

**INTERIM REPORT NO. 19**

**NEED FOR INDIVIDUAL ACCOUNTABILITY  
REGARDING CITY'S VIOLATIONS OF  
THE FEDERAL SECURITIES LAWS**

**REPORT OF THE  
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## I. INTRODUCTION

de · ter [di-tur] (verb) - (1) discourage from doing something through fear of the consequences; (2) prevent the occurrence of.<sup>1</sup>

On 14 November 2006, the Securities and Exchange Commission (“SEC” or “Commission”) issued a cease and desist order finding the City of San Diego (“City”) committed securities fraud in 2002 and 2003 by issuing bond offerings that deliberately concealed the City’s financial troubles. Underscoring the seriousness of this finding, the SEC found that City officials acted with the intent to defraud. The SEC issued the cease and desist order to deter the City from committing future violations of federal securities laws. However, the City, individually and apart from City officials, did not have the required scienter to commit the securities fraud. Rather, as the SEC determined, the “City, through its officials, acted with scienter.”<sup>2</sup> The SEC found that the City possessed the requisite scienter “based on the mental state of its officials.”<sup>3</sup> Therefore, by holding only the City liable for violations of the securities laws, will the SEC’s actions really deter future violations?

As will be shown in this interim report, at all relevant times, former Mayor Dick Murphy (“Mayor”) and certain former and current City Council members knew of their duties under federal securities laws to disclose all relevant material information in connection with a securities offering. In 2002 and 2003, these City officials had information about the City’s true financial state that the investing public would have considered material, but nonetheless approved offering documents that omitted this critical information. The omissions constituted acts of securities fraud, yet the SEC has not held a single City official accountable.

Even the *San Diego Union-Tribune* recently called for certain City officials to be held accountable for this misconduct. In a lead editorial published on 9 September 2007, the *San Diego Union-Tribune* chastised the SEC for not bringing an enforcement action for violations of federal securities laws against any individuals associated with the City.<sup>4</sup> The editorial stated:

The SEC has created an absurd situation in which “the City” has violated federal securities laws but not a single individual has been held accountable. Chairman Cox, cities don’t commit securities fraud.

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<sup>1</sup> The Compact Oxford English Dictionary of Current English, 2005.

<sup>2</sup> 14 November 2006 Cease and Desist Order, p. 19, exhibit 1. Scienter is “a mental state embracing intent to deceive, manipulate or defraud.” *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193, n.12 (1976).

<sup>3</sup> 14 November 2006 Cease and Desist Order, p. 19, exhibit 1. Scienter is “a mental state embracing intent to deceive, manipulate or defraud.” *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193, n.12 (1976).

<sup>4</sup> The full editorial may be obtained online at [http://www.signonsandiego.com/uniontrib/20070909/news\\_lz1ed9top.html](http://www.signonsandiego.com/uniontrib/20070909/news_lz1ed9top.html)

Individuals do. It is time, indeed long past time, for the SEC to uphold its mission and bring to account those who were responsible for the financial wrongdoing at City Hall.

Although all acknowledge the City is in a financial crisis because of decisions made by City officials, no one, including the SEC, appears willing to take the necessary corrective action. This report details the information that was available to Mayor Murphy and the Council members at the time of the bond offerings and concludes that there is sufficient evidence to hold former and current City officials individually accountable for violations of federal securities laws because they acted with the requisite scienter. Unless and until the SEC holds Council members individually accountable for their actions, City officials will not be sufficiently deterred from engaging in similar, future misconduct.

## II. FEDERAL ANTI-FRAUD LAWS APPLY TO CITY OFFICIALS

The City and City officials are subject to the anti-fraud provisions of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder. In addition, the SEC has promulgated a broker-dealer rule, Exchange Act Rule 15c2-12. This rule limits market access for certain municipal securities issues unless and until the issuer agrees to file annual financial disclosures of specified financial and operating information, as well as notices of certain events (notices of any failures to file the requisite documents must also be filed).

The anti-fraud rules apply to all material disclosures and any other material statements made to the market. Section 17(a) of the Securities Act prohibits misrepresentations or omissions of material facts in the offer or sale of securities. Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder prohibit misrepresentations or omissions of material fact in connection with the purchase or sale of any security. These provisions prohibit the making of any untrue statement of material fact or the omission of a material fact in the offer, purchase or sale of securities. A fact is material if there is a substantial likelihood that its disclosure would be considered significant by a reasonable investor.<sup>5</sup>

As the SEC stated,<sup>6</sup> Section 17(a)(1) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5 require a showing that defendants acted with scienter.<sup>7</sup> Scienter is “a mental state embracing intent to deceive, manipulate or defraud.”<sup>8</sup> In the

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<sup>5</sup> *Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1987); *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

<sup>6</sup> This discussion of the federal securities anti-fraud laws is taken directly from the Cease and Desist order issued 14 November 2006 by the SEC in the case *The Matter of The City of San Diego*, which found that City officials acted with scienter. See exhibit 1.

<sup>7</sup> *Aaron v. SEC*, 446 U.S. 680, 701-02 (1980).

<sup>8</sup> *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976).

Ninth Circuit, recklessness satisfies the scienter requirement.<sup>9</sup> Recklessness is “an extreme departure from the standards of ordinary care, and which presents a danger of misleading [investors] that is either known to the defendant or is so obvious that the actor must have been aware of it.”<sup>10</sup>

Scienter, however, need not be shown to establish a violation of Section 17(a)(2) or 17(a)(3).<sup>11</sup> Violations of these sections may also be established by a showing of negligence.<sup>12</sup>

### **III. CITY OFFICIALS ARE EXPLICITLY TOLD THAT THEY HAVE A DUTY OF FULL DISCLOSURE UNDER THE FEDERAL SECURITIES ANTI-FRAUD LAWS**

The City officials involved in this securities fraud were educated about their duties under the federal securities laws in several ways: (1) as a result of the ballpark financing project; and (2) in relation to the bond offerings that eventually were found to contain deficient disclosures. Each is detailed below.

#### **A. BALLPARK FINANCING PROJECT**

This section of the report will provide an analysis of memorandums received and meetings attended by high ranking City officials where they received information about their duties under federal securities laws.

##### **1. FORMER CITY COUNCILMEMBER BRUCE HENDERSON PUTS THE CITY ON NOTICE OF POTENTIAL DISCLOSURE DEFICIENCIES**

Prior to the City bond offerings that failed to disclose the City’s pension problems, the City and its elected officials received educational training regarding federal securities laws and disclosure requirements. This occurred during the period preceding the placement of the bonds for Petco Park, the Padres’ new ballpark. Taxpayer advocate and former City Councilmember, Bruce Henderson, wrote a letter dated 20 September 2001 to the City threatening litigation over the City’s \$225 million bond offering to finance construction of the downtown ballpark for the San Diego Padres. The City’s bond offering was part of Proposition C, originally approved by San Diego voters on 3 November 1998. According to Proposition C, money raised from the bonds would finance construction of a new ballpark and assist in the development of a series of hotels, restaurants and retail shops. Annual payments for the debt service of the \$225 million

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<sup>9</sup> *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1569 (9th Cir. 1990) (en banc).

<sup>10</sup> *Id.* at 1569.

<sup>11</sup> *Aaron v. SEC*, 446 U.S. at 697.

<sup>12</sup> *SEC v. Hughes Capital Corp.*, 124 F.3d 449, 453-54 (3d Cir. 1997); *SEC v. Steadman*, 967 F.2d 636, 643 n. 5 (D.C. Cir. 1992).

bonds were to come from transient occupancy taxes collected by hotels. This plan, however, never came to fruition.

Conflict of interest charges were brought against former City Council member Valerie Stallings for illegally taking gifts from the owner of the San Diego Padres. As a result, the program for constructing the hotels and additional amenities fell through, along with the mechanism to fund the debt service from transient occupancy taxes. Thus, the City became responsible for finding a new funding mechanism to pay the debt service on the bonds. More importantly, the City had an affirmative duty to make changes in the preliminary offering statement ("POS") for the \$225 million in bond offerings to reflect that the funding source for the debt service was no longer available. (Preliminary statements and official statements are writings used to sell municipal bonds.)

In his 20 September 2001 letter, Bruce Henderson raised the issue that changes in the funding mechanism for payment of the debt service were material and must be disclosed in the City's financial statements tied to the bond offering. Henderson demanded that the City restate how the debt service would be funded to repay the \$225 million worth of bonds in the POS. Henderson wrote:

[T]he City will be required to make public the Preliminary Offering Statement setting forth as required by federal law the "material facts" affecting repayment of the City's proposed \$225,000,000 in bond debt as well as payment of the interest costs over the 30-year life of the bonds.<sup>13</sup>

Henderson wrote the letter to the City Attorney, Casey Gwinn, but it was later disseminated to the Mayor and City Council.<sup>14</sup> Henderson thus put Mayor Murphy and the City Council on notice that it was legally obligated to change the POS to reflect the new method of payment of the debt service under the same theory applicable to the bond disclosures found to be deficient by the SEC.

## **2. AS A RESULT OF BRUCE HENDERSON'S LETTER, THE CITY EDUCATED ITS OFFICIALS ABOUT DISCLOSURE REQUIREMENTS**

This section of the report examines steps the City took to educate its officials regarding their duties regarding disclosure requirements under the securities laws after Henderson's letter was received. Each Council member received a copy of Henderson's letter, following their request for a copy, as an attachment to a memorandum from Assistant City Attorney Leslie Girard dated 19 November 2001. Former Assistant City Attorney Leslie Girard wrote:

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<sup>13</sup> 20 September 2001 Letter from J. Bruce Henderson of the Association of Concerned Taxpayers to Casey Gwinn, attached to the 19 November 2001 Memorandum from Leslie J. Girard to Honorable Mayor and City Council Members, exhibit 48.

<sup>14</sup> 19 November 2001 Memorandum from Leslie J. Girard to Honorable Mayor and City Council Members with attached 20 September 2001 Letter from J. Bruce Henderson of the Association of Concerned Taxpayers to Casey Gwinn, attached to the, exhibit 48.

A number of Council members have requested copies of the letter from Bruce Henderson to the City Attorney, dated September 20, 2001, setting forth Mr. Henderson's claims about proceeding with the issuance of bonds for the Ballpark Project at this time. Enclosed please find a copy of the letter for your review. Please call if you have any questions.<sup>15</sup>

In connection with Henderson's correspondence, on 6 November 2001, the City Attorney's Office also sent Mayor Murphy and all Council members a memorandum outlining their responsibilities under the federal securities laws.<sup>16</sup> Attached to this memorandum to the Mayor and Council members was a five-page memorandum dated 29 October 2001 from Gerald Boltz<sup>17</sup> and Matt Anhut that "generally outlines federal securities laws on this subject."<sup>18</sup> The attached memorandum explained in detail the duties owed by public officials under federal securities laws. Although the memorandum specifically referred to the ballpark bond offering, it did so by placing that offering in the context of "an overview of the applicable federal securities laws." The memorandum informed these elected officials that, in an upcoming closed session meeting, "we will be discussing with you your responsibilities regarding the consideration of the Preliminary Official Statement for the City's ballpark bonds." The memorandum said "our outside counsel, Gerald Boltz and Matt Anhut of Bryan Cave LLP along with the City's bond counsel, Paul Webber of Orrick Herrington & Sutcliffe LLP will be discussing these matters with you."

The 29 October 2001 memorandum provided "a framework" against which the Mayor and City Council "must review and evaluate the Preliminary Official Statement ("POS"), and the Official Statement (OS) when completed" that were being prepared in anticipation of the ballpark bond offering. The 29 October 2001 memorandum was very specific, with numerous warnings for the Mayor and Council. The memorandum:

- (1) Warned the Mayor and Council members that they "must read" the POS and the OS.
- (2) Advised the Mayor and Council members that they should "ask questions as to any area or matter that may seem unclear or need

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<sup>15</sup> 19 November 2001 Memorandum from Leslie J. Girard to Honorable Mayor and City Council Members attached the 20 September 2001 Letter from J. Bruce Henderson of the Association of Concerned Taxpayers to Casey Gwinn, exhibit 48.

