Know About Pension Issues; 11 April 2007 Letter from Scott Peters to David Wescoe, Exhibit 40.

[71] See 6 August 2007 Audit Committee Meeting Video Archive, at minute 24:15-24:45 <http://granicus.sandiego.gov/ViewPublisher.php?view_id=24>

VII.
ADVERSE DOMINATION EXPLAINED

As stated above, certain San Diego City officials and employees have used their power to disrupt the efforts to undo the unlawful debt they created in order to benefit themselves and their political supporters at the expense of the City. The actions of these officers and employees violate the fundamental principle that officers of a municipal corporation are agents of the corporate body, and may not use their official position for their own benefit, or for the benefit of any one except the municipality itself. *People v. Sullivan*, 113 Cal. App. 2d 510, 523 (1952).

When a corporation, like the City of San Diego, is adversely dominated by its board, courts have refused to allow a City's cause of action against its board of directors to expire as long as the board remained in control of the corporation, thus precluding the running of the statute of limitations. *See Adams v. Clark*, 22 F.2d 957, 959 (9th Cir. 1927); Michael E. Baughman, Comment, *Defining the Boundaries of the Adverse Domination Doctrine: Is there Any Repose for Corporate Directors?*, 143 U. Pa. L. Rev. 1065, 1066 (1994-95).

California courts follow this principle, as there exists a long line of case authority supporting the adverse domination principle to toll statutes of limitations so long as a corporate board remains in the hands of wrongdoing directors. As stated in *Whitten v. Dabney*, 171 Cal. 621,629 (1915):

> So long as the corporation itself remains under disability and is powerless to act by virtue of the fact that its control is in the hands of a board of directors accused of participation in the frauds the statute of limitations does not run against it.

In *Dabney*, stockholders sued alleging a conspiracy to defraud future stockholders by three corporate founders who were said to control the Dabney Oil Company through the board of directors. *Id.* at 623-24. The conspirators were alleged to have transferred leaseholds of oil lands in exchange for stock in the company. The trio offered stock to the public claiming it was treasury stock and that the proceeds from the sale of the stock would go into the treasury of the Dabney Oil Company and be used in developing its oil mining opportunities. *Id.* at 624-25. To stimulate sales of the stock, false dividends were declared and paid, not out of the earnings of the company, but out of the proceeds of the sale of stock. Dabney and his cohorts also failed to pay back large amounts of money owed the company but instead caused false credits to be entered upon the books of the corporation. Unauthorized commissions were paid by the wrongdoers. They also made false written representations. *Id.* at 626-27. In short, the defendants were alleged to have engaged in a stock jobbing scheme, in which they made quick buys and sales of company stock with the intent of artificially increasing the market price of the company's stock. *Id.* at 626-27.

The Court in *Dabney* likened a corporation controlled by law violating directors to the "minority of an infant." The rights of the corporation, like the minor, "are not lost until he, after attaining majority, acquiesces for the prescribed time and by acquiescence affirms the acts done against his interests." The Court in *Dabney* went on to explain that even if a complaint as "shows that the plaintiff stockholder has waited too long before commencing his action, and that therefore the plea of the statute of limitations must be sustained against his action, this does not operate as a bar to the corporate rights when prosecuted by another stockholder." The *Dabney* court explained that "[o]therwise we would have the anomalous and absurd condition presented of a complacent stockholder waiting for three years, pleading facts showing that his right of action was thus barred, and thus sweeping away every right of the corporation by the judgment which would have to follow." *Id.* at 629-30.

The California Supreme Court applied the adverse domination principle to suspend the statute of limitation for the City of Oakland in 1859. *City of Oakland v. Carpentier*, 13 Cal. 540 (1859). In that case the California Supreme Court stated that so long as the municipal corporation remained under the domination of "confederates" engaged in an unlawful scheme the statute was tolled:

> If these facts be made to appear, the statue of limitations would not begin to run until after the corporation thus defrauded got out of the hands of the confederates, and an opportunity were afforded innocent agents, coming to the management of the affairs of the town, to look into and ascertain the true state of things. Knowledge on the part of the guilty agents of the corporation of the criminal fact is not notice to the corporation of such fraud, so as to give the advantage of this notice to the equally guilty associate of those agents. If this were the law, an agent could always protect himself by joining in a conspiracy to defraud his principal with a convenient friend, who received the principal's property, and who might claim against the principal that the agent had notice of the fraud.

