

INTERIM REPORT NO. 2
REGARDING POSSIBLE ABUSE,
ILLEGAL ACTS OR FRAUD BY
CITY OF SAN DIEGO OFFICIALS

REPORT OF THE
SAN DIEGO CITY ATTORNEY

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I.

INTRODUCTION

The San Diego City Attorney is issuing this Interim Report Number 2 related to possible Abuse, Illegal Acts, or Fraud by City of San Diego Officials.

In recent months, City officials have engaged in a series of acts and practices that have caused a delay in the issuance of a certification by KPMG, the City's outside auditor, for the City's 2003 financial statement.

During October 2004, KPMG requested that the City launch an independent investigation of potential illegal acts by City officials that led to the City's failure to discharge its financial disclosure obligations. Specifically, KPMG has requested a report supported by a thorough investigation and including clear conclusions about whether any relevant laws have been violated and whether individual conduct may have been fraudulent or unlawful. The purpose of the requested report was to provide a basis for determining KPMG's ability to rely on management representations from the City. The City Attorney has undertaken that task.

The City Attorney's First Interim Report reached the following conclusion:

Despite the substantial financial crisis faced by the City due to funding problems in the City pension plan the Mayor's Blue Ribbon Committee Report on City of San Diego Finances represented the funding ratio was 97%. Thus, the Mayor's Blue Ribbon Committee Report on City of San Diego Finances contained a material false statement that the San Diego City Pension Plan's funding ratio was 97% when in fact it was 89.9% funded as of 30 June 2001. The report also

failed to disclose that by 11 October 2001 the audit staff of the City had determined that the investment portfolio of the City's pension plan had dropped significantly. Finally, the possible triggering of the City's duty to make a sizeable balloon payment to the plan was not mentioned. City officials allowed this misinformation to be perpetuated despite various opportunities to correct the record. Thus, taxpayers and other users of the Mayor's Blue Ribbon Committee Report on City of San Diego Finances were misinformed about material financial information regarding City finances.

The failure to include accurate information about the dire financial condition of the City's employee pension plan in the Mayor's Blue Ribbon Committee Report on City of San Diego Finances used in February 2002 raises serious questions of misconduct by City officials. The City Attorney's office is now conducting an investigation to identify the parties responsible for putting the false material statement in the Mayor's Blue Ribbon Committee Report on City of San Diego Finances and allowing this misinformation and/or omitted facts to be disseminated to the Council, the market and the public.

Had the public known that the City faced the very real prospect of having to pay hundreds of millions of dollars into the pension plan in order to meet its contractual duties under the MP1 agreement, would the City have proceeded with its decision to increase employee pension benefits by hundreds of millions of dollars? Had this information been disclosed would the City have continued to sell municipal bonds that did not make needed disclosures about the City's pension funding problems? Had this information been disclosed would the City be facing investigation by the SEC, FBI and US Attorney?¹

On 11 October 2001, Assistant City Auditor Terri Webster understood that the City of San Diego faced a probable pension funding crisis. As the City's Chief fiscal officer,² the auditor had a duty each month to know of and to keep the City Council

¹ Interim Report No. 1 Regarding Possible Abuse, Fraud, and Illegal Acts by San Diego City Officials and Employees, pp. 15-16.

informed about the exact financial condition of the City and of each Department, Division and office thereof.²

By 11 October 2001, Assistant City Auditor Webster had learned of a significant drop in the pension fund earnings for the first two months of fiscal year 2002. She knew that during July and August 2001, pension plan earnings had dropped 71% from the same period fiscal year 2001. Because the losses pushed the City toward having to make balloon payments of several hundred million dollars, this development was ominous.

Ms. Webster's understandable emotional response to this development was captured in an email exchange with City of San Diego Human Resources Director Cathy Lexin entitled "EEEK".

From: Cathy Lexin
To: Webster, Terri
Date 10/11/01 10:13AM
Subject Re: EEEK

FYI

² San Diego City Charter Article V ' 39. (Exhibit 1)

YTD CERS [City Employees Retirement System] earnings as of August 31, 2001 in the CERS Trust fund is about \$15m compared to \$53M same time 2000...a 71% drop! BEFORE 9-11-01! It will be tight to even meet the base undistributed earnings distributions for FY 02 (ie. 13th check, corbett, etc).³

In 1996, the City and the pension board entered into an agreement that allowed the City to avoid its duty to make actuarially determined contributions to the pension plan. The decision to relieve the City from its duty to provide full actuarial funding resulted in a decrease of the pension plan's funding ratio. The pension plan's funding level fell from 97.3% as of 30 June 2000; to 89.9% as of 30 June 2001.⁴ In fiscal year 2002 it fell to 77.3% , in fiscal year 2003 to 67.2%, and in fiscal year 2004 to 65.8%.⁵

³ 11 October 2001 (10:13 AM) Email from Cathy Lexin to Terri Webster on the subject of AEEEEK.@ (Exhibit 47)

⁴ 14 June 2002 Memorandum from Cathy Lexin to Mayor and City Council p. 2. (Exhibit 2)

⁵ San Diego City Employees Retirement System Annual Actuarial Valuations 30 June 2003 p. 13 (Exhibit 3) and 30 June 2004 p. 13 (Exhibit 4); see 14 June 2002 Memorandum from Cathy Lexin to Mayor and City Council p. 2 (Exhibit

2).

Under the terms of the 1996 funding agreement, and in view of the funding ratio dropping to 77% in fiscal year 2002, the City faced the prospect of having to contribute \$159 million to the pension plan in order to restore its funding level to 82.3%. Clearly the growing problem with the pension plan's funding ratio created a financial crisis for the City.⁶ The Mayor and Council would have to find hundreds of millions of dollars in a budget that was already strained. On 30 June 2003, the funding ratio decreased to 67.2% from the 30 June 2002 level of 77.3%.⁷ The descending funding ratio would have required the City to pay the \$159 million in 2004 and

⁶ The funding ratio refers to the ratio between the pension's assets and liabilities.

⁷ 23 July 1996 Memorandum from Cathy Lexin to Larry Grissom re: City Manager's Retirement Proposal, p. 7 (Exhibit 5); see also, 30 June 1996 Actuarial Valuation (Exhibit 6).

another \$371 million in 2005.⁸

⁸ Under the trigger, the City was required to return the pension plan to a 82.3% funding ratio by the July following the applicable actuarial report. The funding ratio fell to 77.3% (5% below the 82.3% trigger) as of June 2002 and 67% (15% below the 82.3% trigger) as of June 2003. Under the trigger formula, the City was required to pay \$159 million by 1 July 2004 ($.05 \times \$3,168,921$) and \$371 million by 1 July 2005 ($.15 \times \$3,532,626$); see, 23 July 1996 Memorandum from Cathy Lexin to Larry Grissom re: City Manager's Retirement Proposal, p. 7 for trigger formula. (Exhibit 5)

This 1996 agreement violated the Charter provision requiring the City to fully fund the pension plan.⁹ The plan's fiduciary counsel permitted the 1996 agreement, which provided for the City to underfund its pension, only on the proviso that if the funding ratio fell below 82.3%, the City would pay the amount needed to restore the funding level to 82.3%:

The basis for the prior fiduciary counsel condoning the original agreement to accept less than full actuarial contributions from the City, was the establishment of a reasonable funding ratio floor (82.3%), and the expectation of progress toward full funding pursuant to this plan.¹⁰

II.

THE SCHEME TO AVOID THE TRIGGER AND BALLOON PAYMENT

A. TRIGGER AND BALLOON PROBLEM DISCOVERED

The agreement requiring the City to keep the employee pension plan at or above 82.3% was set forth in a 23 July 1996 memorandum from City Labor Relations Manager Cathy Lexin to pension plan administrator Larry Grissom:

⁹ San Diego City Charter Article IX ' 143 (Exhibit 7); See, San Diego Municipal Code ' 24.0801 (ante November 2002) (Exhibit 8).

¹⁰ 14 June 2002 Memorandum from Cathy Lexin to Mayor and City Council p. 2. (Exhibit 2)

The City will pay the agreed-to rates shown above for FY 96 through FY 2007. In the event that the funded ratio of the System falls to a level 10% below the funded ratio calculated at the June 30, 1996 actuarial valuation which will include the impact of the benefit improvements included in this Proposal, the City-paid rate will be increased on July 1 of the year following the date of the actuarial valuation in which the shortfall in funded ratio is calculated. The increase in the City-paid rate will be the amount determined by the actuary necessary to restore a funded ratio no more than the level that is 10% below the funded ratio calculated at the June 30, 1996 actuarial valuation.¹¹

The Council and Mayor, City Auditors Ed Ryan and Terri Webster, City Treasurer Mary Vattimo, pension plan administrator Lawrence Grissom, pension plan board member and Blue Ribbon Committee member Richard Vortmann, pension board Chairman Fred Pierce, and other City and pension officials watched with consternation as the pension plan's financial condition deteriorated throughout fiscal year 2002. Together these officials decided not only to keep the people of San Diego in the dark about the situation, but also to withhold the adverse financial facts from investors in the City's bonds. As the pension plan's funding ratio plummeted towards the trigger, the concerns of these financial insiders grew.

On 3 December 2001, in an email she titled "earnings EEEK!" and signed

¹¹ 23 July 1996 Memorandum from Cathy Lexin to Larry Grissom p. 7 (Exhibit 5); the 1996 actuarial valuation was 92.3% (See, Annual Actuarial Valuation as of June 30, 1996 p. 16 (Exhibit 6)).

ASleepless in San Diego,@ Assistant City Auditor Webster wrote pension administrator

Lawrence Grissom about the further deterioration of the City's investment earnings:

Larry

Oct statements showed \$15.4 m loss on sale of stocks and a total monthly loss of \$7m bringing YTD earnings at Oct 31, 2001 to only \$14.1 million compared to \$107 m last year same time. A 87% decrease !EEEK!

Sincerely,
Sleepless in San Diego¹² [emphasis added]

One month later, on 3 January 2002, Ms. Webster, Auditor Ed Ryan, and Human Resources Director Cathy Lexin exchanged more bad news about and made contingency plans in response to the precipitous drop in the pension plan's earnings:

Ed

CERS fund earnings as of 11-30-01 was \$17.4 million compared to \$112.6 at 11-30-00 (85% decrease). {Oct was a 87% decrease so slight movement in the right direction occurred.}

In order to fund the basic items listed in the Muni Code out of earnings using FY 01 numbers \$118 is needed.

Anyway these are SERIOUS consequences and needs attention

¹² 3 December 2001 email from Terri Webster to Lawrence Grissom with a copy to Cathy Lexin on the subject of Aearnings EEEK!@ (Exhibit 9)

Terri ¹³

One month later, on 12 February 2002, Terri Webster wrote Auditor Ed Ryan about the full gravity of the financial disaster enveloping the pension plan. As documented in the most recent actuarial report, there was a swing of \$486 million against the City:

Per Larry the actuary report shows a \$200M loss....that's a \$486m swing from the last report. Funding ratio drops to 90% from 97%...this assumes the \$100m set aside for meet and confer is in assets. The trigger point is 82%. ...

Ugly Ugly [emphasis added]

They project a \$60m shortfall for FY 02 earnings.¹⁴

¹³ 3 January 2002 emails between Cathy Lexin and Terri Webster. (Exhibit 10)

¹⁴ 12 February 2002 Email from Terri Webster to Ed Ryan on the subject of EGF and CERS. (Exhibit 11)

On 12 February 2002, the actuarial report that Ms. Webster referred to in her email to Mr. Ed Ryan was released to pension board members. It showed that the funded ratio of assets to liabilities had dropped to 89.9% and that the unfunded actuarial accrued liability had grown from \$68,959,000 to \$283,893,000, a 290% increase.¹⁵ On 28 February 2002, in light of the further slide of the funding ratio, auditors Ed Ryan and Terri Webster had a discussion with City officials involved in the employment negotiations with the unions representing City workers. The topic of this discussion was the need to include the effect of the trigger on the meet and confer labor negotiations.

2/28/2002 8:10 AM

Email from Mary Vattimo to Ed Ryan, Terri Webster and Cathy Lexin
(cc to Bruce Herring)
Re: CERS earnings

I think that discussing with Ron is good advice; he has indicated he doesn't understand what the big deal is.