<sup>16</sup> 6 November 2001 memorandum from Leslie J. Girard to Honorable Mayor and members of the City Council, Exhibit 2.

<sup>17</sup> According to the SEC, Boltz was a highly-regarded Enforcement Division official who 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. 12 May 2006 SEC News Digest, "Commission Notes Passing of Gerald Boltz," exhibit 3.

<sup>18</sup> 6 November 2001 memorandum from Leslie J. Girard to Honorable Mayor and members of the City Council, Exhibit 2.

clarification, actively seek information from the officials of the City or Authority<sup>19</sup> and professionals retained in connection with the proposed offering, and conduct follow-up as to the information supplied.”<sup>20</sup>

- (3) Under the heading “Overview of the Applicable Federal Securities Law,” the memorandum informed the Mayor and Council that “transactions in municipal securities” were covered by the “antifraud provisions of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5 promulgated thereunder.” The memorandum explained: “these provisions prohibit any person, including municipal issuers, from making a false or misleading statement of material fact, or 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.”<sup>21</sup>
- (4) Warned the Mayor and Council members of penalties that could be imposed for violating federal anti-fraud securities laws, stating that “in the event of a violation of the securities provisions, the SEC has a range of remedies at its disposal, including the authority to seek injunctive relief to stop (in extraordinary circumstances) the offer or sale of securities and the imposition of penalties (which include monetary fines and the placement of limitations on securities related activities). In addition, there is typically a substantial amount of negative publicity that arises in connection with an SEC proceeding.”<sup>22</sup>
- (5) Defined for the Mayor and Council members the terms “scienter” and “negligence,” and put City officials on notice that a violation of anti-fraud provisions of the federal securities laws could be prosecuted on either a scienter or a negligence theory.
- (6) Warned the Mayor and Council that in light of the possible penalties under the federal anti-fraud securities laws, “it is critical that the City

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<sup>19</sup> In this context, the term “Authority” referred to the Public Facilities Financing Authority which was involved in letting the ballpark bonds.

<sup>20</sup> 6 November 2001 memorandum from Leslie J. Girard to Honorable Mayor and Members of the City Council with 29 October 2001 memorandum from Gerald E. Boltz to Leslie J. Girard, pp. 1-2, exhibit 2.

<sup>21</sup> *Id.* at 2.

<sup>22</sup> *Id.*

Council and the Board of Commissioners<sup>23</sup> exercise all due care in reviewing and evaluating the information contained in the POS.”<sup>24</sup>

- (7) Warned that “the statements in the POS ‘must be viewed as part of a mosaic’ to see if those statements, in the aggregate, created a misleading impression.”<sup>25</sup> The “proper test is not the literal truth or the materiality of each positive statement, but the overall misleading impression that it combines to create.”<sup>26</sup>
- (8) Explained that a fact is deemed “material” if there is a . . . substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable [investor]. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the “total mix” of information made available.<sup>27</sup>
- (9) Highlighted a landmark case of public entity securities fraud, an action the SEC took against Orange County in 1996, stating: “the importance of the review of municipal securities disclosure documents was highlighted in connection with an SEC report that was critical of the supervisors of Orange County, California for shortcomings relating to their review of such documents.”<sup>28</sup>
- (10) Explained the SEC ruling in the Orange County case by directly quoting the SEC Report, which found that, as a matter of law, a public official violates anti-fraud provisions when he or she approves a disclosure knowing there are undisclosed facts that bring into question the issuer’s ability to repay securities.<sup>29</sup> In this regard, the 29 October 2001 memorandum from Boltz and Anhut stated:

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<sup>23</sup> The Board of Commissioners was the directors of the Authority that involved in selling the ballpark bonds.

<sup>24</sup> 6 November 2001 memorandum from Leslie J. Girard to Honorable Mayor and members of the City Council with 29 October 2001 memorandum from Gerald E. Boltz to Leslie J. Girard, p.2, Exhibit 2.

<sup>25</sup> *Id.*

<sup>26</sup> *Id.*, citing, *In re Genentech, Inc., Securities Litigation*, 1989, Fed. Sec. L. Rep. (CCH) ¶94, 544 (N.D. Cal. 1989).”

<sup>27</sup> *Id.*, citing, *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

<sup>28</sup> *Id.* at 3, citing, Report of Investigation in the Matter of Orange, California as it Relates to the Conduct of the Members of the Board of Supervisors, Exchange Act Release No. 36761 (January 24, 1996).

<sup>29</sup> The emphasis on this point is particularly relevant in this case: if the City were forced to pay the pension and health care debt, it would not be able to pay for essential services and also pay for the securities to be sold, which then would be due and outstanding.

In authorizing the issuance of securities and related disclosure documents, a public official may not authorize disclosure that the official knows to be false; nor may a public official authorize disclosure while recklessly disregarding facts that indicate that there is a risk that the disclosure may be misleading. When, for example, a public official has knowledge of facts bringing into question the issuer's ability to repay the securities, it is reckless for that official to approve disclosure to investors without taking steps appropriate under the circumstances to prevent the dissemination of materially false or misleading information regarding those facts.<sup>30</sup> (emphasis added.)

After giving these numerous warnings and cautionary messages, Boltz's 29 October 2001 memorandum advised City officials of the duties of disclosure they have when they have knowledge of adverse financial conditions (i.e., the City's hundreds of millions of dollars of unpaid pension and retiree health care debt). The memorandum stated:

**In this matter, such steps could have included becoming familiar with the disclosure documents and questioning the issuer's officials, employees or other agents about the disclosure of those facts.**  
(emphasis in original)<sup>31</sup>

Boltz further advised in the memorandum that:

The message communicated by the statements of the SEC in the foregoing report is that members of the body approving disclosure documents cannot simply 'rubber-stamp' the document. Rather, each member has the responsibility to demonstrate that he or she was actively involved in the process—that is, each person must review the disclosure document, inquire as to the source of the information, ask questions of the City officials and other professionals who provided information (as well as ask if there are other sources of information that should be reviewed), and follow-up to ascertain whether the information makes sense in the circumstances. In short, the members of the City Council and the Board of Commissioners must demonstrate that they have satisfied themselves, after diligent inquiry that all material facts have been accurately disclosed, that the POS is not misleading.<sup>32</sup>

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<sup>30</sup> *Id.*

<sup>31</sup> *Id.*

<sup>32</sup> *Id.*

Finally, Boltz advised that, while City officials could rely on professionals and other City officials who supplied information to be included in the POS, the Mayor and City Council were required to act with reasonable care:

This includes, at a minimum: (1) reviewing the entire POS; (2) asking for clarification as to material parts of the POS that a member may need additional guidance; (3) seeking information and asking questions of the officials, employees, and professionals who supplied information to be included in the POS; and (4) asking follow up questions to determine the reasonableness of any assumptions or estimates that were used in the POS.<sup>33</sup>

Boltz explained that the context of his presentation was as a direct result of the heightened sensitivities following the allegations of wrongdoing involving Council member Valerie Stallings.<sup>34</sup> The Stallings matter was of considerable relevance. Council member Stallings voted on contracts in which she had a financial interest consisting of expected gifts from the private party to the contract. In an unpublished opinion issued by the Court of Appeals, Fourth Appellate District, Division One, Council member Stallings' financial interest was described as follows:

Skane and Mailhot assert that they have essentially alleged in their second amended complaint that public officials like Stallings have conspired with [San Diego Padres owner John] Moores and the Padres, reaching an understanding that as City contracts and other transactions were negotiated, approved and performed to the Padres' financial advantage each of them could be certain that their respective requests, both present and future, for valuable gifts would be met subject only to the continuing implementation of those transactions between the City and the Padres. They accurately point out that the pivotal issue of these consolidated appeals is whether the alleged financial interests being reviewed constitute prohibited conflicts of interest in City contracts or in the performance of such contracts. In other words, does case law and public policy support the City's assertion these alleged financial arrangements are not interests in contracts prohibited by either section 1090 or City Charter section 94, or both? As we shall explain, we conclude the alleged financial arrangements

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<sup>33</sup> *Id.* at 4.

<sup>34</sup> In January 2001, San Diego Councilwoman Valerie Stallings resigned after pleading guilty to two misdemeanors. She admitted she accepted a series of gifts from Padres owner John Moores and the team while voting on the downtown ballpark project. Among the gifts were airline tickets for her relatives while she was undergoing cancer treatment, use of a car and vacation home, and a pretax profit of \$9,391 on stock in a company that Moores headed.

constitute prohibited conflicts of interests under section 1090 and City Charter section 94.<sup>35</sup>

Thus, Boltz quite openly and directly told Mayor Murphy and the Council members about their legal duty to make full disclosures under the federal securities laws in the context of Government Code §1090 and San Diego City Charter § 94,<sup>36</sup> both laws which prohibit City officials from making contracts in which they have a financial interest. Finally, Boltz did not limit the scope of his memorandum to the Stallings matter. Boltz explained to the Mayor and council that, while the context of the presentation was the heightened sensitivities related to allegations involving Councilmember Stallings, his 2001 memorandum explained that the information contained therein was standard for all municipal securities offerings.<sup>37</sup>

#### **IV. CITY OFFICIALS GAIN KNOWLEDGE OF MATERIAL INFORMATION THAT SHOULD HAVE BEEN DISCLOSED IN THE BOND OFFERING DOCUMENTS**

This section of the report will present evidence that Mayor Murphy and members of the City Council were told on numerous occasions of the skyrocketing pension liabilities and retiree health liabilities. The complex nature of these discussions was, in most cases, broken down by presenters to a level that was easily understandable. Evidence provided in this portion of the report will show that Mayor Murphy and the City Council were briefed repeatedly on the contingency factors, or the *quid pro quo* element, of the underfunding agreement which directly led to the financial problems of the pension system.

##### **A. KNOWLEDGE GAINED FROM INVOLVEMENT IN UNLAWFUL *QUID PRO QUO* TRANSACTION**

###### **1. THE BLUE RIBBON COMMITTEE REPORT**

In or around January 2001, Mayor Murphy established the Blue Ribbon Committee on City Finances (“Blue Ribbon Committee”). It was to independently evaluate the City’s fiscal health, review the City’s budgeting principles and report findings to the Mayor and City Council.<sup>38</sup> The Committee defined the term “fiscal health” as the “City’s ability to maintain existing service levels, withstand local and

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<sup>35</sup> *City of San Diego v. Furgatch*, Cal. App. Dist., (not reported) p. 21 2002, exhibit 4.

<sup>36</sup> San Diego City Charter § 94 also prohibits City officials from making contracts in which they have a financial interest. Exhibit 5.

<sup>37</sup> 18 August 2004 memorandum of interview of Gerald Boltz, attorney for Bryan Cave, with Vinson & Elkins, p. 2, exhibit 6.

<sup>38</sup> See February 2002 Blue Ribbon Committee Report on San Diego City Finances, p. 3, exhibit 7.

regional economic disruptions and meet the demands of natural growth, decline and change.”<sup>39</sup>

On 27 February 2002, the Blue Ribbon Committee issued its report.<sup>40</sup> In the report, the Committee examined “Retirement Benefits and Unfunded Pension Liabilities.”<sup>41</sup> It noted great concern over the fact the City was not paying the full cost of the current year’s budget incurred by its workforce for their future pension and retiree health benefits. The report stated:

The City is not paying approximately \$6-8 million a year for future pension benefits. As a result, a portion of the cost of today’s City workforce will be paid by future years’ taxpayers. Further, this non-discretionary item in the budget has been growing steadily and will continue to grow in the future.<sup>42</sup>

The Blue Ribbon Committee devoted four pages of its final report to a discussion of the pension and retiree health care debt problems. As set forth above, the Blue Ribbon Committee expressed concern that the City was not “paying out of its current year’s budget the full cost being incurred by its current work force.” Moreover, the Committee was concerned that the City’s budget process did not “adequately comprehend the steadily growing annual expense obligation, particularly given the uncontrollable and non-discretionary nature of this liability.”<sup>43</sup>

Significantly, the Blue Ribbon Committee warned that City officials were granting pension benefit increases, but passing costs on to future generations. The report stated:

The potential risk is that policy makers grant benefit enhancements today (to satisfy employee concerns, to negotiate trade offs with unions, etc.), but avoid recognizing the actual annual cost of such by actuarially spreading the cost over years far out in the future, long after the individuals who made the policy decisions are gone. This is particularly

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<sup>39</sup> *Id.*

<sup>40</sup> February 2002 Blue Ribbon Committee Report on San Diego City Finances, exhibit 4. In Mayor Dick Murphy’s 8 January 2001 State of the City Address entitled “A vision for San Diego in the Year 2020: A City Worthy of our Affection,” he outlined “10 Goals” for the City to focus on over the four years of his first term. The Mayor raised a concern over whether the City could afford to accomplish the “10 Goals.” As a result, Mayor Murphy announced he would convene a Blue Ribbon Committee on City Finances to perform an independent evaluation on the City’s current fiscal health and make any appropriate recommendations. *See* Blue Ribbon Committee Report on San Diego City Finances p. 2, exhibit 7.