Id. at 552.

The facts of *Oakland v. Carpentier*, are instructive. The complaint sought to set aside a franchise and real estate lease made by the Board of Trustees of the City of Oakland in 1854 with a prominent private citizen of Oakland, Horace W. Carpentier. The City of Oakland "pretended to convey" to Carpentier and his representatives "the exclusive right and privilege of constructing wharves, piers, and docks, at any point within the corporate limits of the town of Oakland, with the right of collecting wharfage and dockage as he might deem reasonable, upon certain conditions expressed in the ordinance." *Id.* at 543-44.

The complaint further alleged that after receiving the pretended conveyance of real estate and franchises, Carpentier "by fraud, procured certain men to be elected again as the Board, who ratified this contract; that the first ordinance was fraudulent, Carpentier

having procured himself to be elected Trustee for the purpose of getting it and having his agents on the Board of Trustees." *Id.* at 544.

Carpentier was alleged to have received from the City of Oakland trustees "the sole privilege, not only of constructing all wharves, but of laying out, establishing, and regulating them, too. This amounts, not to the grant of a license or privilege to erect a wharf, or all the wharves, laid out or ordered by the council, but the grant of an exclusive right to lay out and construct them at his own convenience, in his own way, and to hold and use them on his own terms; and, if he did not choose to exercise this privilege, the corporation is prevented from giving the privilege to any one else; and so of docks, piers, and the like." *Id.* at 545-46.

The Court found the ordinance was not "an exercise of a power under the charter, but as a transfer of the corporate powers intrusted to this Board to this favored grantee." *Id.* at 546. In order to carry out the extraordinary grant of public rights Carpentier was alleged to have "procured men, who were his agents or conspirators with him, to be elected to this Board, for the purpose of getting them to defraud the town, for his benefit, of all this property and these franchises." *Id.* at 551.

Carpentier was also alleged to have in essence "got himself elected to this place, in order to help the contrivance through, whether by his influence, or by keeping out some one else who might have opposed the scheme, then this was sufficient to brand the whole transaction with illegality." *Id.* at 551. If "Carpentier put himself in the position of a member elect of this Board, neither resigning nor qualifying, and took advantage of this position to advance his personal interests, at the expense of those of the corporation, this was a fraud for which a Court of Equity would hold him responsible." *Id.* at 551-52. The Court explained that Carpentier occupied "the position, really, of a Trustee dealing for his own profit with the subject of the trust, and his conduct would be scrutinized with the jealousy with which equity regards the interested dealings of an agent with the principal, in respect to the subject of the trust." *Id.* at 552.

The Court was careful to note that ratification would have no "effect in validating the transaction" by "a subsequent Board, if the members were fraudulently elected, or procured to be elected, by Carpentier." *Id.* at 552. The Court explained that "Carpentier could not protect his fraud by the sanction of his own associates united to effect, together, an illegal enterprise." *Id.* at 552. The Court then went on to find the allegations of adverse domination would be sufficient to toll the statute of limitations until innocent agents took over the management of the City.