Mary

>>>Ed Ryan 02/28/2002 7:54:16 am>>>

Cathy, Bruce You might want to use Ron Saathoff to get their attention.

I don't believe you can conclude meet and confer without knowing what retirement is going to do. That means they have to tell the City likely by the March meeting. [emphasis added] I believe the Manager has to tell Council the budget status before meet and confer concludes and he'd have to know the retirement solution to do that.

¹⁵ San Diego City Employees Retirement System Annual Actuarial Valuation 30 June 2001 p. 13. (Exhibit 12)

>>>Terri Webster 02/27/02 04:40 PM>>>

OH BOYY.the CERS earnings for Jan is negative (\$1.7)Yweare moving in the wrong direction! So thru Jan 02 weare at \$25 million compared to \$146m last year almost 6 times worse than last yearY

I spoke to Fred and still don't think he gets the point that we need answers nowYand not just for a \$60m shortfall but scenarios to cover a \$70m and \$80m shortfall.

Remember the FY 01 funding ratio dropped significantly when earnings were \$165M. So at \$40-60m it will be ugly.

Terri ¹⁶

During this period auditor Webster explained in detail to a member of the pension board why the earning losses created a Afiscal time bomb@ for the City:

I think your questions centered around why does the City care about the solution to the FY 02 earnings problem?

1. Funding Ratio: Fiscal time bomb is attached to this. [emphasis added] If it drops below 82.3% the City has to pay an additional/approx \$26m a year.

Solutions that do not impact the funding ratio are the best. We need to know what the impact to the ratio is for the earnings solution...as well as I asked for the projected ratio based on FY 02 earnings.

The funding ratio is dropping rapidly in the present and last 2 years investment market. If it dropped from 97.3% to 89.9% in one year and FY 02 are 1/5 of the FY 01 earnings....then it is likely to drop real close to the 82.3% trigger. Therefore anything that negatively impacts the ratio needs to be known ASAP.

¹⁶ 28 February 2002 (8:10 AM) Email from Mary Vattimo to Ed Ryan, Terri Webster, Cathy Lexin, copied to Bruce Herring on the subject of CERS earnings.

2. Rating Agency impacts:

The Funding Ratio is a fiscal indicator of the health of the CERS fund which is a major fund of the City. A large drop in funding ratio or dropping below certain benchmarks could result in a negative impact to the City's credit rating. The City has a high credit rating which is vital to keep borrowing costs down for future issuances on the horizon such as for fire stations, main library, and branch libraries, etc.

3. Plan for more declines and Preserve every basis point of the ratio: this is essential now since the impact of the bad market is far from over....the actuary lags a year...so we probably have at least 2 very more lean years ahead.

Don't use assets unless absolutely have to.

4. Meet and Confer: is going on now...answers are needed from retirement now as compensation offers are being exchanged and the Mayor, Council and City Manager need to know what the current and projected CERS status is as they consider possible retirement enhancements.

Terri¹⁷

On 6 March 2002 and 7 March 2002, Ms. Webster and plan administrator Larry Grissom were exchanging the latest information on the erosion of the pension plan earnings and discussing whether the plan would reach the balloon payment trigger:

Lawrence Grissom 03/06/02 5:32PM

Hi Terri

*** Preliminary recommendation from staff (lucky me) is that ----

¹⁷ 18 March 2002 Email from Terri Webster to Rgarnica@unitedcalbank.com on the subject of CERS. (Exhibit 13)

earnings still look to be in the \$50 to \$60 million range. ***

New benefits are a question mark. We are so close to the line on funding ratio, that Rick [Roeder] or I cannot predict until labor relations gives us something specific. If they go the general member increase and increase the offset, my best guess is that with a flat investment environment ie no gains, no losses, we will be around 83%.
Gonna get ugly [emphasis added]

Larry
CC: Cathy Lexin; Ed Ryan¹⁸

On 15 April 2002, the magnitude of the pension plan's staggering losses became clear to Assistant Auditor Webster and pension administrator Grissom:

Lawrence Grissom 04/15/02 3:24PM

Terri

Please treat this as confidential for the moment....haven't shared with any of the other Board members yet.

* I hope I'm wrong, but projections of the value of assets lead me to believe that actuarial losses on investments could be nearly twice as much this year over last year. That could be a reduction in the funding ratio of 7%, if all else is equal. Those two things, without any other actuarial losses or additions to liabilities for new benefits, etc. put us at about 80%. Not a happy situation [emphasis added]

Like I said, don't shoot the messenger.¹⁹

Ms. Webster responded to Grissom, reminding him that the funding ratio was

¹⁸ 6 March 2002 (5:32PM) Email from Lawrence Grissom to Terri Webster. (Exhibit 14)

¹⁹ 15 April 2002 (3:24 PM) Email from Lawrence Grissom to Terri Webster. (Exhibit 15)

really 89% not 89.9%:

From: Terri Webster
To: Lawrence Grissom
Date: 4/15/02 5:58 PM
Subject: Re: Don't shoot the messenger C !!

***also awaiting actuary answers like how exactly calculate the \$95.6 loss...also I think the 89.9% in [sic] around 89% since it appears the actuary counted all of the 105M reserve as since versus just the 100M....²⁰

The avalanche of negative financial reports overwhelmed pension board and City officials. On 26 April 2002, auditor Webster admonished Human Resources Coordinator Cathy Lexin not to discuss the funded ratio until they both could get their stories straight:

From: Terri Webster
To: Cathy Lexin
Subject: funding ratio
Cathy

I recall you mentioning that Larry said we'll be at a 84-86% funding ratio at 6-30-02. That makes no sense! I recommend not mentioning that especially on Monday since we're getting different stories. I have an email from Larry, less than two weeks ago which projected it to be at 85% on 6-30-02...the big drop (7%?) Will be due to FY 02 poor investment growth as well as a 1-2% loss due to the FY02 earnings solution.....so it makes no sense to me to now hear 84%. (Also we're at 89% no 89.9% since the actuary mistakenly gave us credit for \$5.8 million of port money.) [emphasis added]²¹

²⁰ 15 April 2002 (5:58 PM) Email from Terri Webster to Lawrence Grissom. (Exhibit 15)

²¹ 26 April 2002 Email from Terri Webster to Cathy Lexin about the

subject of Afunding ratio.@ (Exhibit 16)

B. CITY STAFF FIGHTS OVER THEIR OWN BENEFITS

By 17 May 2002, pension and City officials were fighting among themselves over their own benefits. The issue that sparked the internal bickering revolved around the lifting of the 90% cap for certain employees including Assistant Auditor Webster:

Terri Webster 5/17 5:25 PM

Why is this still out there? The maker of the Adeal@ Cathy/Dan, clearly clarified that DRAFT language is not binding and if there is a better way to do implement a 90% cap and the 2.5 at 55 that meets the City, union, members, and CERS needs...then Fine, we're not stuck with the old language.

I thought we were now all working on the same project of fine tuning that solution...hence APaul and Holly's@ versions that just need some tweaking on Monday...we're almost there....

Again...why is Cathy's intent still being questioned and desires to move backwards are expressed? [emphasis added]

Terri²²

Three days later, on 20 May 2002, Mr. Grissom lashed out at Ms. Webster and other City officials for A further attempting to pad@ their own benefits:

Terri

If, after being accused of violating everything and further attempting to pad= your own benefits, you guys feel you get another bite at the apple, go for it. I did not read Cathy as being at all amenable to changing the basic concept. If she did, then great! I honestly don't care how we do it, so long as everyone is on the same page. No desire to move backward on my part. You can't move backward until you've gotten somewhere in

²² 17 May 2002 (5:25 PM) from Terri Webster to Lawrence Webster on the subject of the Adeal.@ (Exhibit 17)

the first place. [emphasis added]
Larry²³

Auditor Webster shot back at Grissom, defending herself and arguing that she did not get any A better benefit@ and that the A statement "pad your own benefits" is wrong.@

5/20/2002 (10:26 AM)
From: Terri Webster
To: Lawrence Grissom
Subject: Re: Curmudgeon speaks

For the record, to my knowledge, the people working on this like myself, Holly, Bob, Dan, Paul get no better benefit under "Paul's or Holly's" version that [sic] the original draft/your write up so the statement "pad your own benefits" is wrong.

We're looking at what is fair and reasonable and thinking of the General Members as a whole versus individually. If their [sic] is a specific A hole@ or A risk@ in the theory that you see as the Retirement Administrator, please let Cathy/Dan/all know immediately because at this point no one has stated any problems with "Paul's/Holly's" proposed solution in terms of A detriment/harm/risk@ to the system, the City, or the members.
Terri²⁴

²³ 20 May 2002 (10:03 AM) Email from Lawrence Grissom to Terri Webster. (Exhibit 17)

²⁴ 20 May 2002 (10:26 AM) Email from Terri Webster to Lawrence Grissom regarding A Curmudgeon speaks.@ (Exhibit 17)

C. DISCUSSION SHIFTS TO GRANTING BENEFITS IN EXCHANGE FOR WAIVING THE TRIGGER

When City officials learned of the impending trigger and multi-million dollar balloon payments, they developed a plan to negate the trigger and avoid the payments. To induce the pension board to take these actions, the City extended new benefits to both City workers and to three union presidents. Thus City officials intended to increase benefits even though the pension plan was unable to pay for hundreds of millions of dollars in benefits already granted.

Emails confirm that pension board members violated their fiduciary duties to protect fund assets in exchange for new benefits that they received.²⁵ On 21 May 2002, City Auditor Webster sent an email to labor negotiator Dan Kelly, Auditor Ed Ryan, and other City officials seeking reassurance that Fire Fighter Union President Ron Saathoff would prevail on the pension board to waive the trigger and forgive the balloon payment. Mr. Saathoff was to receive a substantial presidential benefit in exchange for his help:

Dan

²⁵ See, San Diego City Charter Article IX ' 143; Cal State Constitution Article 16 ' 17 (retirement board of public pension plan has fiduciary responsibility for ... administration of the system.) (Exhibit 18)

The local 145 write up you sent out did not state that their increased offset was contingent on the Board laxing the trigger.....I thought ALL retirement improvements (including the presidential [sic] leave(?)) were contingent on the trigger....especially need Ron behind releasing the trigger since he runs the show at CERS.... [emphasis added]²⁶

Within twenty minutes City labor negotiator Mike McGhee had assured Ms.

Webster that Mr. Saathoff was **A**well aware of the contingent nature of the benefits@.