<sup>41</sup> *Id.* at 4.

<sup>42</sup> *Id.* at 6.

<sup>43</sup> *Id.* at 20.

acute where the retiree benefit enhancements are granted 'retroactively,' i.e., new improved benefits, which are applied to past, as well as future, years of service for active employees. This retroactive approach is the general practice of the City.

Major pension improvements (20% increase) were implemented in Fiscal Year 1997 and benefits were increased by another 12% in Fiscal Year 2000 as a result of a litigation settlement. San Diego County is in the final stages of approving major pension improvements, exceeding San Diego City benefits. This will undoubtedly lead to pressure for further increases for City employees.

The City's annual cash contribution expense for pension was \$68 million for Fiscal Year 2001. This is one of the larger items in the City's overall budget. Further, this expense line item has been growing at about a 9% per year compound rate the last five years and at a much faster rate if measured back 10 years.<sup>44</sup>

The Blue Ribbon Committee found the unfunded retiree medical liability to be of equal concern to the pension debt. The Committee noted a 33% increase in retiree health benefits expense. It said, while "this expense line item is much smaller than the pension expense, it might be a false comfort and therefore misleading."<sup>45</sup> The report also noted that the "amount of the total unfunded retiree medical liability is not addressed in SDCERS or City financial documents."<sup>46</sup>

The report reached the following conclusions regarding the retiree health and pension deficit:

1. The City is not paying out of its current year's budget the full cost being incurred by its current workforce for their future pension and retiree health benefits. As a result, a portion of the cost of today's City workforce will be paid by future year's taxpayers. As compared to an alternative, GAAP approved actuarial method; current annual expense has a shortfall of approximately \$6-8 million. The cumulative short fall for Fiscal Years 1997-2000 is \$31 million.
2. The City is experiencing a dramatic, steady increase in non-discretionary pension expense. This is due to the large benefit increases granted to employees by the City. The chart on page 21

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<sup>44</sup> *Id.*

<sup>45</sup> *Id.* at 20-21.

<sup>46</sup> *Id.*

illustrates that annual pension expense in Fiscal Year 2001 was 14.1% of payroll compared to 8.8% in Fiscal Year 1992. Worse, this 14.1% is artificially low since (per #1 above) the City is not paying the full cost of the pension benefit being earned each year. The 14.1% will continue to grow by at least a half percentage point each year. The Committee is very concerned whether the City fully appreciates the impact these increasing expenses have, (and particularly any future improvements in pension benefits granted to employees will have) on future annual City budgets.

3. The City is potentially building up a sizeable non-discretionary liability for retiree health benefits, the magnitude of which is not well recognized in the City's budgetary process.
4. A point of possible concern is that after an unprecedented 9-year boom in the equity market when many pension plans became flush and actually over funded, allowing the sponsors to reduce annual cash contributions, the City still has an unfunded liability. This, taken together with the growing annual liability for the 'retroactive' pension improvements is a cause for concern.<sup>47</sup>

The problems with the pension debt and health care debt were reinforced to the Mayor and City Council when Richard Vortmann, a member of the Blue Ribbon Committee, made a presentation to the City Council's Rules Committee on 27 February 2002. Vortmann stated:

[T]he City is not paying from its current year budget the full cost incurred by its current year work force for their ultimate future pension and retiree health benefits. As a result of that, part of today's cost will be paid by future year taxpayers, and that's a concern. Further, this nondiscretionary pension expense as a budget item has been steadily growing and will continue to grow in the future.

This next chart shows the pension expense as expressed as a percentage of the City's payroll base. And you can see that as a percentage it has been steadily increasing, clearly the pension expense has been increasing faster than the underlying payroll base. The budget line itself has been growing for the last five years at a 9 percent per year compounded rate. And that is a very troublesome trend for any business to see. And particularly when it is, as I said, as a non-discretionary item and in the '01 budget it was already at 68 million dollars, one of the larger line items.

Further, this expense expressed as a percentage of payroll is scheduled to continue to increase by a half percentage point per year. For example, by

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<sup>47</sup> *Id.* at 23.

calculation, by the time you get to FY 06, the current 68 million expense would be 106 million. The Committee came up with two recommendations. First recommendation is to change the City's funding strategy to one that results in the City fully funding its future obligations that are being earned today and that would include both the pension benefits as well as the health benefits. Obviously, this would increase the expense for the current years, but will stop pushing the burden out to future years' taxpayers.

The second recommendation is to make sure that all on the City Council fully understand the mechanics, which are complicated, but the mechanics of the cost of pensions and retiree medical benefits. To ensure that we recommend that you obtain a current and comprehensive analysis of the projected pension expenses and the revenue sources, which includes the current present value of retiree health benefits to determine the impact on future City finances. We believe this is particularly important to get this analysis and understanding before any further pension improvements are considered.<sup>48</sup>

Murphy responded that he understood Vortmann's presentation that the City was underfunding the pension system, that a debt had been created and that the debt would continue growing at an alarming rate. Murphy said:

I totally agree with Mr. Peters. I think this is one example of what the Blue Ribbon Committee report has been helpful. I think some of us thought we were coasting along here, oblivious to the fact that there was any concern at all about the pension plan...we perhaps aren't looking after future generations in the way of funding it.<sup>49</sup>

Additionally, at this Rules Committee meeting, former City Auditor Ed Ryan informed those in attendance that "the way the City agreed to fund the benefit given" resulted in "under funding even the normal obligation because it intentionally back-loaded the funding."<sup>50</sup> In other words, under the agreement between the City and the pension fund, the City was allowed to avoid paying normal and usual costs, which are the present employee pension costs for any particular year. Ryan disclosed that "the City intentionally entered into an agreement [Manager's Proposal 1] with the retirement fund

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<sup>48</sup> 8 February 2005 partial transcript of City Council Rules Committee meeting of 27 February 2002, exhibit 8.

<sup>49</sup> *Id.*

<sup>50</sup> The agreement referred to here is Manager's Proposal I, the *quid pro quo* agreement entered in 1996 where SDCERS allowed the City to underfund the pension system, and in exchange, the City granted employees increased retroactive benefits in an effort to ensure that the employees took no action with regard to the City's intentional underfunding of the pension system.

to give a benefit about 5, 6, or 7 years ago, and came up with a non-standard way of funding it that the Retirement Board and the actuary accepted.”<sup>51</sup>

Highlighting that City officials understood exactly what had occurred with regard to underfunding the pension system, at the 27 February 2002 meeting, one Council member said, “what you are saying, it’s going to have a general fund hit in later years.” Ryan responded, “it was intentionally back-loaded.”<sup>52</sup> The Council member continued, “sounds like someone is going to pick up the tab later.” Vortmann said, “that’s what the committee is telling you.”<sup>53</sup> Acknowledging his agreement, Mayor Murphy admitted that “we sort of put our head in the sand.” The Mayor then reiterated the problem for all present, stating:

As I understand there’s two issues here, separate. One issue is that we are not currently providing funding to make the pension fund whole, I guess for the lack of a better term.

Because of the way our system is structured, we are going to continue to be increasing the percentage of our, as a percentage of our payroll base, going towards retirement.<sup>54</sup> (Emphasis added.)

Incredulously, even though Murphy had put his finger on the exact issue causing the City’s financial issues, the Mayor affirmatively side-stepped the issue.

I don’t see us addressing that in depth prior to the May budget. I see us only dealing it at this level, which is superficial, not meant to be an unkind word but, this requires a greater depth of understanding on our part before we take any action, I guess, and I don’t see us being able to do that between now and the May budget process.<sup>55</sup> (Emphasis added.)

The topic of the Blue Ribbon report came up at the Rules Committee 20 March 2002 meeting to further discuss the looming financial crisis in the pension system. During that meeting, the City Manager admitted the “unfunded pension liability is growing at 9% per year.”<sup>56</sup> The City Manager suggested the Council attend a pension workshop. However, Murphy stated that it was more appropriate for the pension system board to

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<sup>51</sup> *Id.*

<sup>52</sup> *Id.*

<sup>53</sup> *Id.*

<sup>54</sup> *Id.*

<sup>55</sup> *Id.*

<sup>56</sup> Transcript of 20 March 2002 City Council Rules Committee Meeting, exhibit 9.

evaluate the Blue Ribbon Committee Report and to provide a response prior to the Council attending a workshop.<sup>57</sup>

On 15 April 2002, the Blue Ribbon Committee's Final Report was presented to the full City Council. During this presentation, it was quite clear the City Council understood the problems with the pension system. For example, Councilmember Scott Peters stated:

[T]he funding is from the City...I think we are going to have to exercise some independent judgment for our own part if this is in our nondiscretionary expenditure, we're not going to be able to rely on anyone else to look out for us, I think we're going to have to give this a hard independent look.<sup>58</sup>

It is clear from these statements that members of the City Council understood the crux of the portion of the Blue Ribbon Committee Report that focused on the pension: that the system was being underfunded each year by the City Council and that if that course of action was not reversed, considerable debt would be passed on to later generations of taxpayers.

## **2. CLOSED SESSION BRIEFINGS**

This section of the report will provide evidence from a series of closed session meetings of the City Council that the Mayor and Council members were provided in-depth information about the contingent nature of Manager's Proposal 2 ("MP 2"), an agreement to underfund the pension system in exchange for increased retroactive pension benefits to all City employees. This section will also show that the Mayor and City Council members were, yet again, provided information – on numerous occasions – that the City was facing a financial crisis in its pension system.

### **a. 18 MARCH 2002 CITY COUNCIL CLOSED SESSION MEETING**

Murphy and the City Council also received information about the pension and retiree health care debt problems in closed session meetings in early 2002 as a result of negotiations with the City's unions. The following information was presented to the Mayor and Council members in the form of PowerPoint presentations:<sup>59</sup>

- Murphy and the Council were told of the terms of the 1996 Manager's Proposal. (See Slide 61.) A slide stated "increased benefits for all

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<sup>57</sup> 13 January 2005 City Attorney Investigative Memorandum regarding the 27 February 2002 and 20 March 2002 Rules Committee Meeting, exhibit 10.

<sup>58</sup> *Id.*

<sup>59</sup> 18 March 2002 Closed Session report and 15 March 2002 Closed Session Meet and Confer PowerPoint Materials for extended 9 a.m. to 12 p.m. meeting on 18 March 2002, exhibit 11.

employees” including “formula enhancements for safety & general” and “Established DROP.” Also covered was “Enhanced retiree health benefits.”<sup>60</sup>

- Murphy and the Council were told the Manager’s Proposal of 1996 established a “rate stabilization” plan which provided that the City was to pay “agreed to” rates with the City “increasing .50% per year; unless the funding ratio drops 10% from FY 96 ratio of 92.3%.”<sup>61</sup> (See Slide 62.) Vortmann discussed the annual .5% increase in City contribution rates: “[T]his expense expressed as a percentage of payroll is scheduled to continue to increase by a half percentage point per year.”<sup>62</sup>
- Murphy and the Council were told the pension system earnings for Fiscal Year 2002 were estimated to drop to \$50 million to \$60 million, down from \$415 million in 2000 and \$168 million in 2001. (See Slide 66.) The same slide noted the funding level would come within 1.2% of the “Trigger” in the Manager’s Proposal, requiring City to pay full rate (a potential \$40m annual impact).<sup>63</sup>
- Murphy and the Council were told that past “retirement enhancements” had been funded “by absorbing as a future liability of the Retirement System.”<sup>64</sup> (See Slide 67.)
- The presentation warned that “given recent actuarial losses of the System, any consideration to absorb costs must carefully evaluate impact on System’s funding ratio.”<sup>65</sup>

In connection with the above information, two days after the 18 March 2002 closed session at which the pension’s declining funding ratio was discussed, the City Council Rules Committee – chaired by Murphy – took up the Blue Ribbon Committee Report. The City Manager provided the Rules Committee with a written response to the Blue Ribbon Committee recommendations –namely, that the City fully fund the pension and that the Mayor and Council inform themselves of the full extent of the pension and retiree health debt.<sup>66</sup>

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<sup>60</sup> *Id.*

<sup>61</sup> *Id.*

<sup>62</sup> 8 February 2005 partial transcript of Rules Committee meeting of 27 February 2002, exhibit 8.