In another California case issued eight years before *Whitten v. Dabney*, the Court in *Pacific Vinegar and Pickle Works v. Smith*, 152 Cal. 507 (1907), traced the authority for the proposition that knowledge was not to be imputed to the corporation by its wrongdoing officers and agents. The court explained that to do so would allow an officer or agent of the corporation to enforce his own wrong against his principal:

> It would permit an officer of a corporation to enforce his own wrong against the corporation itself. Thus, while this rule of imputable knowledge of the contents of the books of a corporation is presumed for the protection of third persons and stockholders, it is not only never recognized, but distinctly disaffirmed, where the matter complained of is one between the corporation itself and any of its officers or agents. To apply it, would be to put a premium on dishonest bookkeeping, and, as pointed out by Mr. Justice Brewer, in the case of a bank, to permit the bookkeeper and cashier to combine and plunder the bank of all its assets, unknown to any one, through every transaction should be entered in the books, and, after doing this, to receive immunity because of the knowledge imputed to the other officers.

Id. at 514.[72]

Beal v. Smith, 46 Cal. App. 271 (1920) followed the rule established in *Whitten v. Dabney*. In *Beal*, the court reiterated the rule that when the board of directors is under the domination of those who are committing fraud, the limitation period for commencing suit is tolled:

> But where, as alleged here, the corporation and its board of directors were wholly under the domination of those who committed the original fraud the corporation is deemed to be in the same position as an incompetent person or a minor without legal capacity either to know or to act in relation to the fraud so committed, and during such period of incapacity the statute of limitations does not run, at least, against an innocent stockholder who was without knowledge of the fraud.

Id. at 279.

San Leandro Canning Co., v. Perillo, 211 Cal. 482 (1931) also followed the rule established in *Whitten v. Dabney*, *Pacific Vinegar and Pickle Works v. Smith* and *City of Oakland v. Carpentier*. In *San Leandro*, the limitations statute was tolled based upon fraudulent acts of the directors:

> [T]he cause of action set forth in the plaintiff's complaint was not barred at the time of the commencement thereof by any statute of limitations. The unexpressed reason for this ruling was doubtless that set forth in the complaint, to the effect that during the course of the transaction out of which this controversy arose and for a period of time up to within three

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[72] The *Pacific Vinegar* court based its holding that guilty knowledge of agents of a corporation is not attributable to the corporation on three cases originating outside of California: *Scott v. De Peyster*, 1 Edw. Ch. (N.Y.) 513; *Wakeman v. Dalley,* 51 N.Y. 27; and *Wallace v. Lincoln Savings Bank,* 89 Tenn. 630.

> years prior to the date of the commencement of the action the defendants were the directors of said corporation, and as such were in the full control of its affairs and finances. These averments of the complaint having been for the purposes of said decision taken to be true, it would follow, under what we deem to be a well-settled principle of law, that the statute of limitations does not commence to run against unlawful acts and expenditures made by or under the direction of the directors of the corporation while they were in full control of its affairs and of the expenditures of its funds.

Id. at 486-487. (Emphasis added.)

The adverse domination on one level is but an extension of the basic rule of agency law to the effect that knowledge of agents acting adversely to their principal is not imputed to the principal:

> Where an agent acts in a capacity adverse to the principal in the transaction, there is no reason to believe that the agent will keep the principal properly informed, and ordinarily the notice will not be imputed. This rule is, in a sense, derived from the broader principle that knowledge of the agent obtained while acting contrary to or outside the scope of his or her authority will not be imputed. Witkin, Agency and Employment § 155; *See Los Angeles Inv. Co. v. Home Savings Bank of Los Angeles*, 180 Cal. 601 (1919); *Sands v. Eagle Oil & Refining Co.*, 83 Cal. App. 2d 312, 319 (1948); Rest. 2d, Agency §§ 282, 279, and Appendix, Re. Notes, pp. 478, 485.

In order to establish that the management of a city is adversely dominated by wrongdoers, the question of the degree to which the domination exists has to be resolved. Michael E. Baughman, Comment, *Defining the Boundaries of the Adverse Domination Doctrine: Is There Any Repose For Corporate Directors?*, 143 U. Pa. L. Rev. 1065 (1994-95). The source of the modern adverse domination claim is *International Railways of Central America v. United Fruit Co.*, 373 F.2d 408, 414 (2d Cir. 1967):

> One principle emerging with some clarity is that a plaintiff who seeks to toll the statute on the basis of domination of a corporation has the burden of showing a full, complete and exclusive control in the directors or officers charged. (Citation omitted.)