From: Mike McGhee

To: Ryan, Ed; Webster, Terri; Kelley, Dan

CC: Lawrence, Bob; Wilson, Bob; Heap, Elmer

Date: 5/21/2002 9:42 AM

Subject: Re: Meet and Confer Update - Changes for FY 2003 / FY 2004 / FY 2005

Dan shared with me your comments Terri. I assure you that Ron is well aware of the contingent nature of the benefits, after our repeated statements at the negotiations table regarding the benefits being contingent upon your noted approvals. Cathy was very specific on those points at every discussion. The various proposals are all specific to the necessary approvals and available funding from the reserves, although this is not stated in this "highlights" to the departments. [emphasis added]

D. THE MAYOR-S BLUE RIBBON COMMITTEE

²⁶ 21 May 2002 (9:22 AM) Email from Terri Webster to Dan Kelley on the subject of **A**laxing the trigger.@ (Exhibit 19)

On 27 April 2001, San Diego Mayor Dick Murphy convened a Blue Ribbon Committee on City Finances to perform an independent evaluation on the City's current fiscal health.²⁷ The Mayor designated Auditor Ryan and Assistant Auditor Webster as staff for the Committee. The Blue Ribbon Committee's final report described its charge:

In Mayor Dick Murphy's January 8, 2001 State of the City Address entitled "A Vision for San Diego in the Year 2020: A City Worthy of our Affection", he outlined ten goals for the City to focus on over the next four years. A concern raised by the Mayor was whether the City could afford to do the ten 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. Furthermore, the Mayor stated that he would ask the City's independent Auditor and Comptroller Ed Ryan to provide staff support to the Committee.²⁸

²⁷ Mayor's Blue Ribbon Committee Report on City of San Diego Finances (27 February 2002) p. 2. (Exhibit 20)

²⁸ 27 February 2002 Blue Ribbon Committee Report on City of San Diego Finances p. 2. (Exhibit 20)

The Blue Ribbon Committee Work Plan called for the final report to be presented to the Mayor on or around 7 September 2001.²⁹ In fact it was presented to the City Council Rules Committee on 27 February and 20 March 2002, and to the San Diego City Council on 15 April 2002.³⁰ Richard Vortmann, President of National Steel and Shipbuilding Company (ANASSCO), was assigned to be the committee's lead person on the Unfunded Pension Liability issue.³¹ On 21 September 2001, the Mayor also appointed Mr. Vortmann to the City Employees' Retirement System Board of Administration.³²

Mr. Vortmann's source of information about the pension funding crisis came from Blue Ribbon Committee staff Ed Ryan and Terri Webster.³³ Mr. Vortmann also received critical financial information about the adverse financial condition of the pension plan from reports provided to him by the plan actuary, plan administrator

²⁹ See Blue Ribbon Work Plan. (Exhibit 21)

³⁰ 27 February 2002 and 20 March 2002 Rules Committee Agendas; 15 April 2002 City of San Diego City Council Minutes. (Exhibit 22)

³¹ 13 July 2001 Minutes of Mayor Dick Murphy Blue Ribbon Committee on City Finances p. 2. (Exhibit 23)

³² 21 September 2001 Mayor Dick Murphy News for Release Mayor Murphy Appoints Two to Retirement Board City Council Confirms Vortmann and Garnica. (Exhibit 24)

³³ 27 February 2002 Blue Ribbon Committee Report on City of San Diego Finances p. 2. (Exhibit 20)

Lawrence Grissom, and other pension plan staff and board members.³⁴

³⁴ E.g., see 18 February 2002 letter from Mr. Vortmann to Fred W. Pierce IV Chairman San Diego City Employee Retirement System. (Exhibit 25)

By 31 July 2001, Mr. Grissom was communicating with Ms. Webster about pension plan financial matters.³⁵ On that date Mr. Vortmann, through his assistant Leilani Hughes, submitted his draft conclusions to Ms. Webster and Mr. Grissom; he had reached an assessment that the pension plan was **no big issue**:

From: Leilani Hughes
To: TAA.Auditor.cab7-9
Date: 7/31/2001
Questions for City Pension Manager

Ms. Webster,
Mr. Vortmann has asked that I send you the attached with the following note:

Terri
Thank you for your e-mailed comments.

As long as this is comprehended in long term budget planning, then there is no big issue. [emphasis added]
Dick

One month later, on 30 August 2001, Mr. Vortmann issued a memorandum suggesting that Mr. Vortmann had discovered that problems in the pension plan **were** a cause for concern:

However investment performance in YTD FY01 has been less than **2** of that excellent performance in FY00. It is expected that the forthcoming actuarial report will show an increase in the unfunded dollar

³⁵ 31 July 2001 (11:27 AM) Email from Mr. Vortmann's assistant Leilani Hughes to City Auditor Terri Webster re: **Questions for City Pension Manager**. (Exhibit 26)

amount.

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 sponsors to reduce annual cash contributions, the City still has an unfunded liability. This, taken together with the growing annual liability (as a percent of payroll base) for the ~~retroactive~~ pension improvements is a cause for concern.

By the time he wrote his 31 August 2001 memorandum, Mr. Vortmann was already asking for a comprehensive actuarial analysis of the future funding problems at the pension plan:

At a minimum the City should ask for a comprehensive analysis, based on today's known actuarial facts, to determine for how many years in the future will the pension contribution expense have to increase by a half percentage point of the total payroll base.³⁶

By 31 December 2001, two months after he won his appointment to the pension plan board, Mr. Vortmann had taken an even more aggressive stance toward the pension plan funding crisis. On New Year's Eve 2001, Ms. Webster decried Mr. Vortmann's new approach as **Doom and gloom**:

5. Maybe you can talk to Dick before Fri and turn him. He's turned all 6, 100%, reported topics into a negative. Doom and gloom ... were a good looking apple that is rotten once you bit into it.... [emphasis added]

Mr. Vortmann faced substantial pressure not to reveal the whole truth about the pension funding crisis. In an email to auditor Ryan, Ms. Webster celebrated the

³⁶ 30 August 2001 Vortmann memorandum **Employee Retirement Benefit Liabilities**.@ (Exhibit 27)

fact that she had stopped Mr. Vortmann from disclosing all that he knew about the pension funding crisis:

From: Terri Webster
To: Ryan, Ed
Date: 7 January 2002
Subject: my suggestion on Redraft of pension Sections
Ed,

I reviewed Dick's changes...it most places he deleted your recent changes and put back his language...but he did in a small way improve his language. I will suggest some changes to his conclusions to more emphasize the point you made in the meeting Re: % of pension to payroll but after a dozen tries [sic] I don't see the values of arguing with him on the wording of the other issues any more and it is too complicated for the rest of the committee to grasp and help change Dick's mind...so I suggest we agree to disagree...we gave a good shot at changing him...he just didn't fall for it..all... [emphasis added]³⁷

On 12 February 2002, Mr. Vortmann was notified that the pension plan funding ratio had dropped from 97.3% to 89.9%.³⁸ Fifteen days later, on 27 February 2002,

³⁷ 7 January 2002 (5:12 PM) Email from Terri Webster to Ed Ryan on the subject of Amy suggestions on Redraft of Pension Sections.@ (Exhibit 52)

³⁸ 30 June 2001 San Diego City Employees=Retirement System Annual Actuarial Valuation p. 13 (Exhibit 12); 18 February 2002 letter from Mr. Vortmann to

he presented the City Council Rules Committee with the Blue Ribbon Committee's report, which misrepresented the pension plan's funding ratio to be at 97.3%.³⁹

Mr. Frederick W. Pierce, IV (Exhibit 25).

³⁹ 27 February 2002 Blue Ribbon Committee Report on City of San Diego Finances p. 22 (It is currently funded at 97% (i.e. its current assets equaled 97% of the actuarially computed present value of the future Pension Plan Liabilities).@ (Exhibit 28)

Despite the fact that the Committee Report was partially revised on 14 February 2002, it was not changed to show that the plan's funding ratio had dropped to 89%.⁴⁰ Mr. Vortmann recorded his knowledge of this fact in an 18 February 2002 letter to pension board Chairman Fred Pierce:

My reading of the new actuarial report⁴¹ raises several questions. Possibly some (or all) are due to my ignorance but I am concerned there are some significant issues buried here. I would respectfully request that staff address these to assure the full Board truly understands what is happening (or educate me separately if I'm the problem).⁴² [emphasis added]

⁴⁰ Compare 24 January 2002 draft of Blue Ribbon Committee Report on City of San Diego Finances p. 21 (Investment performance in the first five months of Fiscal Year 2002 is lower than in Fiscal Year 2001.) (Exhibit 29) to the 14 February 2002 draft (Investment performance in the first seven months of Fiscal Year 2002 is lower than in Fiscal Year 2001.) (Exhibit 30).

⁴¹ See, 30 June 2001 San Diego City Employees' Retirement System Annual Actuarial Valuation p. 13 showing the pension plan's funded ratio dropping 8% to 89.9%. (Exhibit 12)

⁴² 18 February 2002 letter from Richard Vortmann to Frederick W. Pierce IV. (Exhibit 25)

Mr. Vortmann recognized that the pension plan was a **big issue** and that because of it, a storm cloud was brewing over the City:

Am I confused here? If not, this is a rather big issue- i.e. the \$105m can't be used twice. A funded ratio at 85.6% is getting close to the 82.3% trigger where the current **unconventional** actuarial method is violated.

89.9% -> 85.6% (if Reserve is a true reserve) -> 83.1% (if Corbett [sic] not contingent)

14C. The brewing storm cloud needs to be fully explained.⁴³

When the report was presented to the Rules Committee, Mayor Murphy made comments revealing his personal knowledge of some of the pension funding issues:

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. In other words, we should be putting 6 or 8 million dollars in a year or more to make it actuarially sound.⁴⁴ [emphasis added]

Although Mr. Vortmann had a strong sense that the pension plan's actuary was covering his tracks, his suspicion went undisclosed:

I get a very strong sense of ~~game playing~~ or anticipator ass covering by the Actuary. This is most disturbing. How can they say the ~~system~~

⁴³ 18 February 2002 letter from Richard Vortmann to Frederick W. Pierce IV. (Exhibit 25)

⁴⁴ 8 February 2005 Transcription of City Council Rules Committee Discussion of 27 February 2002. (Exhibit 31)

continues to be in sound condition in accordance with actuarial principles of level cost financing. The actual practice is **not** level cost funding.⁴⁵

[emphasis added]

In the days following the report's release, Mr. Grissom joked with Ms. Webster about telling a *San Diego Union-Tribune* reporter that the City was failing to properly fund the pension plan:

Lawrence Grissom 3/07/02 (4:58 PM)

Hi Terri

Just got a call from Ray Huard at the Tribune wanting comment on the report's statement that the City is seriously funding [sic] its retirement plan. I told him that I had not had the opportunity to read the report and would like to before I made any comment.

Thnik [sic] I'll tell him that we are seriously underfunded due to the City not paying it's fair share.....OK with you???

Seriously, is there any Aparty line@ for me to communicate?

⁴⁵ 18 February 2002 letter from Richard Vortmann to Frederick W. Pierce IV. (Exhibit 25)

Larry⁴⁶

Within two weeks of the report's release, Mr. Grissom informed Mr. Vortmann that daily discussions were occurring about the consequences of hitting the trigger:

From: Lawrence Grissom

To: [Mr. Vortmann]

Date: Wed, March 13, 2002 5:15 PM

Subject: Response to your questions

If the current funding ratio were at or below 82.3%, they would go to the actuarial rate of 15.59%. This would represent an additional dollar contribution of approximately \$25.2 million, which is more than Cathy's estimate of \$20 million.

⁴⁶ 7 March 2002 (5:56 PM) Email from Terri Webster to Lawrence Grissom on the subject of ABlue Ribbon Report.@ (Exhibit 32)

Yes, staff has discussed this situation at length with City management. Currently, there is some discussion of the issue almost daily. [emphasis added]
Larry⁴⁷

The pension problem reported on by the Blue Ribbon Committee was shuffled from one part of City government to another. On 27 February 2002, the report went to the Rules Committee.⁴⁸ From there it was sent to the City Manager. On 20 March 2002, the City Manager returned the report to the Rules Committee.⁴⁹ The Rules Committee then sent the Report to the City Council. The Council passed it on to the Pension Board. A year later the board brought it back to the Rules Committee. The Rules Committee then sent it to the City Manager. The Manager returned it to the Mayor. Then the Mayor gave the report to the Pension Reform Committee. And finally it was returned to the City Council.

⁴⁷ 13 March 2002 (5:16 PM) Email from Lawrence Grissom to Dick Vortmann regarding **A**Response to your questions.@ (Exhibit 33)

⁴⁸ 27 February 2002 San Diego City Council Rules Committee Action. (Exhibit 34)

⁴⁹ 18 March 2002 City Manager Report **A**Response to the Blue Ribbon Committee Report@(Report No. 02-061). (Exhibit 35)

Mayor Murphy attributed his failure to take on the pension problem in 2002 to a desire not to violate Aprotocol:@

The Retirement Board has the legal responsibility under the Charter to oversee the operation of the retirement system and so my recollection is that we only indirectly control what they do. So, to come directly here with a workshop at least seems to violate protocol, if not, losing the lack of Retirement Board thoughts and input on this.⁵⁰

In 2002 Mayor Murphy detailed his knowledge of the deliberate underfunding of the pension plan but attempted to dismiss the seriousness of the problem:

AT]here was, perhaps some decisions made by prior City Councils that deliberately under funded the pension system, in order to cover their budget deficits in the 90s, I mean I don't think it is like a crisis situation but it is a serious situation and we need to address it.⁵¹

Mayor Murphy then zeroed in on the Meet and Confer process that the Mayor and City Council were beginning and how it should affect the pension funding issue:

So, even though I agree with Mr. Vortmann, there is some sense of, there is a need for us to understand that there has been historically an under funding of the retirement system, this year in the meet and confer process we need to be aware of that when we negotiate.⁵²

⁵⁰ Transcription of City Council Rules Committee Discussion of 20 March 2002. (Exhibit 36)

⁵¹ Transcription of City Council Rules Committee Discussion of 20 March 2002. (Exhibit 36)

⁵² Transcription of City Council Rules Committee Discussion of 20 March 2002. (Exhibit 36)

Finally, the Mayor tried to dismiss the seriousness of the problem by claiming that the funding ratio was in excess of 90%.