<sup>63</sup> 18 March 2002 Closed Session report and 15 March 2002 Closed Session Meet and Confer PowerPoint Materials for extended 9 a.m. to 12 p.m. meeting on 18 March 2002, exhibit 11.

<sup>64</sup> *Id.*

<sup>65</sup> *Id.*

<sup>66</sup> 18 March 2002 City Manager Report No. 02-061, exhibit 12.

The City Manager, in his report to the Rules Committee, agreed that retiree health costs would continue to be pushed off to the future. The City Manager proposed to push off a discussion of the pension funding shortfall to the City's Retirement Officer.<sup>67</sup> This report was not returned to the Rules Committee until February 2003 – well after the Mayor and City Council approved another deal, MP 2, in which the City increased pension benefits in exchange for relieving the City from making its full contribution to the pension system.<sup>68</sup>

**b. 15 APRIL 2002 CITY COUNCIL CLOSED SESSION MEETING**

At the 15 April 2002 closed session meeting of the City Council, another PowerPoint presentation was shown to the Mayor and City Council. Again, the Mayor and City Council were shown a PowerPoint presentation outlining labor negotiations and how these negotiations would affect the financial stability of the pension system. The following PowerPoint slides showed:

- a. Slide 16 showed the plan discussed by the Council for avoiding paying the pension debt if the trigger under the 1996 Manager's proposal was hit. The plan was to condition all new benefit enhancement on a loosening of the trigger - "Condition all retirement enhancements on removal of the 'trigger' in 'Managers Proposal regarding CERS funding ratio.'" (i.e., this was another *quid pro quo* to delay funding in exchange for increased benefits to pacify plan participants). A footnote on Slide 16 explained that "if CERS<sup>69</sup> funding ratio drops below 82.3% (currently 89.9%), the City must pay the full actuarial rate, \$25M more annually."<sup>70</sup>
- b. Slide 39, entitled "Earnings Compared with Funding Ratio," informed Murphy and the Council that the pension's investment earnings had dropped significantly. The slide showed the pension's investment earnings declined from \$415 million in 2002 to an estimated \$50 million to \$60 million in 2002. It showed that financial ramifications of a lawsuit known as "Corbett" could drop the unfunded liability to 83.1%, or within 1% of the

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<sup>67</sup> *Id.*

<sup>68</sup> See later discussion of the 5 February 2003 Report of San Diego City Employees Retirement System re: Response to the Blue Ribbon Committee Report on City Finances dated February 2002 Regarding Pension and Health Insurance Funding, exhibit 13.

<sup>69</sup> CERS refers to City Employees Retirement System.

<sup>70</sup> 12 April 2002 Closed Session memorandum for 15 April 2002 Closed Session, exhibit 14; 15 April 2002 PowerPoint slide presentation, exhibit 15.

trigger. The slide stated that if the 82.3% trigger were violated, the City would face “a potential \$40 million annual impact.”<sup>71</sup>

This meeting and the information presented to Murphy and the Council represented the second closed session meeting where the Mayor and City Council were provided in-depth information on the *quid pro quo* nature of the labor negotiations and the looming financial liabilities in the pension system that faced the City.

**c. 29 APRIL 2002 CITY COUNCIL CLOSED SESSION MEETING**

The Mayor and City Council were informed once more about the growing pension deficit and the lack of retiree health care funding at the 29 April 2002 City Council closed session meeting. Another PowerPoint presentation was shown to the Council at the meeting.<sup>72</sup> The following information was presented to the Mayor and Council members in the form of PowerPoint presentations:

- Slide 4 from the 29 April 2002 closed session presentation<sup>73</sup> stated:

<p>Status of Negotiations Bargaining Authority</p>
<p>April 16</p> <ul style="list-style-type: none"><li>• Authorized removal of MVLF contingency</li><li>• * Authorized 3-year economic package</li><li>• *Conditioned all retirement enhancement on removal of the “trigger” in “Manager’s Proposal” regarding CERS funding ratio<ul style="list-style-type: none"><li>- Retiree health</li><li>- Increase in employee “pickups”</li><li>- Increase in General Member formula (2.5% at 55)</li></ul></li></ul>
<p>April 22</p> <p>*Authorized SSA’s and other miscellaneous items all within the April 16 total economic authority</p> <p>*Added 3 SSA’s and requested more info on 3 others</p>
<p>4</p>

<sup>71</sup> 12 April 2002 Closed Session memorandum for 15 April 2002 Closed Session; 15 April 2002 PowerPoint slide presentation, exhibits 14 and 15. On slide 39 the impact of hitting the trigger was stated as a potential \$40 million annual impact and on slide 16 it was stated as a \$25 million impact.

<sup>72</sup> 29 April 2002 City of San Diego Meet and Confer 2002 Closed Session April 29, 2002, PowerPoint presentation, exhibit 16.

<sup>73</sup> *Id.*

- Slide 28<sup>74</sup> for the City Council closed session explained that increased benefits had been given to all employee groups under the 1996 Manager's Proposal.<sup>75</sup> The slide explained that when benefits were increased, the "corridor" plan for funding the pension benefits was created. The slide explained that, under the corridor plan, the City was to pay the pension system less than the actuarially determined rate.<sup>76</sup> The slide warned Murphy and the Council that the City would have to pay more into the pension system if the system's funding ratio dropped below the 82.3% trigger contained in the 1996 Manager's Proposal. A copy of slide 28 follows:

Meet & Confer 2002  
Funding Ratio Impact on City Contribution  
**1996 Manager's Proposal**

1. Increased formulas for all employee groups
2. Created Retiree Health Benefit within CERS
3. Created DROP Program
4. Created "corridor" plan for city contribution rates
  1. annual employer rate increases capped at 0.50%
  2. less than actuarially determined rate
  3. has created a "unfunded" liability
  4. Included "trigger" if funding ratio dropped 10% (to 82.3%), city pays full actuarial rate (FY 02 would be 15.59% v. 10.33%-approximate +25m)

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<sup>74</sup> 29 April 2002 City of San Diego Meet and Confer 2002 Closed Session April 29, 2002, PowerPoint presentation, exhibit 16.

<sup>75</sup> DROP allows employees to receive their salaries and retirement distributions for five years. DROP was to be cost neutral but, in practice, will cost taxpayers several hundred million dollars.

<sup>76</sup> 29 April 2002 City of San Diego Meet and Confer PowerPoint presentation, exhibit 16.

- Significantly, the presentation showed the funding ratio was dropping to the trigger point, which would require the City to pay several million dollars more into the pension fund.<sup>77</sup> Slide 30 stated:

Meet & Confer 2002 Funding Ratio Impact on City Contribution <b>1997 Manager's Proposal</b> Earnings Compared with Funding Ratio		
FY96	\$150.4 m	91.4%
FY97	\$137.4 m	93.3%
FY98	\$247.4 m	93.6%
FY99	\$189.1 m	93.2%
FY00	\$415.9 m	97.3%
FY01	\$168.0 m	89.9%
FY02 Est.	\$20 to \$30 m	?
* \$105 m reserve would drop to = 85.6%		
* "Trigger" in Manager's Proposal = 82.3%		30

- The presentation informed Murphy and the Council that the focus of negotiations was that the City was dangerously close to violating the trigger. Slide 31 provided evidence that negotiations for additional pension benefits was tied to the City's efforts to avoid having to deal with the ramifications of hitting the trigger.<sup>78</sup>

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<sup>77</sup> Compare Slide 39 from the 15 April 2002 PowerPoint presentation (exhibit 13) to Slide 30 for the 29 April 2002 closed session, exhibit 16.

<sup>78</sup> See slide 31 from the 29 April 2002 City of San Diego Meet and Confer PowerPoint presentation, exhibit 16.

- Slide 35 confirmed for Murphy and the Council that the Council had been asked to authorize an increase to 2.5% in the general members' retirement formula in exchange for the City's unions supporting an elimination or reduction of the trigger. Slide 35 stated:

Meet & Confer 2002  
Funding the General Member  
Retirement Formula Improvement

Modifications to Previous Authority:

Approve General Member retirement benefit enhancement of 2.5% @ 55, with contingences that Unions support and CERS Board of Administration agrees to:

- A. Eliminate or Reduce the "trigger" established in the 1997 Manager's Proposal to 75%
- B. If funding ratio "triggers" an increase in City's contribution rate, *phase in over 5 year period*
- C. Absorb Past Liability of the 2.50% at 55 benefit into CERS assets as an unfunded liability (this will reduce funding ratio 1% to 1.5%)

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The information from the presentations to the Mayor and the City Council in these series of closed session meetings clearly left no doubt about the oncoming financial crisis in the pension system as they were discussed in great detail. Indeed, this information was presented to the Mayor and Council while they were engaged in negotiating another *quid pro quo* agreement to further underfund the pension system in exchange for the unions' complicity by granting increased retroactive benefits (an increase which would immediately increase the City's liability to SDCERS).

**3. THE MAYOR AND THE CITY COUNCIL NEGOTIATE AND ENTER INTO AN AGREEMENT TO ALLOW THE CONTINUED UNDERFUNDING OF THE PENSION SYSTEM**

Knowing the City did not have the funds to make the full actuarially required payment to SDCERS, Murphy and the Council voted to approve a plan to increase pension benefits, conditioned on the pension board removing or reducing the multi-million dollar balloon payment due if the funding ratio were to drop below the 82.3% trigger established by Manager's Proposal 1 ("MP 1"). The authority to enter this agreement with the labor unions was given by the City Council on 16 April 2002.<sup>79</sup> However, before authorizing this measure, City officials negotiated the terms of the

<sup>79</sup> See Slide 4 for 29 April 2002 City of San Diego Meet and Confer PowerPoint presentation, exhibit 16; 16 April 2002 Closed Session Report showing former Mayor Murphy and the Council authorized manager's recommendation, exhibit 17.

City's agreement with SDCERS and the unions. These negotiations and this agreement represented another source of knowledge by Murphy and the City Council that the City was experiencing severe financial issues related to the pension system.

The deal did not come together without some bumps in the road. On 14 June 2002, former Human Resources Director Cathy Lexin wrote a memorandum entitled "Meet and Confer: Contingent Benefits-Modified Proposal to San Diego City Employees Retirement System Board of Administration," which stated in relevant part:

During the recently concluded meet and confer, the City Council approved a number of retirement benefit enhancements, with a contingency feature. The contingency was tied to an affirmative vote by the San Diego City Employees Retirement System (SDCERS) Board of Administration related to (a) committing \$25 million from FY 2000 SDCERS investment earnings to pay for retiree health insurance, (2) using an existing SDCERS reserve to pay for negotiated increases in the amount the City "picks up" of employee's retirement contributions, and (3) the City's contribution rates and funding status.<sup>80</sup>

Lexin explained the contingency was "to lower the funding ratio floor to 75% with a commitment from the City to bring forward a long term solution within the next year."<sup>81</sup> Lexin explained that the City Manager had made a "conceptual presentation" at a special meeting of the SDCERS Board and that the SDCERS board had concerns:

Based upon conversations with the Retirement Administrator this week, it appears that the Board's outside fiduciary counsel is 'uncomfortable' expressing an opinion that approval of this proposal is within the Board's reasonable discretion as fiduciaries of the system.<sup>82</sup>

Lexin explained that the "rate stabilization plan stipulates that the City's contribution rates, beginning in FY 97 would increase at a fixed 0.50% per year, which is less than the actuarially determined rate necessary to ensure stable funding of the system."<sup>83</sup> She recounted the Council's closed session discussions about the proposal:

As we discussed in closed session earlier, implementation of the "rate stabilization plan" in the 1997 Manager's Proposal did not have any significant impact on the funding of the retirement system prior to FY01's actuarial valuation wherein the funding ratio dropped from 97.7% to

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<sup>80</sup> 14 June 2002 Cathy Lexin memorandum to Mayor and City Council re: Meet and Confer Contingent Retirement Benefits-Modified Proposal p. 2, exhibit 18.