The version of adverse domination taken from the *United Fruit* case is known as the "complete domination test." See *Federal Deposit Ins. Corp v. Dawson* 4 F.2d 1303, 1309 (5th Cir. 1993); Michael E. Baughman, Comment, *Defining the Boundaries of the Adverse Domination Doctrine: Is There Any Repose For Corporate Directors?*, 143 U. Pa. L. Rev. 1065, 1082 (1994-95). Complete domination is an issue of fact, not merely a numerical question. In *Farmers & Merchants National Bank v. Bryan*, 902 F.2d 1520 (10th Cir. 1990), the court was asked to find that adverse domination did not apply as a matter of law because there were two outside directors on the board who were not accused of wrongdoing. The *Bryan* court held that the question of domination is one of

fact for the jury to decide, and noted that "a plaintiff may also demonstrate adverse domination by proving that an informed director, though capable of suing, would not do so." *Id.* at 1523. Another court applying the "complete domination test," has further held the doctrine of adverse domination is "inherently fact-specific" and that "control sufficient to warrant the tolling of the statute of limitations may occur where culpable directors constitute less than a majority of a board of directors . . . ." *Resolution Trust Corporation v. Thomas*, 837 F.Supp. 354, 359 (D.Kan. 1993).

However, as one commentator has noted, the trend of adverse domination is toward applying a "majority test," in which a plaintiff "must show only that a majority of the board members were wrongdoers during the period the plaintiff seeks to toll the statute." *Federal Deposit Ins. Corp. v. Dawson* 4 F.2d 1303, 1310 (5th Cir. 1993). In adopting the majority test, the Court in *Dawson* reasoned that "the mere existence of a culpable majority on the board is so likely to preclude the corporation from filing suit against the wrongdoers that tolling is thereby justified." *Dawson,* 4 F.2d at 1310. The majority test is exclusively a numerical one and has been adopted by most courts. Michael E. Baughman, Comment, *Defining the Boundaries of the Adverse Domination Doctrine: Is There Any Repose For Corporate Directors?*, 143 U. Pa. L. Rev. 1065, 1082 (1994-95).

VIII.
PUBLIC OFFICIALS HAVE FORGOTTEN GOVERNMENT ESTABLISHED TO SERVE THE PEOPLE

City officials and employees have deviated so far from their fundamental duties to the people of San Diego that it is necessary and useful to review the fundamental purpose of local government. San Diegans, like Americans in general, have always acted upon the deep-seated conviction that local matters can be better regulated by the people of the locality than by the state or central authority.

One controlling idea of local self-government is to bring the officials nearer to the people whose interests are immediately affected by official conduct, in deference to the fundamental maxim in the American system of government that the nearer the officers are to the people they represent, the more easily and readily are reached the evils that result from political corruption and the more speedy and certain the cure. Local self-government is, thus, a guaranty of individual liberty. *Penhallow v. Doane*, 3 Dall 54, 93, 1 L Ed 507 (1795); 1 McQuillin Mun. Corp. § 1.44 (3rd ed.)

However, the right of the people of San Diego to participate in fundamental decisions made by their City officials and employees has been frustrated by the course of illegal conduct described in this report. As a consequence, in the operation of San Diego's local self-government, the public has been alienated from their City government. It is hoped that a candid discussion of the issues in this report will help to awaken the public to take an active hand in redressing the crisis faced by their local government. 1 *McQuillin Mun. Corp. §* 1.37 (3rd ed); *See* Gerald E. Frug, *The City as a Legal Concept*, 93 Harv. L. Rev 1059 (1980).