And you recall that the numbers here on the report show that the funding in some where between, in excess of 90 percent of the needs of the system, but 100 percent would be the ideal way to operate⁵³

On 29 April 2002, Mr. Vortmann sent a revealing letter to his fellow Blue Ribbon Committee board members, to auditors Ed Ryan and Terri Webster, and to Dennis Gibson, the Mayor's Senior Policy Adviser. In the letter, Mr. Vortmann admitted that the pension portion of the Blue Ribbon Report was materially false:

After much discussion of whether the sky was really falling and did we really want to say all that, we, as a group, with my concurrence, evolved to the final version of our conclusion i.e. The city in good fiscal shape, but ...

Interesting, the several citizen comments I have received regarding our report have all been essential [sic] the same Yeah, my balance sheet and credit rating would be good too. If I didn't maintain my house and pay all my expenses.

The committee's unstated concern over the ball park financing and any impact to the city's credit rating in general are now behind us. However certain recent developments since our report deliberation seems to accentuate the abuts we made in our report.

Fourth, as I continue to learn more about the City's pension system, coupled with the impact of the equity market bubble burst on the pension

⁵³ Transcription of City Council Rules Committee Discussion of 20 March 2002. (Exhibit 36)

portfolio, it is clear the City has deferred to future taxpayers far more dollars than our report assumed. Further, there appears a chance the City will grant further pension benefits this year which will either increase the pension budget line item or (more likely) push yet more current costs out to future taxpayers. Unlike deferred maintenance, these are mandatory costs which ultimately must be paid; and these amounts explicitly grow with interest when they are deferred.

I have a growing and daunting concern that we possibly did our City a disservice by not ringing a very loud bell that:

- i) the City's fiscal health is not what it appears,
- ii) there are serious problems,
- iii) their solutions will be painful in terms of reduced services and/or increased taxes and fees, and
- iv) a comprehensive multi-year strategic plan to deal with the situation must immediately be developed; difficult decisions must be made now.⁵⁴

Was this letter shared with Mayor Murphy? Mr. Vortmann has declined a request from the City Attorney to be interviewed about this matter. Mr. Gibson, Mayor Murphy's Senior Policy Adviser, who received a copy of the letter, has also refused the City Attorney's request for an interview.

The Mayor was quoted in the *San Diego Union-Tribune* as stating that Mr. Gibson had not shared Mr. Vortmann's 29 April 2002 letter with him:

⁵⁴ 29 April 2002 letter from Richard H. Vortmann to Blue Ribbon Committee members and City officials. (Exhibit 37)

Murphy said yesterday that Gibson never showed him the letter. He said his chief of staff, John Kern, told him Gibson never gave him the letter, either. "He probably should have showed it to me, but I get hundreds of letters, and particularly those that aren't even addressed to me I would not normally see," Murphy said. Knowing Vortmann's concerns in April 2002 might not have changed the way the council voted on the pension system later that year, Murphy said. "By the spring of '02, the city manager was discussing with us this whole underfunding issue and how to deal with it," Murphy said. "One letter, would that have made a difference? I don't know."⁵⁵ [emphasis added]

E. COUNCIL'S KNOWLEDGE OF PENSION FUNDING CRISIS

The City Council is required to adopt an ordinance setting salaries for all City employees each year:

The City Council shall annually adopt an ordinance establishing salaries for all City employees. The City Council shall adopt this ordinance not later than May 30 of each year⁵⁶

The City Council may enter into multiple year agreements with its recognized labor organizations:

⁵⁵ 3 February 2005 San Diego Union-Tribune article (Matt T. Hall) AS.D. panelist's memo warned of fiscal woes.@ (Exhibit 38)

⁵⁶ San Diego City Charter Article III ' 11.1. (Exhibit 39)

Notwithstanding any provisions of this Charter to the contrary, nothing in the Charter shall be construed to preclude the Council from entering into a multiple year memorandum of understanding with any recognized City employee organization concerning wages, hours and other terms and conditions of employment if, in the prudent exercise of legislative discretion as provided in this Charter, the Council determines it is in the best interests of the City to do so; and further provided that said exercise of legislative discretion is expressed affirmatively by a two-thirds vote of the entire Council.⁵⁷

In the spring of 2002 the City Council⁵⁸ began negotiating a multi-year agreement regarding salary and benefits. Within the City these negotiations are referred to as AMeet and Confer.@ The Mayor and Council learned facts about the pension plan funding crisis, the trigger and balloon payments during their closed session briefings and discussions. These briefings and discussions began by 26 February 2002.⁵⁹

The Council eventually embraced a plan to pay increased pension benefits in exchange for a waiver of the 1996 trigger and balloon payment agreement:

⁵⁷ San Diego City Charter Article III ' 11.2. (Exhibit 39)

⁵⁸ At that time the City Council included Mayor Dick Murphy, Council members Scott Peters, Toni Atkins, George Stevens, Byron Wear, Brian Maienschein, Donna Frye, Jim Madaffer, and Ralph Inzunza.

⁵⁹ 21 February 2002 Closed Session Agenda Items for 26 February 2002 AConference with Labor Negotiator, pursuant to Government Code ' 54957.6: Agency negotiators: Michael Uberuaga, Lamont Ewell, Cathy Lexin, Dan Kelley, Stanley Griffith, Mike McGhee; Employee organizations: Municipal Employees Association, Local 127AFSME, AFL-CIO, Local 145 International Association of Firefighters AFL-CIO, San Diego Police Officers Association. (Exhibit 40)

Substantial benefit improvements granted by the City since the adoption of the City Manager's Retirement Proposal dated July 23, 1996 (Manager's Proposal) have created additional un-funded liability to SDCERS that was not anticipated when the City agreed to the trigger provisions.

Significant improvements in benefits are contained in this three-year proposal. Consequently, the trigger provisions must be adjusted as a condition of the City's three-year proposal, therefore, this three year proposal is contingent upon, and subject to, approval by the SDCERS Board of Trustees of an adjustment to the trigger provisions contained in the Manager's Proposal.⁶⁰

On 15 March 2002 City labor negotiator Daniel E. Kelley provided the Council with Closed Session Meet and Confer Material for March 18, 2002.⁶¹ Included with the material was a PowerPoint presentation for the extended 9 a.m. to 12 p.m. meeting on Monday, March 18, 2002. Powerpoint Slide number 51 explained how the pension plan actuary computes the annual valuation.⁶²

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⁶⁰ 24 May 2002 Memorandum to Honorable Mayor & City Council from Daniel E. Kelley, Labor Relations Manager, regarding Final Three Year offer to San Diego Police Officers Association. (Exhibit 41)

⁶¹ 15 March 2002 Memorandum to Mayor and City Council providing Closed Session Meet and Confer Materials for March 18, 2002. (Exhibit 42)

⁶² 15 March 2002 Memorandum to Mayor and City Council providing

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| | Meet & Confer 2002 Retirement System and Meet & Confer |
| | <p>% The System's Actuary performs an annual Avaluation which tests certain Aassumptions@ against actual experience:</p> <ul style="list-style-type: none">% Investment return (earnings)% Employee withdrawals prior to vesting% Mortality rates% Disability rates% Pay increases% Age at retirement% Others |
| | 51 |

Slide 52 disclosed to Council Members that the pension plan's funding ratio had dropped to 89.9% by 2001.⁶³

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| | <p>Meet & Confer 2002 Retirement System and Meet & Confer</p> <p>An annual actuarial valuation measures the funding status of the system (actuarially computed present value of future retirement liabilities)</p> <p>FY96 = 91.4% FY97 = 93.3% FY98 = 93.6% FY99 = 93.2% FY00 = 97.3% FY01 = 89.9%</p> <p style="text-align: right;">52</p> |
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⁶³ 15 March 2002 Memorandum to Mayor and City Council providing Closed Session Meet and Confer Materials for March 18, 2002, Slide 52. (Exhibit 42)

Slide 65 explained how the ARate Stabilization Plan@had worked under Managers Proposal 1. It also set forth the decline in earnings experienced and that created the 2002 funding crisis:⁶⁴

Meet & Confer 2002

Employer Contribution Rate Stabilization Plan

| Period | PUC Rate | Actual Rate | City Paid Rate | Difference % | Difference \$ | Earnings |
|--------|------------|-------------|----------------|--------------|---------------|-------------|
| FY96 | 8.60% | 8.60% | 7.08% | 1.52% | \$5.33m | \$150.4m |
| FY97 | 10.87% | 9.55% | 7.33% | 3.79% | \$13.88m | \$137.4m |
| FY98 | 12.18%*Est | 10.87% | 7.83% | 4.35% | \$16.67m | \$247.4m |
| FY99 | 12.18%*Est | 10.86% | 8.33% | 3.85% | \$15.40m | \$189.1m |
| FY2000 | 12.18%*Est | 11.48% | 8.83% | 3.35% | \$14.00m | \$415.9m |
| FY2001 | 12.18%*Est | 11.96% | 9.33% | 2.85% | \$12.45m | \$168.0m |
| FY2002 | 12.18%*Est | 12.58% | 9.83% | 2.35% | \$10.72m | \$52.0m est |
| FY2003 | 12.18%*Est | 15.59% | 10.33% | 1.85% | \$8.82m | |
| FY2004 | 12.18%*Est | | 10.83% | 1.35% | \$6.73m | |

⁶⁴ 15 March 2002 Memorandum to Mayor and City Council providing Closed Session Meet and Confer Materials for March 18, 2002, Slide 65. (Exhibit 42)

| | | | | | | |
|--------|------------|--|--------|------|----------|----------|
| FY2005 | 12.18%*Est | | 11.33% | .85% | \$4.43m | |
| FY2006 | 12.18%*Est | | 11.83% | .35% | \$1.91m | |
| FY2007 | 12.18%*Est | | 12.18% | -0- | -0- | |
| FY2008 | 13.00%* | | 13.00% | -0- | -0- | |
| Total | | | | | \$110.35 | |
| | | | | | | Slide 65 |

The minutes from the 18 March 2002 Closed Session City Council meeting refer to discussions about and a vote taken on the several meet and confer issues, including a **A**willingness to discuss retirement + trigger.⁶⁵

On 16 April 2002 the City Council again met in Closed Session to discuss meet and confer issues, including those related to the pension funding crisis. PowerPoint slides 16 and 17 made specific reference to the Council conditioning the granting of more pension benefits on a waiver of the **A**trigger.⁶⁶

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| | <p>Meet & Confer 2002 Authorization of Final Economic</p> |
|--|--|

⁶⁵ 18 March 2002 Closed Session Report City of San Diego. (Exhibit 43)

⁶⁶ 16 April 2002 Closed Session Presentation, Slide 16. (Exhibit 44)

| Bargaining Authority (Action) | |
|--------------------------------------|--|
| | Management Team Recommendation: |
| \$ | Authorize removal of MVLF contingency language |
| \$ | Authorize the proposed three year agreement as the City's final economic bargaining position |
| \$ | Condition all retirement enhancements on removal of the <u>Atrigger@</u> in the AManagers Proposal regarding CERS funding ratio* |
| \$ | Retiree health |
| \$ | Increase in Pickups |
| \$ | Increase in General Member Formula |
| | *If CERS funding ratio <u>drops below 82.3%</u> (currently 89.9%) City must pay full actuarial rate, \$25m more annually. |
| | 16 |

Again, Slide 17 repeats the statements about conditioning all retirement enhancements on removal of the Atrigger:@⁶⁷

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| | Meet & Confer 2002 |
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⁶⁷ 16 April 2002 Closed Session Presentation, Slide 17 and copy of Slide 17 with handwritten notes. (Exhibit 45)

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| | <p>Authorization of Final Economic Bargaining Authority (Action)</p> <p>Management Team Recommendation:</p> <ul style="list-style-type: none"> \$ Authorize removal of MVLF contingency language \$ Authorize the proposed three year agreement as the City's final economic bargaining position \$ Condition all retirement enhancements on removal of the <u>trigger</u> in the Managers Proposal regarding CERS funding ratio* <ul style="list-style-type: none"> \$ Retiree health \$ Increase in Pickups <i>until CERS reserve depleted</i> \$ Increase in General Member Formula <p>*If CERS funding ratio drops below 82.3% (currently 89.9%) City must pay full actuarial rate, \$25m more annually.</p> <p style="text-align: right;">17</p> |
|--|---|

A hand written note on a copy of slide 17 states **Approved 6-3 At, Ar, Inz.** The Closed Session Report from the 16 April 2002 meeting shows districts 3, 4 and 8 voting no on the Manager's proposal considered at the Closed Session.⁶⁸

The Mayor and Council met again to discuss meet and confer issues in Closed Session six (6) days after the Council's 16 April 2002 meeting, on 22 April 2002.