<sup>81</sup> *Id.*

<sup>82</sup> *Id.*

<sup>83</sup> *Id.*

89.9%. In the past two years, several significant and unpredictable events impacted the funding status of the system. The settlement of the Corbett litigation resulted in approximately \$150 million in additional unfunded liability and the drastic decline in investment earnings to the system (from \$415.9 million to less than \$50 million estimated by year end FY02).<sup>84</sup>

Lexin reminded Murphy and the City Council about the Blue Ribbon Committee's recommendations regarding the pension:

As you know, the Mayor's Blue Ribbon Committee on City Finances also made findings and recommendations regarding the retirement system liabilities and funding status. It is clear that the current arrangement whereby the City's contribution rate increases by a fixed 0.50% per year will not accomplish full funding as contemplated in the plan.<sup>85</sup>

However, in apparent disregard of the Blue Ribbon Committee's findings and recommendations, the City moved forward and made a proposal to SDCERS to further underfund the pension system. On 21 June 2002, the SDCERS Board considered the City's modified proposal regarding City contribution rates and the 75% funded ratio trigger. SDCERS rejected the proposal. Lexin informed Murphy and the Council that the draft report from fiduciary counsel was "quite negative."<sup>86</sup> Undeterred by this setback, the 9 July 2002 closed session report shows Murphy and the City Council approved a motion to "Authorize modification of proposal – leave trigger at 82% of funding but 1-year grace period to pay (retirement formula), but only as back-up if original proposal (75% trigger) fails at Retirement Board."<sup>87</sup>

At the SDCERS Board meeting on 11 July 2002, a Board member made a motion to further modify the proposal approved by the Council by eliminating the request to lower the funded ratio floor. Instead, a five-year phase-in was added to modify the trigger (82.3% funded ratio).<sup>88</sup> The modification motion was made by the president of the firefighter's union.<sup>89</sup> The SDCERS board approved the modified motion, which provided:

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<sup>84</sup> *Id.*

<sup>85</sup> *Id.*

<sup>86</sup> *Id.*

<sup>87</sup> 9 July 2002 City Council Closed Session Report, exhibit 19.

<sup>88</sup> 11 July 2002 SDCERS Board minutes pp. 33-35, 38, exhibit 20.

<sup>89</sup> *Id.* Thereafter, the Mayor and Council granted the firefighters' union president a special presidential benefit in which he was allowed to count his union pay towards his retirement, even though he did not pay into the pension plan based upon his union income. (6 May 2002 Meet and Confer PowerPoint presentation Slides 38-39, exhibit 21; 13 June 2002 memorandum from Cathy Lexin to Mayor and City Council, exhibit 22.)

Motion to modify the 97 MP: 1) to allow the City's repayment schedule to be the difference between the rate at the time and the actuarial PUC rate if the 82.3% trigger is hit; 2) that this amount would be phased in incrementally on an annual basis between that point and 2009; 3) that this be based on the current actuarial projections with the City to increase its payment 1.0% per year; 4) that the city would reach the PUC rate in 2009 as included in the 97 MP sunset language; and, 5) to fund \$25 million for purposes of paying retiree health care benefits. Additionally, this motion does not include lowering the funding floor from 82.3% and is contingent upon a written agreement between the city and retirement board.<sup>90</sup>

Thereafter, the City Council began the formal public approval process for reduced pension contributions for the increased benefits deal on 21 October 2002.<sup>91</sup> It was a foregone conclusion that the approval of MP 2 would meet no resistance. The City's unions, being complicit in the scheme to underfund the pension system, were given increased retroactive benefits by the City as a direct effort to buy their assent to MP 2.

#### **4. DIANN SHIPIONE WARNS THE MAYOR AND COUNCIL THAT THE MP 2 AGREEMENT IS ILL-ADVISED**

The increased pension benefit for reduced contributions agreement, MP 2, was brought before the City again on 18 November 2002. Before this meeting, SDCERS trustee Diann Shipione sent a letter to Murphy and the Council.<sup>92</sup> In her letter, Shipione stated, the proposal "represents a potential insolvency formula for the City of San Diego in less than 9 years."<sup>93</sup>

SDCERS trustee Diann Shipione warned the Mayor and Council of the dire circumstances they faced -- that the proposal represented "a potential insolvency formula" for the City.<sup>94</sup> In her letter to the Mayor and Council, Shipione carefully explained the long-term financial consequences of increased pension benefits while the City gave less funding than required to the pension system. Her letter explained that

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<sup>90</sup> 11 July 2002 SDCERS Board minutes pp. 33-35, 38, exhibit 20.

<sup>91</sup> See 21 October 2002 San Diego City Council meeting minutes pp. 9-11, exhibit 23.

<sup>92</sup> 18 November 2002 letter from Diane Shipione to former Mayor Murphy and the City Council, re: City asked to enter into imprudent financing program which fails to correct accounting irregularities and threatens safety of city employees retirement and benefit system in conflict with actuary's advice, exhibit 24.

<sup>93</sup> See 21 October 2002 San Diego City Council meeting minutes pp. 9-11, exhibit 23.

<sup>94</sup> 18 November 2002 letter from Diane Shipione to former Mayor Murphy and the City Council, re: City asked to enter into imprudent financing program which fails to correct accounting irregularities and threatens safety of city employees retirement and benefit system in conflict with actuary's advice, exhibit 24. See also 21 October 2002 San Diego City Council meeting minutes pp. 9-11, exhibit 23.

under the existing 1996 City Manager's Agreement, if SDCERS funding fell below 82.3%, the City would be required to make a much larger contribution, possibly "\$25 -75 million this year and even larger in future years."<sup>95</sup>

Shipione explained the City was trying to avoid making required contributions to the pension:

It appears that the City does not want to make these required payments. This new agreement before you today was reached to allow the City not to have to make the required payments and in return an additional employee benefit was granted. The new agreement "back-loads" the entire accrued burden to the City Council of 2009.<sup>96</sup>

Shipione succinctly laid out the facts for the Mayor and the City Council. She stated:

Because the City could not compel the Retirement Board to accept this dangerous agreement, the City "conditioned" the labor deal on Retirement Board approval of the City's diminished pension contribution agreement and balloon payment obligation agreement, and then had City representatives and Labor representatives vote it through the Retirement Board this past Friday (the motion passed with two dissenting votes, myself and that of Tom Rhodes). This conditioning of benefit enhancement on Retirement Board approval created conflicting concerns on the part of the City and Labor representatives that sit as Trustees on the Retirement Board. The City Trustees faced concerns of job preservation and personal economic benefit, and the Labor Trustees faced the obviously enhanced pension benefits to their members. The City should not have put the City and Labor members of the Retirement Board in this awkward position. Tying a labor contract benefit to a separate fiduciary decision co-ops the Board's normal role as overseer of the "administration" of benefits. In a sense, it gives the appearance, if not the reality, that the City "bought" votes on the Retirement Board.<sup>97</sup>

Shipione provided Murphy and the City Council with legal authorities, facts and other information showing the adverse impact of the proposal on the City's debt and ability to pay its bills. However, Murphy and the City Council chose to ignore Shipione's warnings and instead approved the deal to increase pension benefits and

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<sup>95</sup> 18 November 2002 letter from Diane Shipione to former Mayor Murphy and the City Council, re: City asked to enter into imprudent financing program which fails to correct accounting irregularities and threatens safety of city employees retirement and benefit system in conflict with actuary's advice, exhibit 24.

<sup>96</sup> *Id.*

<sup>97</sup> *Id.*

decrease contributions.<sup>98</sup> The SDCERS Board members, apparently concerned over the propriety of this transaction if they were ever to be sued as a result of voting in favor of this proposal, were given blanket indemnification for the actions they took by an affirmative vote of Murphy and the Council.<sup>99</sup>

#### **5. SDCERS COUNSEL FORMALLY OPINES THAT MANAGER'S PROPOSAL 2 IS ILLEGAL**

Four months after the SDCERS board approved increased benefits for decreased contributions, SDCERS' outside counsel concluded that the proposal, as Shipione warned, violated state law. The legal opinion issued by the law firm of Seltzer, Caplan, McMahon and Vitek found the following legal transgressions:

1. The Individual Defendants breached their fiduciary duty by adopting the '02 Proposal in its modified form because it resulted in a lower contribution obligation by the City, as well as an increase in vested liabilities, without any basis for accepting the City's contention that it would meet its increased contribution obligations in the final years covered by the '02 Proposal. It is unclear whether plaintiffs are asserting a breach of fiduciary duty by SDCERS, as contrasted with its Board.
2. The Individual Defendants subordinated SDCERS' interests to the interests of themselves, their unions, and the City.
3. SDCERS Staff should recommend to the Board that it exercise its right under the November 18, 2002 Agreement to "nullify this Agreement to the extent required by its duties established under the California Constitution..." \*\*\*<sup>100</sup>

This legal opinion was backed up by a second, separate and independent, legal opinion. SDCERS was advised by additional counsel that the 2002 transaction -- in which pension benefits were increased in exchange for allowing the City to make reduced contributions -- violated California laws relating to prohibited self-interests in contracts. A memorandum from the Hanson Bridgett law firm concluded that the agreement increasing pension benefits in return for reduced pension contributions may be void because it violated Government Code § 1090, which prohibits public officials from

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<sup>98</sup> 18 November 2002 San Diego City Council minutes pp. 8-10, and 39, exhibit 25; 18 November 2002 transcript of City Council meeting, exhibit 26.

<sup>99</sup> 18 November 2002 San Diego City Council minutes pp. 8-10, and 39, Exhibit 25; handwritten note of SDCERS closed session, exhibit 27.

<sup>100</sup> 5 March 2002 letter from Seltzer, Caplan, p. 3, exhibit 28.

making contracts in which they have a financial interest.<sup>101</sup> On 13 May 2004, the SDCERS Board attorneys concluded, “[i]t is probable the Court would conclude the Board’s vote to adopt Manager’s Proposal 2 violated Government Code section 1090, thereby invalidating its vote.”<sup>102</sup>

## 6. MURPHY AND THE COUNCIL LEARN THAT THE CITY’S FINANCIAL SITUATION IS WORSE THAN THEY THOUGHT

In February 2003, three months after Shipione warned Murphy and the Council about the propriety of MP 2, the pension debt again was on the City Council Rules Committee’s agenda. Rules Committee members at that time were Mayor Murphy and Council members Scott Peters, Brian Maienschein, Jim Madaffer and Ralph Inzunza. The Rules Committee was told that SDCERS had \$2.53 billion in assets and \$3.17 billion in liabilities – amounting to a deficit of \$720 million.<sup>103</sup> The Rules Committee was told in a letter that SDCERS’ assets were only 77.3% of its liabilities (below the 82.3% trigger level). Thus, Rules Committee members were made fully aware and put on notice that the retirement fund was “short” approximately \$720 million.<sup>104</sup> These Council members were told the value of the liability for paying the health insurance premiums for current active members in the pension system who had not yet retired was “in the neighborhood of \$1.1 billion dollars.”<sup>105</sup>

Moreover, Rules Committee members were provided with a chart showing the City’s contribution to the pension board rising from 17.8% of payroll in 2004 to 31.8% of payroll in 2009.<sup>106</sup>

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<sup>101</sup> 20 February 2004 legal memorandum re: San Diego City Employees Retirement System-Analysis of Conflict of Interest Issue, exhibit 29.

<sup>102</sup> 13 May 2004 letter from Seltzer Caplan to Lawrence Grissom, exhibit 30.