It is important to remind San Diego City officials and employees that under our form of government, the repository of ultimate sovereignty is in the people. *Adkins v. Children's Hospital of the District of Columbia*, 261 US 525, 544 (1923); 1 McQuillin Mun. Corp. § 1.44 (3rd ed.). The people in political and legal theory are the <u>supreme law-givers, law-interpreters, and law-administrators</u>. In them resides the <u>law-making, law-interpreting and law-enforcing power</u>. No officer, agent or department can run counter to the public will unless and until a change in that will is reflected by a change in the Constitution. 1 McQuillin Mun. Corp. § 1.44 (3rd ed.). (Emphasis added.)

IX.
THE FIDUCIARY DUTIES OF PUBLIC OFFICIALS

It is universally agreed that local government officers owe their government, and the people of their city, a fiduciary duty of the highest possible fidelity and of the greatest skill and diligence as to their work. Osborne Reynolds, Jr., *Local Government Law* § 84 p. 293 (2d ed.); *Terry v. Bender*, 143 Cal. App. 2d 198 (1956). In discharging their duties, city officers may <u>not</u> go beyond the law. McQuillin Mun Corp § 12.126 p. 599-600 (3d ed); *Kennedy v. Ross*, 28 Cal 2d. 569 (1946); *Bolger v. San Diego*, 239 Cal. App. 2d 888 (1966); *Powell v. San Francisco*, 62 Cal. App. 2d 291 (1944). The principles within which city officers operate are set by law:

> These rules are firmly established and uniformly enforced by the courts: municipal officers are only agents of the local public in its corporate capacity, they act under defined powers and duties, limited and restricted by law, and the extent of these powers is to be strictly construed and may not be enlarged by usage or custom.

McQuillin Mun Corp § 12.126 (3d ed.) p. 601; *People v. Sullivan*, 113 Cal. App. 2d 510 (1952).

San Diego's charter and California State law forbids City officers from being directly or indirectly interested in any contract with the city. San Diego City Charter § 94; Cal. Gov't Code §§ 1090, 1092; *Thomson v. Call*, 38 Cal 3d 633 (1985); *Berka v. Woodward*, 125 Cal. 119 (1899); *Imperial Beach v. Bailey*, 103 Cal. App. 3d 191 (1980); 3 McQuillin Mun. Corp. § 12.136 (3d ed.) The general rule is that there should be strict enforcement of conflict of interest statutes so as to provide a strong disincentive for officers who might be tempted to take personal advantage of their public offices. 3 McQuillin Mun. Corp. § 12.136 (3^d ed.)

City officials' ability to create debt in the name of the City is restrained by debt limitations contained in the San Diego City Charter and the California State Constitution. San Diego Charter § 99 and California Constitution Article 16 § 18 require a vote of the people for debt or liabilities incurred in any one year that exceed that year's revenue.

These debt limit provisions are intended to prohibit the accumulation of public debt without the consent of the taxpayers, and require governmental agencies to carry on their operations on a cash basis. In re *Southern Humboldt Community Healthcare Dist.*, 254 B.R. 758 (Bankr. N.D. Cal. 2000); 56 Am.Jur.2d, Municipal Corporations, Counties, and Other Political Subdivisions, § 606. Claims made on loans in excess of borrowing limitations are unenforceable. 64A C.J.S., Municipal Corporations, § 1599, citing, *inter alia, City of Los Angeles v. Offner*, 19 Cal.2d 483, 486 (1942); *see also* 15 McQuillin Mun. Corp. § 41:1 (3d ed.)

Debt-limitation provisions are designed to promote the common good and welfare. In re *Southern Humboldt Community Healthcare Dist.*, 254 B.R. 758 (Bankr. N.D. Cal. 2000); 15 McQuillin Mun. Corp. § 41:1 (3d ed.) Their purpose to serve as a limit to taxation and as a protection to taxpayers; to maintain municipal solvency, to keep municipal officials from abusing the taxpayers' credit, and to protect them from oppressive taxation. 15 McQuillin Mun. Corp. § 41:1 (3d ed.) Moreover, these debt limit laws seek to prevent current councils from binding future councils, and to prevent today's legislators from making future taxpayers pay today's bills. As Thomas Jefferson once stated "...public debt (is) the greatest of dangers to be feared." 15 McQuillin Mun. Corp. § 41:1 (3d ed.)