Closed Session minutes show several 9 to 0 votes taken on the Manager's proposal.

No writings were located indicating whether the pension trigger and balloon payment

⁶⁸ 12 April 2002 Closed Session memorandum to Mayor and City Council from Cathy Lexin, Human Resource Director, and Elmer Heap Deputy City Attorney regarding the subject of **Closed Session Met and Confer Agenda for April 15, 2002.**

issues were discussed by the Mayor and Council.

The Mayor and Council returned to Closed Session on meet and confer matters on 29 April 2002. The Closed Session agenda for the 29 April 2002 Closed Session meeting includes a subsection under Management Team Recommendations for Bargaining Authority, entitled Funding Ratio and Impact on City's Contribution Rate. PowerPoint slides attached to the 29 April 2002 Closed Session memorandum (Slides 27-31) include references to the funding ratio trigger of 82.3%, waiving the trigger in exchange for new benefit grants, and the status of the under funding ratio.⁶⁹ Slide 27 shows funding ratio information was to be presented to the Council. It also shows the benefits that were to be give in exchange for a waiver of the trigger:

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| | <p style="text-align: center;">Meet & Confer 2002</p> <p>Retirement Issues:</p> |
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⁶⁹ 26 April Closed Session Memorandum on the Subject of Closed Session Meet and Confer Agenda for April 29, 2002. (Exhibit 46)

| | |
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| | Retirement Issues: \$ Funding Ratio Impact on City Contribution (Info) \$ 2.5% at 55 General Member Formula (Action) \$ Increases in Employee Pick-ups (Info) \$ Retiree Health Insurance and Funding (Action) \$ Authority to Pay A13 th @ Check to Retirees (Action) \$ Presidential Leave and Retirement Benefits (Action) 27 |
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Slide 28 of the PowerPoint included with the 26 April 2002 Closed Session Memorandum provides detailed information regarding the funding ratio's effect on the City's pension contribution:

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| | <p style="text-align: center;">Meet & Confer 2002 Funding Ratio Impact on City Contribution 1997 Manager's Proposal</p> <ol style="list-style-type: none"> 1. Increased formulas for all employee groups 2. Created Retiree Health Benefit within CERS 3. Created DROP Program 4. Created Acorridor@ plan for city contribution rates <ol style="list-style-type: none"> 1. annual employer rate increases capped at 0.50% 2. less than actuarially determined rate 3. has created Aunfunded@ liability 4. Included Atrigger@ if funding ratio dropped 10% (to 82.3%), city pays full actuarial rate (FY02 would be 15.59% v. 10.33% - approximately +\$25m) <p style="text-align: right;">28</p> |
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On Slide 29, the effect of the funding on the City's pension contribution is discussed in terms of the current funding ratio. City staff represented to the Council that the funding ratio trigger would require the City only to pay the Afull actuarial rate@ of approximately \$25 million. However, the 1997 Managers Proposal (AMP 1")

required the City Council to maintain the funding ratio at 82.3%. In June 2002 the plan's funding ratio fell to 77.3% - - 5% below the trigger point of 82.3%. In order to return the funding level to 82.3%, the Council was required to make a balloon payment of \$159 million. The City was required to pay 5% of the Actuarially Accrued Liability in order to bring the funding level back up to 82.3%. The Actuarially Accrued Liability in June 2002 was \$3,168,921. Five percent of the Actuarially Accrued Liability (.05 x \$3,168,921) is \$159 million.⁷⁰

Slide 29 of the PowerPoint for the 29 April 2002 Closed Session Meeting of the City Council shows the actuarial funding ratio dropping 8% to 89.9% during fiscal year 2001:

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| | Meet & Confer 2002 |
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⁷⁰ The City's duty to keep the plan at a funding ratio is set forth in the 23 July 1996 memorandum from Cathy Lexin to Larry Grissom re: A City Manager's Retirement Proposal (Exhibit 5); the Actuarially Accrued Liability for 2002 is contained in the San Diego City Employees' Retirement System Annual Actuarial Valuation 30 June 2002 p. 13 (Exhibit 48).

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| | <p>Funding Ratio Impact on City Contribution</p> <p><i>1997 Manager's Proposal</i></p> <p>An annual actuarial valuation measure the funding status of the system (actuarially computed present value of future retirement liabilities)</p> <p>FY96 = 91.4%</p> <p>FY97 = 93.3%</p> <p>FY98 = 93.6%</p> <p>FY99 = 93.2%</p> <p>FY00 = 97.3%</p> <p>FY01 = 89.9%</p> <p>A 82.3% funding ratio triggers full actuarial city rate</p> <p style="text-align: right;">29</p> |
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Slide 30 paints an even more detailed picture of the funding ratio sliding toward the trigger point. This slide includes a specific reference to an estimated drop in plan earnings from \$168 million in fiscal year 2001, which saw a 8% drop in the funding ratio, to \$20 to \$30 million in fiscal year 2002. In fiscal year 2002 the funding ratio would drop 12.6% to 77%.⁷¹ Slide 30 contains a comparison between plan earnings and the plan's funding ratio. It shows that even with the plan earning over \$1.1 billion between fiscal year 1996 and 2000, a negative funding ratio (97.3%) occurred in fiscal

⁷¹ San Diego City Employees Retirement System Annual Actuarial Valuation 30 June 2002 p. 13. (Exhibit 48)

year 2000.⁷²

Slide 30 of the PowerPoint for the 29 April 2002 meeting painted a substantial part of the under funding picture for the Mayor and Council:

| Meet & Confer 2002 | | |
|---|---------------------------------|---------|
| Funding Ratio Impact on City Contribution | | |
| <i>1997 Manager's Proposal</i> | | |
| 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% |
| \$ | ATrigger@ in Manager's Proposal | = 82.3% |

30

⁷² The Pension Reform Committee found in 2003 that only 6% of the under funding problem was due to earnings losses; see, City of San Diego Pension Reform Committee page 11 of 74. (Exhibit 49)

The report for the 29 April 2002 Closed Session Council meeting shows votes were taken on ten meet and confer issues. On nine (9) of the issues the vote was nine in favor none opposed. On the issue of retroactively awarding 2.5% and allowing retirement at age 55, Council District 6 (Ms. Frye) voted in the negative.⁷³

⁷³ Closed Session Report for the 29 April 2002 San Diego City Council Closed Session. (Exhibit 50)

Another slide (31) included in the 29 April 2002 Closes session materials provided that the Management team has and will: 1. Include contingencies that address the trigger-concern in all retirement enhancements that create additional unfunded liability.⁷⁴

Slides 27, 32, 36, 38, 43, and 46 of the PowerPoint included with the 29 April 2002 Closed Session of the City Council and Mayor make specific reference to Presidential Leave and Retirement Benefits as one of the retirement issues for which council action is required.⁷⁵ The Presidential Leave and Retirement Benefits refers to a proposal approved by the City Council in 2002 that gave certain special benefits to the Presidents of the Firefighters Union and the Municipal Employees Association (AMEA).⁷⁶

⁷⁴ 26 April Closed Session Memorandum on the Subject of Closed Session Meet and Confer Agenda for April 29, 2002. (Exhibit 46)

⁷⁵ 26 April Closed Session Memorandum on the Subject of Closed Session Meet and Confer Agenda for April 29, 2002. (Exhibit 46)

⁷⁶ The Police Officers Association President was not included in the final meet and confer agreement which, as to the Police Officers Association, went to

Aimpasse@ in 2002.

Slide 35 from the 29 April 2002 Closed Session describes the City Manager's Retirement Formula Improvement.⁷⁷ It calls for an increase in a general retirement benefit enhancement of 2.5% @ 55, with contingencies that Unions support and CERS Board of Administration agrees to. It also called for absorption of Past Liability of the 2.50% at 55 benefit into CERS assets as an unfunded liability. This last funding change was predicted to reduce funding ratio 1% to 1.5%.⁷⁸

Slide 35 from the 29 April 2002 Closed Session meeting of the City Council reads:

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| | <p>Meet & Confer 2002 Funding the General Member Retirement Formula Improvement</p> <p>Modifications to Previous Authority: Approve General Member retirement benefit enhancement of 2.5% @ 55, with contingencies that Unions support and CERS Board of Administration agrees to:</p> <ul style="list-style-type: none">A. Eliminate or <i>Reduce</i> the Trigger established in the 1997 Manager's Proposal to 75%B. If funding ratio Triggers an increase in City's contribution rate, <i>phase in over 5 year period</i>C. Absorb Past Liability of the 2.50% at 55 benefit into CERS assets as an unfunded |
|--|--|

⁷⁷ 26 April Closed Session Memorandum on the Subject of "Closed Session Meet and Confer Agenda for April 29, 2002" (Slide 35). (Exhibit 51)

⁷⁸ 26 April Closed Session Memorandum on the Subject of "Closed Session Meet and Confer Agenda for April 29, 2002" (Slide 35). (Exhibit 51)

| | | |
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| | liability (this will reduce funding ratio 1% to 1.5%) | 35 |
|--|--|----|

For fourteen (14) years Judie Italiano, president of the Municipal Employees Association, has been making contributions to the retirement system based upon her MEA salary.⁷⁹ Her payments to and participation in the City employee pension plan have been found to be unlawful under federal tax laws.⁸⁰ MEA, Ms. Italiano's union employer, is not a San Diego City Employees' Retirement System employer. Therefore, the pension plan should not have accepted the MEA as a plan participant. This decision threatens the tax-exempt status of the San Diego City Employees' Retirement System.⁸¹

A 13 June 2002 memo from Cathy Lexin, San Diego City Human Resources Director, to the Mayor and City Council brought essential facts of this problem to their attention:

While the City maintained its position that it never condoned this arrangement, it was clearly acquiesced to by the City Retirement

⁷⁹ 13 June 2002 memorandum from San Diego City Human Resources Director Cathy Lexin to the Mayor and City Council. (Exhibit 53)

⁸⁰ 29 October 2004 memorandum from SDCERS Administrator Lawrence Grissom to San Diego City Manager Lamont Ewell. (Exhibit 54)

⁸¹ 29 October 2004 memorandum from SDCERS Administrator Lawrence Grissom to San Diego City Manager Lamont Ewell. (Exhibit 54)

Office.⁸²

Rather than putting a stop to the illegal practice of accepting payments from non-plan participants during the 2002 meet and confer process, the Council was asked to extend the scheme to Ron Saathoff, president of the Firefighters Union:

As you may recall, two of the four Union Presidents, Bill Farrar of POA and Judie Italiano of MEA, have been on leave without pay for two and fourteen years respectively. Both Mr. Farrar and Ms. Italiano have been making contributions to the retirement system based on the salary their respective Unions have been paying them. While the City maintained its position that it never condoned this arrangement, it was clearly acquiesced to by the City Retirement Office.