<sup>103</sup> 5 February 2003 San Diego City Employees’ Retirement System memorandum to City Council Committee on Rules, Finance and Intergovernmental Relations re: Response to the Blue Ribbon Committee Report on City Finances dated February 2002 Regarding Pension and Health Insurance Funding p. 2, exhibit 13.

<sup>104</sup> *Id.*

<sup>105</sup> *Id.*

<sup>106</sup> *Id.*

Fiscal Year	Total Contribution	% of Payrolls
2004	\$108.3	17.8%
2005	\$127.4	20.0%
2006	\$148.4	22.4%
2007	\$172.5	24.9%
2008	\$200.6	27.9%
2009	\$239.6	31.8%

At that same meeting, the Rules Committee was informed of the projected costs of health benefits. The Committee members were told that in the most recent meet and confer negotiations (2002), the retiree health benefit was modified to index any future retiree health insurance premium reimbursements to a national health expenditure formula, with an annual increase cap of 10%. The Committee members were told the retiree health premiums would balloon from “today’s \$10 million dollar annual payment for current retirees to over \$60 million dollars based upon today’s retiree population of approximately 5,000 health eligible retirees.”<sup>107</sup> The Committee also learned the pension system actuary had “estimated the present value of the liability just for today’s health insurance eligible retirees is in the vicinity of \$400 million.”<sup>108</sup> The Rules Committee was told the actuary estimated the present value of retiree health care costs for active employees “in the neighborhood of \$750 million.”<sup>109</sup> Thus, “the City’s future liability to cover the health insurance reimbursements of its retirees and active employees is in excess of \$1.1 billion dollars.”<sup>110</sup> The Rules Committee was also told the City “was not making any contributions to the Retirement Fund today for this liability, nor is the Fund’s Actuary pricing the cost of this benefit and future liability in calculating the actuarial contribution rate of the Fund.”<sup>111</sup> The Rules Committee heard that absent a change in the benefit or a “dramatic decrease” in future health insurance costs, “the City could be facing significant funding obligations to cover this benefit in future years.”<sup>112</sup>

Frederick Pierce, Chairperson of the SDCERS Board, explained to the Mayor and the rest of the Rules Committee that if the funding was not changed, then the City’s annual payments to the pension would grow substantially. Pierce stated:

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<sup>107</sup> *Id.*

<sup>108</sup> *Id.*

<sup>109</sup> *Id.*

<sup>110</sup> *Id.*

<sup>111</sup> *Id.*

<sup>112</sup> *Id.*

[D]uring this period, and Mr. Grissom will explain what's all inclusive in these numbers, if other actions are not taken, then what'll happen will be precipitous increase in the city's contributions from what, in fiscal year [20]04, will be...\$100 million in total to a number estimated at \$240 million by fiscal year [20]09. So, so, no doubt, a very significant ramping up.<sup>113</sup>

Pierce also explained to Mayor Murphy and the Rules Committee that the funding ratio had fallen significantly. More importantly, Pierce specifically reminded the Rules Committee that as a result of MP 2, the City would continue to underfund the system, which would continually push the unfunded liability lower through 2009.

[Y]ou've heard a little bit or read a little bit about the funded status of the system. And, in fact, the investment marketplace has taken us from where we were 97% funded two years ago to where we're 77% funded based on our last actuarial report. That does represent an unfunded liability of \$720 million. Um, now the underfunding, because we're ramping up to full funding, over the years between now and 2009...we'll actually go from 77 to about 70% funded. So it will decline primarily due to the fact that we won't be contributing during that interim period.<sup>114</sup>

Pierce explained the extra costs associated with the contingent benefits, which were required to be paid but were not included in the unfunded liability projections. In other words, these costs were added on top of the annual contribution the City was expected to make. Pierce stated:

Three of the main ones that you'll see are the 13<sup>th</sup> check. The present value of that future liability, uh, is \$58 million. The second is the Corbett retiree benefit...The present value of that benefit is about \$75 million. And finally, the overwhelming issue of retiree health care, which currently is essentially, uh, paid on a current year basis...[T]hat present value is \$1.1 billion, uh, to actuarially fund retiree health care...<sup>115</sup>

In case anyone at the Rules Committee meeting did not understand Pierce's presentation, Lawrence Grissom, administrator of the pension fund, provided a more elementary explanation of the problem for all in attendance. Grissom stated:

[O]ur current funding ratio at June 30 is 77.3%. This means that we have \$3.17 billion in liabilities. What are those liabilities? This represents the

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<sup>113</sup> Transcript of the 12 February 2003 meeting of the San Diego City Council Rules Committee. Members present included Mayor Dick Murphy, Council member Scott Peters, Council member Jim Madaffer, Council member Ralph Inzunza, and Council member Brian Maienschein. Exhibit 31.

<sup>114</sup> *Id.*

<sup>115</sup> *Id.* at 13.

amount of money, on a present value basis, that we should have in the bank in order to pay all of the benefits to those people currently retired plus all of the benefits that those who are still active members of this system have accrued and are assumed to accrue through their retirement and the rest of their lives. Our assets are, uh, market value of assets, which gets a little complicated to explain, but the actuary goes through a process, uh, to come up with this starting with our base, and there's a comparison between the book and the market value of \$2.53 billion. You run those numbers, you come to the bottom line, as Fred said. Uh, we have an unfunded liability of \$720 million.<sup>116</sup>

Grissom then gave the Rules Committee an in-depth breakdown of all the pension-related liabilities facing the City. He stated:

Here again we're projecting the total of all of the stuff that we have just told you about. Our current unfunded liability is \$720 million. The 13<sup>th</sup> check and health insurance for current retirees has a projected liability of \$433 million. Retiree health insurance for those that are currently active, that will retire in the future, has a projected liability of \$750 million. And then the contingent liability of the Corbett benefit of 75. The total adds up to nearly \$2 billion, which is a large dollar.<sup>117</sup>

Clearly, members of the Rules Committee were now on notice, in the most elementary terms possible, that the City was facing a massive liability – approaching \$1 billion -- to the retirement system. For example, Council member Scott Peters, in his comments following the presentation, showed his understanding that the unfunded liability was currently at 77%<sup>118</sup> and illustrated that he comprehended the severity of the problem. Peters stated, “obviously, we have a very serious problem we want to deal with.”<sup>119</sup>

At the meeting, Mayor Murphy illustrated that he understood the severity of not only the pension liability, but, also the retiree health liability. Murphy stated:

I think we need to – we need to see how that all fits together in terms of – because I think that the issue here that is most troubling to me is the health benefits issue ... [A]s Mr. Peters pointed out, we – this health benefit liability is, um, not exactly contingent... And if the retirement system doesn't, um, account for this and provide adequate resources, uh, it's going to come out of the general fund of it's going to come out of the

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<sup>116</sup> *Id.* at 19.

<sup>117</sup> *Id.* at 38.

<sup>118</sup> *Id.* at 72.

<sup>119</sup> *Id.* at 69.

general fund plus the enterprise fund. So, I mean, I just think it's a serious issue.<sup>120</sup>

Murphy provided further evidence that he was aware the City's underfunding of the pension system was simply a temporary deferral of the cost and that this debt would grow and eventually burden future generations. Murphy stated:

[B]ut we need to be, as stewards of the system address the long term responsibilities as the people in charge of the city, to make sure that, as we look out 10 or 20 years we've addressed the problems now and didn't just sweep it under the rug...<sup>121</sup>

It is clear that, throughout this presentation, the representatives of SDCERS broke down the complexity of the problems to a level that the Mayor and Council members on the Rules Committee could understand. The SDCERS system representative explained the problems to the Mayor and Council members in terms of percentages, dollars and the effect on future budgets and future taxpayers.

#### **7. DIANN SHIPIONE WARNS THAT WASTEWATER BONDS CONTAIN MATERIAL MISSTATEMENTS OF FACT**

On 5 September 2003, SDCERS trustee Diane Shipione discovered that bond sales documents used by the City to sell its wastewater bonds contained a material misstatement of fact. Shipione wrote an email to SDCERS administrator Lawrence Grissom in which she notified him of the misinformation contained in the City's bond offering documents. Shipione stated:

It has been brought to my attention from several individuals that information regarding the San Diego City Employees Retirement system is being circulated by the Public Financing Authority of the city of San Diego regarding the soon to be sold Subordinated Sewer Revenue Bonds. The pension materials are apparently included in the addendum. These materials appear intentionally dated and substantively incorrect, including, by example, the following:

The actuary believes the corridor funding method is an excellent method for the City and that it will be superior to the PUC funding method. The actuary is in the process of requesting the GASB to adopt the Corridor funding method as an approved expending method which would then eliminate any reported NPO.

The independent SDCERS Actuary indicates that these comments are, in fact, dated and taken out of context. He apparently was not asked to opine

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<sup>120</sup> *Id.* at 72.

<sup>121</sup> *Id.* at 83.

as to his current thoughts on the “corridor funding method” which he views in a very different light than that being represented to the purchasers of these securities. Other aspects of the circulated information are likewise incorrect.

From my own reading, the materials do not provide any of the material deficit concerns even at the levels described by our staff.<sup>122</sup>

Shipione’s 5 September 2003 memorandum forced the City to withdraw the offering document because it contained the false information she identified. By November 2003, the City was advised to make substantial disclosures in voluntary filings to correct prior City of San Diego offering documents.<sup>123</sup>

**V. MAYOR MURPHY’S RECOLLECTION OF THE FACTS SUPPORTS THAT HE KNEW OF MATERIAL INFORMATION THAT WAS NOT DISCLOSED IN THE CITY’S BOND OFFERINGS**

Mayor Murphy also made numerous statements that illustrate his knowledge of the critical information about the size and significance of the pension and retiree health care debt. Mayor Murphy’s knowledge was gained from numerous sources.

In interviews with Mayor Murphy, the former mayor recalled knowing that the City Manager’s office believed the funding ratio could drop below 82.3% and require full actuarial funding of the pension system, which the City could not afford without cuts in services.<sup>124</sup> The former mayor admitted the claim that MP 2 would take the City to full funding by 2009 was a “disingenuous agreement, but noted that everyone was concerned about the possible costs.”<sup>125</sup> Murphy also admitted that a benefit increase was discussed at the same time the disingenuous plan to postpone full funding to 2009 was discussed. Murphy said the benefit increase was proposed by the City Manager to convince employees to forego a salary increase in FY 2003.<sup>126</sup> It was Murphy’s understanding that MP 2 was a condition for the whole labor agreement.<sup>127</sup> Murphy admitted he knew that SDCERS board members had asked for indemnity in connection with MP 2.<sup>128</sup> And as a

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<sup>122</sup> 5 September 2003 email from Diane Shipione to Lawrence Grissom, exhibit 32.

<sup>123</sup> 26 November 2003 notes made of conversation with Vincent and Elkins attorney Paul Maco, exhibit 33.

<sup>124</sup> *Id.*

<sup>125</sup> *Id.*

<sup>126</sup> *Id.*

<sup>127</sup> *Id.* at 2-3.

<sup>128</sup> *Id.*

former Superior Court judge, Murphy would have understood the reason SDCERS board members had requested this indemnity.

Murphy said he had notes of the SDCERS presentation to the City Council Rules Committee in 2003. He independently recalled that, at the Rules Committee meeting, it was reported that the funded ratio had dropped 20%, from 97% to 77%. Murphy admitted he and the Council had become aware by this point that the underfunded pension system was a serious problem.<sup>129</sup> He also admitted there was a discussion of the contingent benefits at the February 2003 Rules Committee meeting, and that the emphasis had turned from the Blue Ribbon Committee report and the post-retirement benefits to the large underfunded liability that needed to be addressed. Murphy said the large drop in the funding ratio had caught his and the Council's notice.<sup>130</sup>

Murphy knew lawsuits had been filed alleging the pension "underfunding was illegal."<sup>131</sup> By this time, Murphy also knew there were some errors in the FY 2002 financial statements.<sup>132</sup>

As to the bond offerings at issue, John Kern, chief aide to Murphy, admitted that bond offering documents went to the Mayor's office when the Rules Committee sign-off was needed to put them on the docket. Once on the docket, the bond documents were delivered to Mayor Murphy. Murphy admitted he spent some time reviewing the bond documents.<sup>133</sup>

Murphy admitted that there had probably been statements made by securities attorneys from the Bryan Cave law firm in the 6 November 2001 closed session meeting of the City Council that the POS should be reviewed by the Mayor and City Council.<sup>134</sup> For most offerings, the Mayor would ask if the council wanted a report.<sup>135</sup> And for most offerings, there was a package of documents, which members reviewed with varying

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<sup>129</sup> 27 February 2002 transcript San Diego City Council Rules Committee, exhibit 8; 8 July 2004 Vinson & Elkins interview with former Mayor Murphy, p. 4, exhibit 34.