Specifically, California Constitution Article 16 § 18 provides that no city "shall incur any indebtedness or liability in any manner or for any purpose exceeding in any year the income and revenue provided for such year, without the assent of two-thirds of the voters." San Diego City Charter § 99 provides that the "City shall not incur any indebtedness or liability in any manner or for any purpose exceeding in any year the income and revenue provided for such year unless" approved by City voters.

When a San Diego City public official negotiates a City contract in which they hold a financial interest they violate Government Code § 1090 and Charter § 94. When a city official agrees to indebt the City in excess of available same year revenues he violates Charter § 99 and the California State Constitution Article 16 § 18.

X.
EFFORT TO SETASIDE UNLAWFUL PENSION DEBT

Between 2005 and 2007 the City Attorney issued a series of Interim Reports detailing the unlawful acts of city officials related to the unlawful pension debt and efforts to hide and cover-up the nature and extent of the related problems created for the City.[73] On July 8, 2005 the City Attorney, on behalf of the City of San Diego, filed in San Diego Superior Court a cross-complaint directed at setting aside the unlawful pension debt. The matter was assigned to the Honorable Jeffrey B. Barton.

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[73] Go to www.sandiegocityattorney.org Investigative Reports

In addition, the granting of illegal benefits and the intentional underfunding of the pension system has generated numerous lawsuits in which the City has been involved. These lawsuits can be separated into several categories, lawsuits brought by the City, lawsuits against the City and taxpayer initiated lawsuits.

In the first category, lawsuits brought by the City, the City has brought lawsuits against several of the professionals paid to render competent advice to the City and SDCERS regarding the operation of the pension fund, but who failed to competently render the advice paid for. Defendants in these actions include Callan & Associates, who were involved in the bond issuance, Gabriel, Roeder, Smith & Company, SDCERS' former actuary, Caporicci and Larson, an audit firm, and Calderon, Jaham & Osborn, another audit firm. Monetary recoveries from some of these cases have netted the City in excess of $6,000,000, with several other cases still pending.

In other pension related lawsuits, the City has been sued. Specifically, in the case before Judge Barton, SDCERS initiated this action when it sued the City. In this lawsuit, the City has asserted a cross-complaint seeking a determination of whether or not the agreements known as Manager's Proposal 1 and Manager's Proposal 2 are legal. Manager's Proposal 1 and Manager's Proposal 2 are the agreements between the City and SDCERS in which SDCERS agreed to allow the City to intentionally underfund the pension system in exchange for the City agreeing to increase pension benefits retroactively and prospectively.

Other lawsuits, in which the City has been named as the defendant, include the federal cases brought by the San Diego Police Officer's Association against the City. In these lawsuits, the SDPOA complained that the City was not providing the police officers with an actuarial sound pension system. Judge Huff has dismissed all the federal claims brought by the SDPOA as being unmeritorious.

Last, taxpayers have sued the City with regards to pension issues. The two most notable cases are the ones that were brought by Jim Gleason and William McGuigan. In these two cases, both sought relief the City's decision to intentionally underfund the pension system. Both of these cases were settled after the City agreed to contribute additional funds to the pension system.

In the course of the litigation the City Attorney's office responded to 6 demurrers, and 3 summary judgment/adjudication motions. The City brought its own summary judgment motion. In addition the City filed 2writs to the State Appellate Court and 1 writ to the California Supreme Court.

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XI.
OPTIONS FOR CITY OF SAN DIEGO TO SETASIDE UNLAWFUL DEBT

A. APPEAL

The City Attorney's office is pursuing and proposing several options for undoing the illegal pension and retiree health care debt.[74] The City is appealing Judge Jeffrey B. Barton's ruling dismissing the City's Cross-complaint on several grounds. First, the City believes that Judge Barton read the law prohibiting City officials from negotiating contracts in which they have a financial interest (Government Code § 1090) too narrowly. The Court found that even if officials were involved in the original violations Government Code § 1090, those violations were waived by later contracts in which some of the same officials participated. The City believes that the only way that a Government Code § 1090 violation can be corrected is after full disclosure and vote by a disinterested board.