⁸² 13 June 2002 memorandum from San Diego City Human Resources Director Cathy Lexin to the Mayor and City Council. (Exhibit 53)

Ron Saathoff, President of Local 145, had requested a similar arrangement approximately one year ago and that matter became a part of these negotiations as well. As a condition of reaching agreement on successor MOU-s, the Council approved the Management Team-s recommendation to allow the Union-paid salary (not to exceed the salary of the Labor Relations Manager as a cap) as the basis for retirement benefit calculations.⁸³

⁸³ 13 June 2002 memorandum from San Diego City Human Resources Director Cathy Lexin to the Mayor and City Council. (Exhibit 53)

Slides 47-52 from the 29 April 2002 Closed Session of the San Diego City Council described the **APresidential Benefit** in precise and exact detail. It set forth the employment status and source of wages for each of the union presidents of the Police Officers Association, Firefighters Union Local 145, and the Municipal Employees Association President.⁸⁴ the POA and MEA presidents were each identified as a **AFull-time Union President** who had **AUnpaid Leave from the City**.⁸⁵

| Meet & Confer 2002 | | |
|--|----------------|--|
| Union Presidential Leave & Retirement Benefits | | |
| Current Status of Union Presidents | | |
| Union President | | Status |
| POA | Bill Farrar | Full-time Union president Unpaid Leave from City |
| Local 145 | Ron Saathoff | Full-time employee. Release time for Union activities |
| MEA | Judie Italiano | Full-time Union president Unpaid Leave from City |
| Local 127 | Tony Padilla | Full-time employee. Release time for Union activities |
| | | 47 |

Slide 48 from the 29 April 2002 Closed Session meeting of the City Council went on to describe the retirement benefit that was approved by the City Council for

⁸⁴ 26 April Closed Session Memorandum on the Subject of **AClosed Session Meet and Confer Agenda for April 29, 2002**" (Slides 47-52). (Exhibit 55)

⁸⁵ 26 April Closed Session Memorandum on the Subject of **AClosed Session Meet and Confer Agenda for April 29, 2002**" (Slide 47). (Exhibit 55)

Ms. Italiano during the 2002 Meet and Confer. As stated above, the City was unable to reach agreement with the Police Officers Association during the 2002 Meet and Confer:

| Meet & Confer 2002 | | | |
|----------------------------------|---|--|-----------|
| Union/President | Employment Status | Retirement Issue | |
| MEA Judie Italiano | - Leave of Absence 14 years - Payroll Specialist - Full-time MEA President & General Manager | - Purchase past service - Contributes to Retirement on Union Salary (\$102,128) - Retirement formula= high one year on union salary* | |
| POA Bill Farrar | - Leave of Absence 2 years - Police Officer II - Full time POA salary (\$82,300) President | - All Service Paid - Contributions to Retirement on union - Retirement formula= High one year on Union salary* | |
| *Approximate un-funded liability | | Judie Italiano | \$145,000 |
| | | Bill Farrar | \$56,000 |
| | | | 48 |

Slide 49 from the 29 April 2002 PowerPoint presentation to the City Council set forth the Management Team's recommendation for MEA and POA union presidents.⁸⁶

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⁸⁶ 26 April Closed Session Memorandum on the Subject of "Closed Session Meet and Confer Agenda for April 29, 2002" (Slide 49). (Exhibit 55)

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| | <p>Meet & Confer 2002 Union Presidential Leave & Retirement Benefits Issue 1 - Current Union Presidents</p> <p>Management Team Recommendation: \$ Authorize inclusion of union salary in high one-year calculation; establish a maximum retirement high one-year salary at level equal to City Labor Relations Manager (approx. \$108k)</p> <p style="text-align: right;">49</p> |
|--|---|

The next slide, Slide 50, from the 29 April 2002 Closed Session Meeting of the City Council, described the retirement and employment benefits that were to be provided to AProspective Union Presidents:@

| | |
|--|--|
| | <p>Meet & Confer 2002 Union Presidential Leave & Retirement Benefits Issue 2: Prospective Union Presidents</p> <p>Management Team Recommendation: \$ City to allow each union to have a full-time City-paid union President \$ Union President/employee to be paid for normal work period at current level and receive current benefits with <u>no</u> overtime \$ Union President to be entitle to retirement benefits consistent with his/her classification and level of compensation \$ Union may compensate the union president for services to the union outside the normal work period. Such compensation shall not affect or be a part of City compensation, nor affect or add to retirement benefits</p> |
|--|--|

| | |
|--|---|
| | <p>\$ Subject to final review and clearance by City Attorney</p> <p>Estimated Cost: \$170,000 annually for two active presidents</p> <p style="text-align: right;">50</p> |
|--|---|

The President of Firefighters Local 145 was provided for separately in the PowerPoint presentation for the 29 April 2002 Closed Session. First, in PowerPoint Slide 51, Ron Saathoff, president of Firefighters Local 145, was identified as a Full-time City employee.⁸⁷ In another column of Slide 51, the Retirement Issue was described as Use City salary and union salary for high one year calculation (approx. \$80k + 40K = \$120k).⁸⁸ In the 29 April 2002 PowerPoint presentation, the Management Team Recommendation was to not authorize inclusion of union salary in high one-year calculation for Firefighter president Saathoff.⁸⁹ However, an

⁸⁷ 26 April Closed Session Memorandum on the Subject of "Closed Session Meet and Confer Agenda for April 29, 2002" (Slide 51). (Exhibit 55)

⁸⁸ 26 April Closed Session Memorandum on the Subject of "Closed Session Meet and Confer Agenda for April 29, 2002" (Slide 51). (Exhibit 55)

⁸⁹ 26 April Closed Session Memorandum on the Subject of "Closed Session

alternative also contained in the Management Team Recommendation was to A Treat current President under Issue 1, combine City salary and Union salary; cap retirement high one-year salary at level equal to City Labor Relations Manager (approx. \$108k).⁹⁰

Meet and Confer Agenda for April 29, 2002" (Slide 52). (Exhibit 55)

⁹⁰ 26 April Closed Session Memorandum on the Subject of A Closed Session Meet and Confer Agenda for April 29, 2002" (Slide 52). (Exhibit 55)

Slide 51, identified as "Issue 3," the Requested Presidential Leave for Local

145 :

| Meet & Confer 2002 | | |
|--|--|---|
| Union Presidential Leave & Retirement Benefits | | |
| Issue 3 - Requested Presidential Leave for Local 145 | | |
| Union/President Local 145 Ron Saathoff | Employment Status - Full-time City - Use City salary and employee - Fire captain | Retirement Issue union salary for high one year calculation (approx. \$80k + \$40k = \$120k) - No retirement contribution made on union salary* |
| * Approximate Unfunded Liability | \$100,000 | |
| | | 51 |

Slide 52 set out the Manager's recommendation that Firefighter President Saathoff should not be permitted to include his salary in the calculation of his City retirement benefit:

| Meet & Confer 2002 | |
|--|--|
| Union Presidential Leave & Retirement Benefits | |
| Issue 3 - Requested Presidential Leave for Local 145 | |
| Management Team Recommendation: \$ Treat current President under Issue 2; do not authorize inclusion on union salary in high one-year calculation. | |
| Alternative: Treat current President under Issue 1, combine City salary and Union salary; cap retirement high one-year salary at level equal to City Labor Relations Manager (approx. \$108k) | |

Although at the 29 April 2002 closed door session the Management Team appears to have recommended against allowing Firefighter Union president Ron Saathoff to include his union income in his City retirement benefit, the Manager changed his position and eventually recommended in favor of Mr. Saathoff. The revised position of the Management Team is described in the 13 June 2002 memorandum from Human Resources Director Cathy Lexin to the Mayor and City Council: The Council approved the Management Team's recommendation to allow the Union-paid salary (not to exceed the salary of the Labor Relations Manager as a cap) as the basis for retirement benefit calculations.⁹¹

⁹¹ 13 June 2002 memorandum from San Diego City Human Resources Director Cathy Lexin to the Mayor and City Council. (Exhibit 53)

It appears that at the 29 April 2002 Closed Session meeting the Council unanimously approved the proposed retirement benefit that would allow the POA President to include his Union salary in City retirement calculation.⁹² Minutes of the 30 April 2002 Closed Session meeting of the City Council shows that the presidential leave proposal was approved for the MEA and POA presidents on a nine in favor, zero opposed vote: Presidential leave MEA & POA only Mgr. Recommendation-base retirement on high 1 year union salary. 9-0-0. The same minutes show that the presidential retirement issue for Firefighter president Ron Saathoff was trailed one week: Trail 1 wk.⁹³

The next Closed Session Council meeting to consider the retirement issues and the presidential leave retirement calculations was on 6 May 2002.⁹⁴ Slide 4 from the PowerPoint Closed Session presentation on 6 May 2002 reiterated the City Council's position that all retirement enhancements were conditioned on removal of the trigger in Manager's Proposal regarding CERS funding ratio.

| | |
|--|------------------------|
| | Status of Negotiations |
|--|------------------------|

⁹² 29 April 2002 Closed Session Report which reflects a 9-0 vote on the POA Safety Requirement Status. (Exhibit 50)

⁹³ Minutes of 30 April 2002 Closed Session City Council Meet and Confer meeting. (Exhibit 56)

⁹⁴ Minutes of 6 May 2002 Closed Session City Council Meet and Confer meetings. (Exhibit 57)

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

The PowerPoint presentation included slides repeating the Current Status of Union Presidents employment and retirement benefits. Those slides (36-38) showed that MEA president Judie Italiano had been on a Leave of Absence 14 years. It also repeated the Management Team's recommendation: Authorize inclusion of union salary in high on[e] year calculation; establish a maximum retirement high one-year salary at level equal to City Labor Relations Manager (approximately \$108,000 currently).⁹⁵

The 6 May 2002 Closed Session PowerPoint contained new terms of a proposal for the Firefighter Union President Ron Saathoff. The Management Team's recommendation was to allow the current Local 145 President to begin Presidential

⁹⁵ 6 May 2002 PowerPoint presentation for Closed Session City Council meeting regarding Meet and Confer issues (Slides 36-38). (Exhibit 57)

Leave under the terms described in Issue 2 effective July 1, 2002.⁹⁶ The Management Team also recommended that Mr. Saathoff be allowed contributions on union salary in addition to the City's contribution on Captain's salary, to a max of \$108,000 for the one year period prior to July 1, 2002 to establish a high one year.⁹⁶

| | |
|--|--|
| | <p>Meet & Confer 2002 Union Presidential Leave & Retirement Benefits Issue 2: current Local 145 President</p> <p>Management Team Recommendation:</p> <ol style="list-style-type: none">1. Allow the current Local 145 President to begin a paid Presidential Leave under the terms described in Issue 2 effective July 1, 20022. Allow contributions on union salary in addition to the city's contributions on Captain's salary, to a max of \$108,000 for the one year period prior to July 1, 2002 to establish a high one year <p style="text-align: right;">39</p> |
|--|--|

⁹⁶ 6 May 2002 PowerPoint presentation for Closed Session City Council meeting regarding Meet and Confer issues (Slide 39). (Exhibit 57)

The Management Team made additional generous recommendations for prospective union presidents, which were described in Slide 40 of the 6 May 2002 PowerPoint presentation at the City Council's Closed Session Meet and Confer meeting.⁹⁷

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| | <p>Meet & Confer 2002 Union Presidential Leave & Retirement Benefits Issue 3: Prospective Union Presidents</p> <p>Management Team Recommendations:</p> <ol style="list-style-type: none">1. Authorize full-time City-paid union Presidential Leave for each of the 4 unions beginning July 1, 20022. Union President/employee to be paid for normal work period at the salary of their current class when become President; receive regular benefits for the class; with <u>no</u> overtime3. Retirement benefits consistent with his/her classification and level of compensation4. Union may compensate the union president for |
|--|--|

⁹⁷ 6 May 2002 PowerPoint presentation for Closed Session City Council meeting regarding Meet and Confer issues (Slide 40). (Exhibit 57)

| | |
|--|---|
| | <p>services to the union outside the normal work period. Such compensation shall not affect or be a party of City compensation, nor affect or add to retirement benefits</p> <p style="text-align: right;">40</p> |
|--|---|

Minutes from the 6 May 2002 Closed Session City Council Meet and Confer meeting shows that the APresidential Leave Mgr=s recommendation 9-0.@⁹⁸ A 24 May 2002 memorandum from City Labor Relations Manager Daniel E. Kelley addressed to the Mayor and City Council included Athe City=s final three-year offer to the San Diego Police Officers Association@ which explained in blunt terms that the Council was conditioning the granting of new retirement benefits on the pension board waiving the fiduciary protections for plan participants:

Substantial benefit improvements granted by the City since the adoption of the XCity Manager=s Retirement Proposal= dated July 23, 1996 (Manager=s Proposal) have created additional un-funded liability to SDCERS that was not anticipated when the City agreed to the Xtrigger= provisions.