<sup>130</sup> 27 February 2002 transcript San Diego City Council Rules Committee, exhibit 8; 8 July 2004 Vinson & Elkins interview with former Mayor Murphy, p. 3, exhibit 34.

<sup>131</sup> *Id.*

<sup>132</sup> 27 February 2002 transcript San Diego City Council Rules Committee, exhibit 8; 8 July 2004 Vinson & Elkins interview with former Mayor Murphy, p. 6, exhibit 34.

<sup>133</sup> 27 February 2002 transcript San Diego City Council Rules Committee, exhibit 8; 8 July 2004 Vinson & Elkins interview with former Mayor Murphy, p. 7, exhibit 34. (John Kern, former chief of staff to Mayor Murphy, also attended the interview.)

<sup>134</sup> 27 February 2002 transcript San Diego City Council Rules Committee, exhibit 8; 8 July 2004 Vinson & Elkins interview with former Mayor Murphy, p. 8, exhibit 34.

<sup>135</sup> 8 July 2004 Vinson & Elkins interview with former Mayor Murphy, p. 8, exhibit 34.

levels of detail.<sup>136</sup> Murphy admitted he did not know if the review met the standards set forth in the Bryan Cave memorandum.<sup>137</sup>

Murphy's understanding of MP 2 was that "they would increase the retirement factor from 2.25 to 2.5 if the trigger was reduced to 75%."<sup>138</sup> The Retirement Board rejected that, so they called the City Manger's bluff.<sup>139</sup> At that point, Murphy understood that a new proposal was made, "to decrease the contribution levels in exchange for a ramp-up."<sup>140</sup> Murphy understood that the "ramp-up" would allow the City to gradually bring the City's funding up to full actuarial funding as opposed to having to make a lump sum balloon payment.<sup>141</sup>

Knowing that the March 2002 meet and confer PowerPoint presentation had put him on notice as to the trigger issue, Murphy explained that he realized that, due to the economic downturn, they would have trouble balancing the budget that June.<sup>142</sup> Murphy also suspected that he saw the 8 July 2002 memorandum from Lexin and Elmer Heap, a deputy city attorney, to the Mayor and City Council regarding contingent retirement benefits and the modification of the pending Manager's Proposal.<sup>143</sup>

Murphy recalled the SDCERS Board indemnification resolution that accompanied MP 2. He recalled "it was demanded from the Retirement Board."<sup>144</sup> The former mayor also recalled the SDCERS Board balked at the terms of MP 2 after the City had granted increased benefits and that one of the conditions of the "contractual relationship" was that the Board be indemnified, and thus, the SDCERS Board would only approve MP 2 if they had proper indemnification.<sup>145</sup>

Murphy remembered the 6 February 2003 SDCERS PowerPoint presentation entitled "Report on the Mayor's Blue Ribbon Committee on City Finances."<sup>146</sup> Page 9 of

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<sup>136</sup> *Id.*

<sup>137</sup> *Id.*

<sup>138</sup> *Id.* at 14.

<sup>139</sup> *Id.*

<sup>140</sup> *Id.*

<sup>141</sup> *Id.* at 14.

<sup>142</sup> *Id.* at 15.

<sup>143</sup> *Id.*

<sup>144</sup> *Id.*

<sup>145</sup> *Id.*

<sup>146</sup> *Id.* at 9.

that presentation stated that, as of 30 June 2002, the funding ratio of SDCERS was 77.3%. Murphy believed the City Manager was asked to respond to this information within 60 days, a response that would have constituted his final recommendations on this issue.<sup>147</sup>

The former mayor also recalled Diann Shipione's 18 November 2002 letter, in which she alleged MP 2 was illegal. Murphy recalled that he was "shocked" by Shipione characterizing the contingent element of MP 2 as "blatantly corrupt."<sup>148</sup> In response to Shipione's letter, Murphy believes he would have consulted with Kern or Dennis Gibson, a senior policy advisor, about this issue.<sup>149</sup>

Despite Shipione's concerns regarding the legality of MP 2, Murphy recalled that he and the rest of the City Council really wanted to pass this measure without delay and that the City Manger tried to push the agreement through.<sup>150</sup> The minutes of the 18 November 2002 meeting of the City Council show MP 2 was approved; however, Mayor Murphy believed that this was just an approval of the benefits, not the underfunding provision.<sup>151</sup>

Finally, with regard to the ballpark offering, Murphy recalled that Bruce Henderson had threatened to file a complaint with the SEC or bring his own securities fraud action with regard to the ballpark bonds.<sup>152</sup> As a consequence, Murphy recalled that someone directed him and the Council to read the ballpark preliminary official statement and to look for inaccuracies. He was to do this to make sure it was accurate, to ensure they complied with all disclosure compliance laws as an affirmative defense in the event any lawsuit was filed.<sup>153</sup> Murphy recalls the City Comprehensive Annual Financial Report (CAFR) was an appendix to the bond offering statements.<sup>154</sup>

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<sup>147</sup> *Id.*

<sup>148</sup> *Id.* at 16.

<sup>149</sup> *Id.* at 17.

<sup>150</sup> *Id.*

<sup>151</sup> *Id.*

<sup>152</sup> *Id.* at 20-21.

<sup>153</sup> *Id.* at 21.

<sup>154</sup> *Id.* at 22.

## VI. COUNCIL MEMBER SCOTT PETERS RECOLLECTION OF THE FACTS SUPPORTS THAT HE KNEW OF MATERIAL INFORMATION THAT WAS NOT DISCLOSED IN THE CITY'S BOND OFFERINGS

All council members who take affirmative action to bring the City to its current financial state should be held responsible for their actions. No council member should be able to absolve himself or herself from individual liability if it can be shown that he or she knew of the relevant material information that was not disclosed in the bond offerings.

For example, it is clear that Council members Scott Peters, Brian Maienschen, Jim Madaffer and Ralph Inzunza all had knowledge of the City's dire financial condition with regard to the pension system. As already detailed above, each of these Council members was on the Rules Committee when the Rules Committee was told that SDCERS had \$2.53 billion in assets and \$3.17 billion in liabilities – totaling a deficit of \$720 million.<sup>155</sup> The Rules Committee, comprised of Council members Scott Peters, Brian Maienschein, Jim Madaffer and Ralph Inzunza, were told in a letter that SDCERS assets were only 77.3% of its liabilities (below the 82.3% trigger level). In other words, these Council members now specifically knew that the retirement fund was “short” approximately \$720 million.<sup>156</sup> The Rules Committee was also told that the value of the liability for paying the health insurance premiums for current active members in the pension system who had not yet retired was “in the neighborhood of \$1.1 billion dollars.”<sup>157</sup>

As shown above, Council members Scott Peters, Brian Maienschein, Jim Madaffer and Ralph Inzunza clearly had knowledge of the City's adverse financial situation and knowledge that the financial situation was getting worse, not better. Thus, while any of these council members could be found to have the requisite scienter for violation of the federal securities laws, for purposes of brevity, this report examines just Council member Peters' knowledge of the material facts, and why he chose not to disclose them even though under a duty to do so. Much of the information pertinent to Council member Peters is relevant to the knowledge of the other council members.

With regard to the ballpark securities offerings, Council member Peters recalls the presentation of the Bryan Cave letter which identified the due diligence duties of the council members in connection with reviewing securities offerings.<sup>158</sup> Council member Peters recalls this fact as this presentation occurred around the time of the Valerie

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<sup>155</sup> See *infra* Section VI(A)(6).

<sup>156</sup> *Id.*

<sup>157</sup> *Id.*

<sup>158</sup> 1 May 2006 Wilkie Farr interview with Council member Scott Peters p. 14, Exhibit 35.

Stallings debacle, after which the council had to revote on all the ballpark related issues.<sup>159</sup>

Council member Peters remembers welcoming the idea of the Mayor's Blue Ribbon Committee.<sup>160</sup> Council member Peters wanted the Blue Ribbon Committee to report candidly about what it really perceived the City's financial health to be.<sup>161</sup> Council member Peters recalls hearing the Blue Ribbon Committee's presentation at the 27 February 2002 Rules Committee in which it was disclosed that the pension fund contribution deficit was \$6 million to \$8 million.<sup>162</sup>

At the February 2003 Rules Committee meeting, Council member Peters recalls first hearing about MP 1 and "corridor funding."<sup>163</sup> At this meeting, Council member Peters recalls hearing about SDCERS low funding ratio, and that the "trigger had been hit, or was going to be hit."<sup>164</sup> Council member Peters recalls that when someone asked about the financial impact if the trigger were hit, he was told that the cost to the City would be around \$20 million.<sup>165</sup>

Council member Peters believed that MP 2 was the way to solve the underfunding problem. Council member Peters perceived that the contribution relief proposal being linked to the benefits discussion in that the City would not be able to support the increase benefits unless it got the requested contribution relief.<sup>166</sup> Council member Peters believed that there was a sense of contingency between the benefits and the contribution relief as "that was the strategy of the team."<sup>167</sup> Interestingly, because both Council member Peters, Mayor Murphy and the rest of the Council were concerned about leaks regarding negotiations with the unions, which included the MP 2 agreement, the Council made it a misdemeanor to disclose any information about any of the meet and confer issues.<sup>168</sup>

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<sup>159</sup> *Id.*

<sup>160</sup> *Id.* at 4.

<sup>161</sup> *Id.* at 5.

<sup>162</sup> *Id.*

<sup>163</sup> *Id.* at 8.

<sup>164</sup> *Id.*

<sup>165</sup> *Id.*

<sup>166</sup> *Id.* at 10.

<sup>167</sup> *Id.*

<sup>168</sup> *Id.* at 9.

Instead of performing any type of inquiry or investigation into the source of the City's financial problems, Council member Peters chose to rely upon others. By doing so, Council member Peters ignored numerous signals that warned of actual and potential problems with the pension fund. For example, Council member Peters recalls Diann Shipione's letter warning of the illegality of MP 2 and thought that she raised serious issues, but states that, overall, the "mantra" within City government was that Diann Shipione was crazy and mad at the Mayor and that people should not worry about the pension fund.<sup>169</sup> Council member Peters took no follow up action with regard to Ms. Shipione's letter.

Council member Peters also recalled that the City Manager informed him that MP 1 and MP 2 were plans to address the shortfall of the pension system in a graduated way, and he recalls having confidence in those statements when he voted on the MP 2 agreement.<sup>170</sup> Moreover, Council member Peters remembered relying on the fact that City Manager Michael Uberuaga and SDCERS Retirement Administrator Lawrence Grissom would have never down played the significance of the pension problem in public reports, but rather would have provided reassurance through informal channels and contacts.<sup>171</sup> Council member Peters saw these officials weekly at both open and closed session meetings and they would provide him with reassurances on a steady basis.<sup>172</sup> Even though Council member Peters knew he had an affirmative duty to read the bond offering documents for accuracy, Council member Peters expected that the auditors and bond counsel or disclosure counsel would have conducted a careful review of all disclosure language.<sup>173</sup>

With regard to potential changes in the retirement system to avoid repeating the same problems of the past, Council member Peters noted that certain changes have already been mandated, namely the voter mandate that a 15-year amortization period be used to repay the underfunding.<sup>174</sup> However, the SDCERS Board and the City have intentionally disregarded this public mandate and chose to use a 20-year amortization.<sup>175</sup>

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<sup>169</sup> *Id.* at 7; 25 June 2004 Vinson & Elkins interview with Council member Peters, p. 3 Exhibit 36.

<sup>170</sup> 1 May 2006 Wilkie Farr interview with Council member Scott Peters p. 4, Exhibit 35.