The City also believes the Court ignored clear decision of the legislature to set a four year from the date of discovery statute of limitations for Government Code § 1090 actions. The Court found that a one year statute applied. The Court also erred in ruling that anyone affected by an order to set aside the contracts creating the illegal debt because they violated Government Code § 1090 would have to be personally named in the case. The City believes fundamentally that Judge Barton's narrow reading of Government Code § 1090 was inconsistent with decades of judicial precedent.

Further, The City also believes that Judge Barton erred in refusing to resolve whether the liability limit law had been violated in connection with the creation of the pension debt. The Court misstated the City's theory in ruling that the liability limit law did not apply to the pension board. The City's case was based upon the theory that there was a dispute between the City and the pension board over whether City officials in creating the pension debt violated the liability limit law.

B. COUNCIL ACTION TO RESCIND ILLEGAL DEBT

The City Attorney recently proposed an additional step the City could take to set aside the illegal pension debt. Judge Barton has ruled that the City's action to set aside the unlawful pension debt was not properly presented before the court. However, the City Attorney proposed in a memorandum of 10 August 2007 that the Council take action that would join the issue of whether the debt was created in violation of the liability limit law. These recommendations by the City Attorney included, among others, that the Council take the following actions:

1. Rescind, as void and in violation of Article IV, Section 17, Article XI, Section 10(a), Article XVI, Section 6, and Article XVI, Section

[74] See City Attorney proposal for resolving the pension crisis. (See Exhibit 31.)

18 of the California Constitution, the retroactive portion of the "2.0% at 55" pension increase for all general employees and the "2.5% at 50" pension increase to all safety employees who received such retroactive increase as part of Manager's Proposal 1 ("MP 1")[75] and the "2.5% at 55" pension increase for all general employees and the "3.0% at 50" pension increase Manager's Proposal 2 ("MP 2")[76], except that members who retired after such retroactive increase took effect shall not be required to repay any pension payments representing the retroactive increase that they have actually received, but shall only be ineligible to receive payments attributable to such retroactive increase going forward;

2. Rescind, as void and in violation of Article XVI, Section 6, Article IV, Section 17 and Article XI, Section 10(a) of the California Constitution the DROP program following its initial three year trial period. DROP was intended to be a cost-neutral program. DROP was proven to be a non-cost neutral program prior to the expiration of its three year trial period. Its continuation following the three year trial period in which it guarantees its participants an 8% return compounded quarterly even after the participant has left City employment and the DROP program constitutes an illegal gift of public funds.

3. Rescind, as void and in violation of Article XVI, Section 6, Article IV, Section 17 and Article XI, Section 10(a) of the California Constitution the purchase of service program. The purchase of service program was intended to be a cost-neutral program. However, SDCERS set the price for the purchase of service of credits at an arbitrary value, with said purchase price being way too low. The arbitrarily low price was eventually increased, but only after, the public employees were informed that the price was

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[75] The multiplier increases under MP 1 were dependent on age. The retirement multiplier for general members started at 2.0% at age 55 and went up to 2.55% for anyone retiring at age 65 or greater. Safety members (excluding lifeguards, who had their own separate sliding scale) multiplier began at 2.5% at age 50 and went up to 2.99% at age 56 and above. Lifeguards multiplier started at 2.20% at age 50 and went up to 2.77% at age 56 or above. Thus, when this memo discusses the pension increases granted under MP 1, the author is referencing all the multiplier increases contained within MP 1.