Significant improvements in benefits are contained in this three-year proposal. Consequently, the Xtrigger= provisions must be adjusted as a condition of the City=s three-year proposal, therefore, this three year proposal is contingent upon, and subject to, approval by the SDCERS Board of Trustees of an adjustment to the Xtrigger= provisions contained in the Manager=s Proposal

⁹⁸ 6 May 2002 Closed Session Meeting Minutes. (Exhibit 57)

In an endeavor to meet converging interests and time lines, the City agreed to benefit enhancements through labor negotiations which have impacts on retirement funding, and consequently these benefit enhancements were offered contingent upon successfully addressing the potential ~~trigger~~ in the 1997 Manager's Proposal.⁹⁹

By June 2002 the center of gravity for the pension funding crisis had shifted back to the pension board. The City Council's proposal to wipe out the trigger and balloon payment protection for plan beneficiaries ran into difficulties at the pension board because the board's outside counsel balked at passing on the proposed arrangement.

These developments were described in a 14 June 2002 memorandum from City Human Resources Director Cathy Lexin to the Mayor and Council:

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 (1) committing \$25 million from FY2000 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.

⁹⁹ 24 May 2002 Memorandum from Daniel E. Kelley, Labor Relations Manager for the City of San Diego to the San Diego City Mayor and Council. (Exhibit 58)

We expect that the SDCERS Board will approve the first two items. The third item regarding the City's contribution rates and funding status of the system is the most complex of the issues and is currently under critical review by the SDCERS Board's outside fiduciary counsel and outside actuary.¹⁰⁰

¹⁰⁰ 14 June 2002 Memorandum from San Diego City Human Resources Director Cathy Lexin to the San Diego Mayor and City Council p. 1. (Exhibit 2)

Ms. Lexin went on in her 14 June 2002 memorandum to remind the Mayor and Council that the City Manager had presented the City Council's plan to do away with the 82.3% trigger and balloon payment at a conceptual presentation before the SDCERS Board at a special meeting held on 29 May 2002.¹⁰¹ Ms. Lexin informed the Council that the SDCERS outside counsel was "uncomfortable" expressing an opinion that approval of the City's proposal was "within the Board's reasonable discretion as fiduciaries of the system."¹⁰²

The current "rate stabilization plan" stipulates that the City's contribution rates, beginning FY 97 would increase a fixed 0.50% per year, which is less than the actuarially determined rate necessary to ensure stable funding of the system. The basis for prior fiduciary counsel condoning the original agreement to accept less than full actuarial contributions from the City, was the establishment of a reasonable funding ratio floor (82.3%), and the expectation of progress toward full funding pursuant to this plan. Currently fiduciary counsel is concerned that the City is requesting a further reduction to the funding ratio floor (from 82.3% to 75%) with no balancing aspect to the proposal, no quid pro quo.¹⁰³

Ms. Lexin goes on to further remind the Mayor and Council of the precipitous drop in the retirement plan's funding ratio. She also explains to the Mayor and Council that the funding arrangements in the 1997 Manager's proposal proved to be an

¹⁰¹ 14 June 2002 Memorandum from San Diego City Human Resources Director Cathy Lexin to the San Diego Mayor and City Council p. 1. (Exhibit 2)

¹⁰² 14 June 2002 Memorandum from San Diego City Human Resources Director Cathy Lexin to the San Diego Mayor and City Council p. 2. (Exhibit 2)

¹⁰³ 14 June 2002 Memorandum from San Diego City Human Resources

inadequate safeguard of the plan's funding ratio:

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. A thorough analysis needs to occur and a funding policy developed that is acceptable to the SDCERS Board as Trustees and the City as Plan Sponsor.¹⁰⁴

Ms. Lexin then delivered the bad news: The SDCERS outside fiduciary counsel was not going to approve the Mayor's and Council's proposal to lower the trigger and eliminate the balloon payment:

Director Cathy Lexin to the San Diego Mayor and City Council p. 2. (Exhibit 2)

¹⁰⁴ 14 June 2002 Memorandum from San Diego City Human Resources Director Cathy Lexin to the San Diego Mayor and City Council p. 2. (Exhibit 2)

We had hoped the SDCERS Board would accept our proposal 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. It does not appear that the fiduciary counsel will support this request.¹⁰⁵

Ms. Lexin suggested that the Mayor and Council sweeten the deal by increasing the annual increase in City contribution from 0.50% per year to 1.00% per year beginning in FY05 (an approximate \$2.5 million increase).¹⁰⁶ Ms. Lexin supported her suggestion by citing City Auditor, who supported the new 1.00%-a-year proposal as Aa means to avoid the potential triggering of the fully actuarial rate in FY04 (a \$25 [M] impact).¹⁰⁷

Ms. Lexin urged the Mayor and Council to back the 1.00% per year increased funding proposal in order to avoid having to make the balloon payment:

¹⁰⁵ 14 June 2002 Memorandum from San Diego City Human Resources Director Cathy Lexin to the San Diego Mayor and City Council p. 2. (Exhibit 2)

¹⁰⁶ 14 June 2002 Memorandum from San Diego City Human Resources Director Cathy Lexin to the San Diego Mayor and City Council p. 2. (Exhibit 2)

¹⁰⁷ 14 June 2002 Memorandum from San Diego City Human Resources Director Cathy Lexin to the San Diego Mayor and City Council p. 2. (Exhibit 2)

IF we do not make this offer, it is likely that the SDCERS Board will not approve the proposal based upon a negative report from their fiduciary counsel. It is also a possibility that the funding ratio calculated for year ending FY02 will fall below 82.3% and trigger the full actuarial rate in FY04.¹⁰⁸

In no uncertain terms Ms. Lexin informed the Mayor and Council that the Meet and Confer benefits were a quid pro quo for a waiver of the trigger and balloon payment:

If either the original or this proposal fails, the retirement benefit improvements in the labor agreements with MEA, Local 127 and Local 145 will not occur. MEA has indicated that they will not schedule their ratification vote until this matter is heard by the SDCERS Board, and they anticipate that without the 2.5% at age formula improvements in FY03, the 3-year MOU may fail a ratification vote, in which case we would be bargaining again with the MEA next spring.¹⁰⁹

One member of the SDCERS Board, Richard Vortmann, expressed objections over being put in the middle of labor negotiations:

Given everyone's (on the Board, Counsel, Actuary) feeling the Board

¹⁰⁸ 14 June 2002 Memorandum from San Diego City Human Resources Director Cathy Lexin to the San Diego Mayor and City Council p. 2. (Exhibit 2)

¹⁰⁹ 14 June 2002 Memorandum from San Diego City Human Resources Director Cathy Lexin to the San Diego Mayor and City Council p. 2. (Exhibit 2)

should not be put in the middle of labor negotiations, particularly when we now become the "go-no go,"¹¹⁰

¹¹⁰ 24 June 2002 Letter from Richard Vortmann to SDCERS Board Members and Administrators. (Exhibit 59)

Mr. Vortmann also asked for a clear statement from the City officials about why they feel it is necessary to violate their previous 96 agreement.¹¹¹ Mr. Vortmann next asked the obvious question: **What** is so compelling to violate the 96 safeguard? Is not that why the safeguard was part of the 96 deal?¹¹² Mr. Vortmann then put his finger on the issue that the Mayor and Council were unwilling to face:

The problem is very simply that the City does not want to pay currently for what they want to give the employees. They clearly are addicted to the give now, pay later or burden the future years's taxpayers when they no longer have any say in the decision - i.e. the decision being locked down now, with the mandatory bill being paid later.

Since the City is in essence asking the Board to be an enable to the City in their addition, the Board at least deserves to hear everybody enunciate the truth **B** not a bunch of smoke about tough economic times, the State is screwing us, etc.¹¹³

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¹¹¹ 24 June 2002 Letter from Richard Vortmann to SDCERS Board Members and Administrators. (Exhibit 59)

¹¹² 24 June 2002 Letter from Richard Vortmann to SDCERS Board Members and Administrators. (Exhibit 59)

¹¹³ 24 June 2002 Letter from Richard Vortmann to SDCERS Board Members and Administrators. (Exhibit 59)

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F. CITY COUNCIL SWEETENS THE DEAL

On 3 July 2002, San Diego Deputy City Manager Bruce Herring sent a memorandum to SDCERS administrator Lawrence Grissom which extended a modified version of the proposal described in Ms. Lexin's 14 June 2002 memorandum to the Mayor and Council.

Mr. Herring described the proposal to Mr. Grissom in a 3 July 2002 memorandum:

This proposed modification would increase the City's agreed to rate by 1.00% beginning in FY05, projecting to reach the PUC actuarial rate by FY09, then continuing with 0.50% annual increases, but no less than the PUC rate, until the EAN rate is achieved.

It is also proposed that the funded ratio floor be amended to 75% from 82.3%, and if the floor is effectuated, the City would begin paying at a rate that would achieve full PUC actuarial rate within five years, but no later than FY09. Once at PUC, the City would continue with 0.50% increases until EAN rate is achieved.

As indicated in our June 10 and June 18 reports, the cost of any new benefits which may be considered by the City in the future, would not be absorbed, but paid for in addition to the agreed to City rates.¹¹⁴

¹¹⁴ 3 July 2002 Memorandum from Bruce Herring to Lawrence Grissom re: City's Proposal Regarding Contribution Rates and Reserves and Responses to Questions from SDCERS Trustees. (Exhibit 60)

On 8 July 2002 San Diego City Human Resource Director Cathy Lexin issued a memorandum to the Mayor and City Council with the latest information from the SDCERS Board about the Mayor's and Council's proposal to avoid the trigger and balloon payments. Ms. Lexin informed the Mayor and City Council that the SDCERS Board would likely require a further modification of the City's proposal. This modification eliminated the request to lower the funded ratio floor, it included a five year phase-in if the trigger (82.3% funded ratio) is effectuated.¹¹⁵ Ms. Lexin urged the Council to approve the modification again with an eye toward avoiding the trigger and balloon payment put into place to protect plan beneficiaries:

Given the importance of avoiding a immediate full rate implementation (versus five year phase in), it is recommended that the Council authorize staff to agree to this modification should the proposal currently before SDCERS not prevail.¹¹⁶

¹¹⁵ 8 July 2002 Memorandum from Cathy Lexin to the Mayor and City Council re: Meet and Confer: Contingent Retirement Benefits and Proposal to SDCERS, p. 2. (Exhibit 61)

¹¹⁶ 8 July 2002 Memorandum from Cathy Lexin to the Mayor and City Council re: Meet and Confer: Contingent Retirement Benefits and Proposal to SDCERS, p. 2. (Exhibit 61)

Ms. Lexin informed the Council of the need to act because the SDCERS Board had scheduled a special meeting for Thursday, 11 July 2002, to consider the Mayor and Council proposal.¹¹⁷ The minutes for the City Council's Closed Session on 9 July 2002, held the day after Ms. Lexin's memorandum to the Mayor and Council, indicate that the Council approved additional modifications to their proposal to avoid the trigger and balloon payment. The minutes read:

Authorize[d] 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.@

This change was approved by a vote of nine (9) in favor, none opposed.¹¹⁸

On 11 July 2002 the SDCERS Board approved the modified version described in Ms. Lexin's 8 July 2002 memorandum to the Council. The motion passed 9-2 with one abstention. Mr. Vortmann and Ms. Shipione had departed the meeting prior to

¹¹⁷ 8 July 2002 Memorandum from Cathy Lexin to the Mayor and City Council re:@Meet and Confer: Contingent Retirement Benefits and Proposal to SDCERS.@ (Exhibit 61)

¹¹⁸ 9 July 2002 Closed Session Meeting Minutes for the San Diego City Council. (Exhibit 62)

the vote.¹¹⁹

On 18 November 2002 the City Council approved the modification passed by SDCERS:

¹¹⁹ 11 July 2002 Minutes SDCERS Board Meeting. (Exhibit 63)

On July 11, 2002, the Board approved modifications to the Managers Proposal. This Agreement is entered into in order to provide a transition period for City contributions to be brought, by Fiscal Year 2009, to the full contribution rates that would be applied if the projected unit credit funding method were used to provide accelerated contributions by the City if SDCERS funding ratio goes below 82.3% before the end of the term of this Agreement, and to terminate all transition arrangements regarding contributions with the City at the end of the Fiscal Year 2009.¹²⁰

The Presidential Benefit was approved by the Council and Mayor on 21 October 2001 as Item-53.¹²¹ The other benefits and increases in wages were

¹²⁰ Minutes of the Council of the City of San Diego for the Regular Meeting of Monday, November 18 p.39-40 (ITEM-133: Two actions related to Approval of Agreements on SDCERS Board Indemnification & City SDCERS Employer Contributions.@) (Exhibit 64)

¹²¹ Minutes of the Council of the City of San Diego for the Regular Meeting of Monday, October 21, 2002 p.9 (ITEM-53: Approval of Ordinance amending the San Diego Municipal Code related to FY 2003 Negotiated Retirement Benefit Enhancements. (Exhibit 65)

approved by the Council on 18 November 2002.¹²² The Mayor and Council granted substantial benefit increases including general salary increases and an 11% per year increase in pensions for general members, and special retirement benefits for the incumbent presidents of the MEA, POA, and Firefighters= unions.