<sup>171</sup> *Id.* at 7.

<sup>172</sup> *Id.*

<sup>173</sup> 25 June 2004 Vinson & Elkins interview with Council member Peters, p. 3 Exhibit 36.

<sup>174</sup> *Id.* at 19.

<sup>175</sup> Vigil, Jennifer, "Payment span set on pension debt," *San Diego Union-Tribune*, 17 March 2007, [http://www.signonsandiego.com/uniontrib/20070317/news\\_1m17pension.html](http://www.signonsandiego.com/uniontrib/20070317/news_1m17pension.html)

## **VII. CITY OFFICIALS CLEARLY KNEW THAT THEY HAD A DUTY TO DISCLOSE MATERIAL INFORMATION IN CONNECTION WITH ANY SECURITIES OFFERINGS, BUT CHOSE NOT TO DISCLOSE THE PENSION FINANCIAL CRISIS**

The facts detailed in this report clearly illustrate how Mayor Murphy and the City Council were fully briefed about their legal duties related to securities offerings, including the laws requiring them to fully and openly disclose all material information. As set forth above, they were briefed carefully and explicitly about these duties to try to avoid another scandal like that involving former Council member Valerie Stallings – whose acceptance of illegal gifts from Padres owner John Moores led to a need to re-vote on agreements related to the ballpark. Council members learned from that experience about the ramifications of Government Code § 1090 as well as various other laws and regulations.

Despite these briefings, history repeated itself. Instead of learning from prior mistakes, Mayor Murphy and City Council members failed to disclose material information in City bond offerings about the pension crisis and related financial forecasts. Not only did Mayor Murphy and the City Council fail to disclose relevant material information, they voted to make it a misdemeanor to even discuss this information publicly.<sup>176</sup>

These failures by Mayor Murphy and the City Council to disclose material information to the investing public and citizens of the City of San Diego came full circle when a taxpayer, William Gleason, in 2003, filed a lawsuit against the City related to the pension underfunding provision of MP 2. The City resolved the lawsuit by agreeing to increase pension funding; however, the other half of the *quid pro quo* agreement, the increased pension benefits, remains intact.

## **VIII. CITY OFFICIALS SPEND PUBLIC FUNDS TO HAVE A REPORT ISSUED CLEARING THEM OF LIABILITY**

This section of the report will provide evidence that the Mayor and the City Council allocated more than \$20 million in City funds to pay for investigative reports specifically designed to clear them of any responsibility in the approval of financial documents that omitted material information regarding the City's declining financial health.

### **A. VINSON & ELKINS INVESTIGATES THE CITY**

In February 2004, Vinson & Elkins was retained by the City to investigate and review the City's financial disclosure practices and respond to an SEC inquiry. Following its investigation, Vinson & Elkins, issued a report on 16 September 2004

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<sup>176</sup> See *infra* Section IX of this report; see also 2 May 2006 Wilkie Farr interview with former Mayor Dick Murphy p. 4, exhibit 37.

titled, "Report on Investigation: The City of San Diego, California's Disclosure Obligations to Fund the San Diego City Employees' Retirement System and Related Disclosure Practices." The report found that a series of federal securities law disclosure violations had occurred. However, the report found "no evidence of affirmative deception." City outside auditor KPMG immediately voiced concerns about the quality of the investigation and the resulting conclusions. KPMG wrote the City on 11 October 2004, labeling the report insufficient to meet professional auditing standards and stating that an "illegal acts" analysis was necessary for an ongoing audit to be completed.

Murphy and the City Council read and interpreted this report as a finding that there was "no evidence that accounting and disclosure errors were intentional."<sup>177</sup> City officials were quick to jump on the finding of no wrongdoing. Former City Attorney Casey Gwinn issued a press release: "I am gratified to learn that Vinson & Elkins found no evidence that any City official or employee acted with intent to mislead or defraud investors." Gwinn claimed: "It appears that the troubles with the City's pension system were fully covered in news reports and public meetings. It is difficult to conclude under those circumstances that the City was attempting to hide from the public or the investing community the impact of the City's obligation to fund the system."<sup>178</sup>

However, given the record set forth above, the finding of no wrongdoing by City officials has been discredited. Moreover, even though Murphy and the City Council spent more than \$7 million for the Vinson & Elkins report, the report was judged to be wholly unsatisfactory by the City's auditor.<sup>179</sup>

## **B. ARTHUR LEVITT INVESTIGATES THE CITY**

As the City's outside auditor found Vinson & Elkins' report insufficient for its purposes, Murphy and the City Council contracted with another firm to perform a second investigation into the alleged illegal conduct associated with the pension and retiree health debt described in this report. City officials hired Arthur Levitt, Jr. -- the former SEC boss of Vincent & Elkins' attorney Paul Maco -- to oversee the second investigation. Levitt, in turn, employed a staff and attorneys that included former SEC accountant Lynn E. Turner and accountant and attorney Troy A. Dahlberg. These individuals, working with New York-based law firm Willkie Farr & Gallagher, issued a second report that found Mayor Murphy and the Council members had acted negligently.

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<sup>177</sup> 17 September 2004 *San Diego Union-Tribune* article entitled Pension report slams City Hall "Document: Errors rooted in confusion and dysfunction." Exhibit 38.

<sup>178</sup> 16 September 2004 San Diego City Attorney Casey Gwinn News Release, exhibit 39; *see also* similar news release issued by former City Attorney Casey Gwinn on 17 September 2004, exhibit 40.

<sup>179</sup> *See* 11 October 2004 letter from the City's outside auditor KPMG to Leslie J. Girard finding that the Vinson & Elkins report did not satisfy the audit requirements, exhibit 41.

The second investigative report made the following findings:

The Council's awareness of potentially significant liabilities in advance of several of those issuances should have caused the Council to take appropriate steps to make sure the City was not disseminating inaccurate or misleading information about these liabilities, by reading the disclosures or even just asking questions. It took no such steps. As such, the Mayor and City Council must share the responsibility for some of the City's disclosure failures due to their negligent behavior.<sup>180</sup>

**C. BOTH VINSON & ELKINS' REPORT AND LEVITT'S REPORT PROVED TO BE INSUFFICIENT**

Both the Vinson & Elkins and Levitt investigative reports failed to adequately analyze evidence showing Murphy and the Council members knew of the substantial pension and retiree health debt missing from the bond disclosure documents they authorized.<sup>181</sup> Indeed, if the SEC found that City officials had the requisite scienter to hold the City liable for securities fraud, how could Vinson & Elkins and Arthur Levitt's findings of no wrongdoing and negligence be considered credible? Indeed, even though the City spent more than \$25 million on these reports, both reports ignored critical facts in order to conclude that City officials either acted properly or were merely negligent in their duties. Public comments by the attorney who made the decision that Mayor Murphy and Council members acted negligently made clear he was aware the SEC had not typically charged public officials with violating the SEC anti-fraud provisions based upon a finding of negligence:

We conclude that they acted negligently in that they did not exercise reasonable care in authorizing the disclosure documents. Ordinarily, that does not constitute a violation of the anti-fraud provisions because anti-fraud, under the securities laws, requires a more culpable or bad state of mind. It requires something that we in the legal business call scienter, or wrongful purpose. It is more than carelessness. It is more serious than sloppiness or indifference. A person with scienter is a person who acts and knows that what they are doing is probably wrong and proceeds anyway. We do not conclude the City Council members had that state of mind when they authorized the public disclosures when they did ...<sup>182</sup>

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<sup>180</sup> 8 August 2006 Report of the Audit Committee of the City of San Diego Investigation into the San Diego City Employees' Retirement System and the City of San Diego Sewer Rate Structure p. 236, exhibit 42.

<sup>181</sup> Compare this report, the City Attorney's Second Interim Report (exhibit 43) (with exhibits available at [www.sandiego.gov/cityattorney/reports/index.shtml](http://www.sandiego.gov/cityattorney/reports/index.shtml)) to the Vinson & Elkins and Levitt reports, exhibit 42.

<sup>182</sup> 8 August 2006 transcript of Benito Romano, exhibit 44.

**D. FORMER SDCERS BOARD MEMBERS AND CITY OFFICIALS MUST STAND TRIAL FOR CRIMINAL VIOLATIONS RESULTING FROM THEIR INVOLVEMENT IN MP 2**

The Vinson & Elkins and Levitt reports found no one sufficiently culpable to be held accountable for securities fraud. Yet, on 7 September 2007, the California Court of Appeals, Fourth District, Division One, concluded there was sufficient evidence to proceed with a criminal trial against several former SDCERS board members and City officials for criminal violations of California's law related to the prohibition against making contracts in which one has a self-interest (Government Code § 1090) as a result of MP 2.<sup>183</sup> The Court found that "a reasonable person could harbor a strong suspicion that enhanced benefits in which each defendant did have an interest were contingent upon SDCERS's approval of MP 2."<sup>184</sup>

**IX. CONCLUSION**

It is axiomatic that if you cannot pay your debts you shouldn't increase them. But, this is what current and former City officials did – in exchange for reducing the amount of the City's payment, the City agreed to increase pension benefits retroactively. The retroactive benefit increases created an immediate unfunded liability. The practical effect of this agreement was that the City began to negatively amortize its payment obligation to SDCERS. This is equivalent to a person who cannot pay his outstanding credit card payment making an agreement with the credit card company to the effect that if it agreed to reduce the minimum monthly payment, he would agree to instantaneously increase his debt!

This was not a tough concept for Mayor Murphy and the Council members to grasp; what was tough for these individuals was facing up to and disclosing the truth. Like a Ponzi scheme, these individuals failed to disclose the truth in City offering documents hoping that with the right amount of time (through the funding relief agreement, MP 2) and the right amount of luck (that the stock market would have another incredible run), the deficit would magically disappear and no one would be the wiser. Unfortunately, for these individuals, that did not happen.

In short, the question is not, did these individuals know about the adverse financial condition of the pension system, but why did they choose not to disclose it? As one can see, there was and is a substantial record showing that Murphy and the Council members who approved the bond offering documents knew that the City had entered into an improper transaction in which the City was permitted to shortchange the pension system in exchange for increased benefits to those pension board members who agreed to

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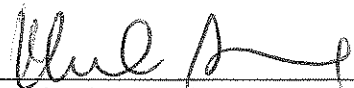
<sup>183</sup> One of the persons criminally charged was the president of the firefighter's union, the individual who introduced and moved approval of MP 2 at SDCERS and who voted for the *quid pro quo* deal to increase pension benefits in exchange for allowing the City to pay less than the actuarially determined amount to the pension fund. (7 September 2007 appellate decision in *Lexin v. Superior Court of San Diego County*, exhibit 45.)

<sup>184</sup> *Id.* at 38.

look the other way. The nature, extent and repetition of the transactions drawing Mayor Murphy and Council members into the vortex of the illegal scheme clearly demonstrates that they knew of the unlawful scheme. Once in possession of this material information, they authorized bond sales documents and permitted financial statements to be issued that omitted and misrepresented material information. Thereafter they spent millions of taxpayer dollars to avoid responsibility, by hiring expensive attorneys and consultants to issue self-serving reports.

Based on the above, it is quite clear that Murphy and the Council members had the requisite education, training and knowledge to understand that the City offering documents contained materially misleading information and/or omitted material information. Yet, they failed to in their duties to make this information public to the purchasers of the City of San Diego's securities offerings. Indeed, the SEC found scienter on the part of the City through the scienter of its officials.

Subsequent events have shown that the City's elected officials have not fully absorbed the importance of compliance with federal securities laws and the City appears to be drifting back to its previous bad practices.<sup>185</sup> Without enforcement action against any individuals, including former Mayor Murphy and any of the Council members who took the actions that brought this financial crisis upon the City, the City of San Diego potentially will commit future securities fraud violations. The best deterrent to prevent future violations is for the SEC to hold individuals accountable for the securities fraud violations committed by the City of San Diego. As the *San Diego Union-Tribune* succinctly stated in its editorial, "cities don't commit securities fraud. Individuals do."

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<sup>185</sup> See the City Attorney's letter to Mayor Jerry Sanders dated September 7, 2007, Exhibit 46; see also City Attorney's Interim Report No. 18, exhibit 47.