[76] The multiplier increases under MP 2 were dependent on age. The retirement multiplier for general members started at 2.5% at age 55 and went up to 2.8% for anyone retiring at age 65 or greater. Safety members, including lifeguards, multiplier was increased to 3.0% at age 50 and above. Thus, when this memo discusses the pension increases granted under MP 2, the author is referencing all the multiplier increases contained within MP 2.

below the system's cost and encouraged to buy the maximum amount of service credits before the price was increased. The purchase of service allows a retiring member (including a member in DROP) to receive pension benefits that were not fully paid for by the employee, but rather, is being subsidized by the City. The amount the City now needs to contribute to fund the purchase of service annuity for each member who purchased service credits at below cost constitutes an illegal gift of public funds.

4. Direct the City Attorney to immediately file a Declaratory Relief action in the San Diego County Superior Court against each of the City's unions and the San Diego City Employees' Retirement System ("SDCERS"), confirming the rescission, seeking a judicial declaration that (1) the retroactive portion of the pension increases violates the debt limitation provisions, is a gift of public funds, and is extra compensation paid to public employees, all in violation of Article IV, Section 17, Article XI, Section 10(a), Article XVI, Section 6, and Article XVI, Section 18 of the California Constitution, (2) the DROP program's continuation after its initial three year trial period is a gift of public funds, and is extra compensation paid to public employees, all in violation of Article IV, Section 17, Article XI, Section 10(a), Article XVI, Section 6, (3) the purchase of service program is a gift of public funds, and is extra compensation paid to public employees, all in violation of Article IV, Section 17, Article XI, Section 10(a), Article XVI, Section 6, (4) that the City of San Diego has no obligation to make any further payments toward the retroactive portion of the pension increase, and enjoining further payments by SDCERS of the portion of payments to retirees based on the retroactive portion, (5) that the City of San Diego may discontinue the DROP program, and (6) that the service credits purchased prior to July 2005 be marked down to their actual value; and

5. Direct the City Attorney to send a letter to the Chief Executive Officer of SDCERS informing him that the City Council considers the retroactive portion of the pension increases to all members pursuant to MP 1 and MP 2 unconstitutional and void, that the City of San Diego will not include as its future payments the retroactive increase, requesting that SDCERS immediately calculate the required future payments based on the rate prior to the enactment of MP 1, the rate following MP 1 and prior to MP 2 and the rate following MP 2, that the City is discontinuing the DROP program and that service credits purchased prior to July 2005 be marked down to actual value.

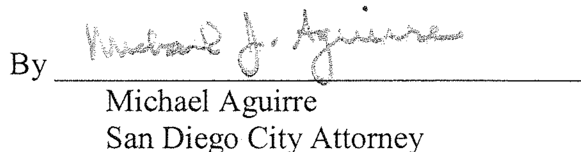
6. Following enacting the appropriate legislation to rescind these benefits, stay enforcement of the rescission of the retroactive benefits, the DROP program and the mark down of the purchased service credits for sixty days so that any interested party can challenge the legality of the rescission in a court of competent jurisdiction.

C. AWAIT A NEW CITY COUNCIL

A new City Council will be elected by November 2008. A new City Council made up of members who did not participate in the unlawful conduct by which the illegal pension and retiree health care debt was created will be more inclined to take the action needed to protect the City and its taxpayers. Under the adverse domination doctrine, the statute of limitations is tolled until a new City Council, made up of members not adversely dominating the City's government, takes office as the knowledge giving rise to the City's cause of actions to set aside the unlawful debt cannot be imputed to the City.

XII.
CONCLUSION

The City is currently facing a funding debt in excess of $2 billion in its pension system as a result of a number of governmental decisions including, but not limited to, the creation of illegal retirement benefits. The City Council and the Mayor need to take action now to reverse the creation of this illegal public debt so that all citizens of the City of San Diego can benefit from funds that would now be available for public services. However, the people who participated in creation of this illegal debt remain on the City Council. If these persons do not take the actions necessary to benefit the public at large, but rather, continue to thwart all attempts to undue the creation of the illegal debt, then these persons adversely dominate the City Council, and the right of the citizens of the City of San Diego to legally redress this wrong is stayed until these persons leave office.

By 

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