¹²² Minutes of the Council of the City of San Diego for the Regular Meeting of Monday, November 18 p.8-10 (ITEMS-50 and 51: Approval of Ordinances amending the San Diego Municipal Code related to FY 2003 Negotiated Retirement Benefit Enhancements.) (Exhibit 66)

On 21 October 2002, the Council unanimously approved the introduction of the ordinance containing the retirement benefit increases negotiated in the 2002 meet and confer process.¹²³ The Presidential Benefit was passed by Council Resolution Number 297212 that same day. When the ordinance received its second reading on 18 November 2002, it was approved by an 8-1 vote, with Councilmember Frye voting against it.¹²⁴ The Presidential Benefit was passed by Council Resolution Number 297212 that same day. When the ordinance received its second reading on 18 November 2002, it was approved by an 8-1 vote, with Councilmember Frye voting against it.

III.

FAILURE TO COMPLY WITH REQUIRED FEDERAL SECURITIES LAW

A. THE DUTY TO DISCLOSE MATERIAL FACTS

Securities & Exchange Rule 10(b)5 prohibits the making of material false statements and the omission of facts needed to make statements not misleading:

Rule 10b-5 -- Employment of Manipulative and Deceptive Devices

It shall be unlawful for any person, directly or indirectly, by the use of

¹²³ Ordinance No. 19121.

¹²⁴ Minutes of 18 November 2002 Council Meeting. (Exhibits 64, 66)

any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

- a. To employ any device, scheme, or artifice to defraud,
- b. To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
- c. To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.¹²⁵ [emphasis added]

The Securities & Exchange Commission has brought enforcement cases against public officials and public bodies relying upon Rule 10(b)5 and other antifraud provisions of federal securities law. Enforcement actions have been brought against officials in Miami, Florida (*In the Matter of the City of Miami, Florida, Cesar Odio and Manohar Surana*, Securities Act Release No. 7741, Exchange Act Release No. 41896, A.P. File No. 3-10022).

The City's outside counsel, as early as November 2003, spotted the SEC enforcement case against Miami as having at least some application to San Diego. On 26 November 2003 Paul Maco, the City's outside legal counsel, informed auditor Terri Webster that an SEC enforcement action against the City of Miami found that disclosures like those included in the City of San Diego's financial statement footnotes

¹²⁵ 13 FR 8183, Dec. 22, 1948, as amended at 16 FR 7928, Aug. 11, 1951. (Exhibit 67)

could be the basis of a fraud violation:

Miami case **B** related to CAFR footnote misleading disclosure **B** found footnote to be fraudulent. In ruling we get the message:

* Even though something is immaterial per GAAP it can still be in violation of anti-fraud law.

Paul M. can see how Paul W. could find these error material due to (1) quantity (2) the big error on leases (3) lack of solid processes on City & CJO that didn't catch this stuff **B** loose [sic] credibility¹²⁶

¹²⁶ Handwritten notes by Terri Webster dated 11/26/03. (Exhibit 68)

Another critical case involved Orange County. *In re County of Orange, California; Orange County Flood Control District and County of Orange, California Board of Supervisors*, Securities Act Release No. 7260, Exchange Act Release No. 36760, A.P. File No. 3-8937 (January 24, 1996), *Report of Investigation in the Matter of County 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); *SEC v. Robert L. Citron and Matthew R. Raabe*, Civ. Action No. SACV 96-74 GLT (C.D. Cal.), Litigation Release No. 14792 (January 24, 1996) (complaint), *SEC v. Robert L. Citron and Matthew R. Raabe*, Litigation Release No. 14913 (May 17, 1996) (settled final orders). As detailed below, the application of the SEC enforcement action against Orange County officials was brought to the attention of San Diego City officials. City of San Diego officials, the Mayor and Council were told they could not authorize disclosure that the official knows to be false nor could they authorize disclosure while recklessly disregarding facts.¹²⁷ [emphasis added]

Other relevant cases brought by the SEC against public entities and officials include the Boston cases (*In the Matter of the Massachusetts Turnpike Authority and James J. Kerasiotes*, Securities Act Release No. 8260, A.P. File No. 3-11198 (July 31, 2003); *SEC v. Robert D. Gersh, Boston Municipal Securities, Inc., and*

¹²⁷ 6 November 2001 Closed Session Minutes. (Exhibit 69)

Devonshire Escrow and Transfer Corp., Civ. Action No. 95-12580 (RCL) (D. Mass.), Litigation Release No. 14742 (November 30, 1995) (complaint); *SEC v. Robert D. Gersh, Boston Municipal Securities, Inc., and Devonshire Escrow and Transfer Corp.*, Litigation Release No. 15310 (March 31, 1997) (settled final order); the Pennsylvania case (Injunctive proceedings *SEC v. David W. McConnell*, Civ. Action No. 00CV-2261 (E.D. Penn.), Litigation Release No. 16534, AAE Release No. 1254 (May 2, 2000); the San Antonio case, *SEC v. San Antonio Municipal Utility District No. 1, et al.*, Civ. Action No. H-77-1868 (S.D. Tex.), Litigation Release No. 8195 (November 18, 1977) (settled final order); the State of Washington cases, *SEC v. Whatcom County Water District No. 13, et al.*, Civ. Action No. C77-103, (W.D. Wash.), Litigation Release No. 7810 (March 7, 1977) (complaint); *SEC v. Whatcom County Water District No. 13, et al.*, **Litigation Release No. 7592 (May 10, 1977) (settled final order)**; *SEC v. Washington County Utility District, et al.*, Civ. Action No. 2-77-15 (E.D. Tenn.), Litigation Release No. 7782 (February 15, 1977) (complaint), *SEC v. Washington County Utility District, et al.*, Litigation Release No. 7868 (April 14, 1977) (default entered).

Additional cases have been brought by the SEC: *SEC v. Reclamation District No. 2090, et al.*, Civ. Action No. 76-1231-SAW (N.D. Cal.), Litigation Release No. 7460 (June 22, 1976) (complaint); *SEC v. Reclamation District No. 2090, et al.*, Litigation Release No. 7551 (September 8, 1976) (settled final order); *In re Newport-*

Mesa Unified School District, Securities Act Release No. 7589, A. P. File No. 3-9738 (September 29, 1998); *In re City of Moorhead, Mississippi*, Securities Act Release No. 7585, Exchange Act Release No. 40478, A.P. File No. 3-9724 (September 24, 1998); Securities Act Release No. 7616, Exchange Act Release No. 40770, A.P. File No. 3-9724 (December 10, 1998); *In re City of Carthage, MS., et al.*, Securities Act Release No. 40194, A. P. File No. 3-9650 (July 13, 1998) (administrative cease and desist proceedings against 38 municipalities and settled administrative orders); *In re County of Nevada, City of Ione, Wasco Public Financing Authority, Virginia Horler and William McKay*, Securities Act Release No. 7503, Exchange Act Release No. 39612, A.P. File No. 3-9542 (February 2, 1998).

Additional cases brought by the SEC against government bodies and public officials include: *In re County of Nevada*, Securities Act Release No. 7535, A.P. File No. 3-9542 (May 5, 1998); *In re Wasco Public Financing Authority*, Securities Act Release No. 7536, A.P. File No. 3-9542 (May 5, 1998); *In re City of Ione*, Securities Act Release No. 7537, A.P. File No. 3-9542 (May 5, 1998); *In re City of Syracuse, New York, Warren D. Simpson, and Edward D. Polgreen*, Securities Act Release No. 7460, Exchange Act Release No. 39149, AAE Release No. 970, A.P. File No. 3-9452 (September 30, 1997); *In re Maricopa County*, Securities Act Release No. 7345, Exchange Act Release No. 37748, A.P. File No. 3-9118 (September 30, 1996); *In re*

Maricopa County, Securities Act Release No. 7354, Exchange Act Release No. 37779, A.P. File No. 3-9118 (October 3, 1996).

Cases that have focused on public officials brought by the SEC also include: *SEC v. Larry K. O'Dell*, Civ. Action No. 98-948-CIV-ORL-18A (M.D. Fla.), Litigation Release No. 15858 (August 24, 1998) (settled final order).

B. MATERIALITY

The United States Supreme Court has found that for information to be material 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.¹²⁸ [emphasis added] *TCS Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

For financial statements misstatements or omissions of facts needed to make those statements not misleading are material when:

[T]he magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement.¹²⁸

In addition to the Rule 10(b)5 prohibitions, Exchange Act Rule 15c2-12 prohibits the underwriting of municipal securities unless the underwriters have

¹²⁸ Statement on Auditing Standard no 47, Audit Risk and Materiality in Conducting an Audit (AU ' 312.10). (Exhibit 70)

reasonably determined that the issuers for whom they are providing underwriting services have undertaken to provide the marketplace with certain required on-going information.¹²⁹ The participating underwriter must determine that the contractual undertaking A meets the standards of the rule.@¹³⁰

¹²⁹ Exchange Act Release No. 34,961 (Nov. 10, 1994).

¹³⁰ Fippinger, Robert A. *The Securities Law of Public Finance* ' 6:5.1 (6-42).

Rule 15c2-12 creates a duty to update annually the financial information and operating data that are set forth in the final official statement.¹³¹ The anti-fraud provisions should be viewed as the standard of care for the preparation of the annual disclosures required by Rule 15c2-12.¹³² When a municipal issuer releases information to the public that is reasonably expected to reach investors and the trading markets, those disclosures are subject to the antifraud provisions.¹³³

The City of San Diego's outside legal counsel determined that the following information about the City of San Diego's financial statement was material and should be disclosed. This information was not previously disclosed until the City, acting on

¹³¹ Fippinger, Robert A. *The Securities Law of Public Finance* ' 6:5.1 (6-42).

¹³² Fippinger, Robert A. *The Securities Law of Public Finance* ' 6:5.2 (6-44)

¹³³ Fippinger, Robert A. *The Securities Law of Public Finance* ' 6:5.2 (6-45); Release No. 33-7049 (9 March 1994).

the advice of the City's outside bond counsel Paul Weber, disclosed it on 27 January 2004 in a special filing with the various municipal disclosure depositories¹³⁴:

Mr. Webber believed that the basic information that should be disclosed was: (1) the City's currently required payment amounts, (2) the amount that the City is paying, per collective bargaining agreements, of its employees' share of their currently required contributions, and (3) the amount of supplemental benefits paid from Plan Assets, thus increasing the UAAL. Other information he thought should be conveyed included methodologies used in calculating UAAL, such as amortization periods, and key assumptions, such as investment returns.

¹³⁴ Since 1990, underwriters of municipal securities have filed the official statement or offering document, for most municipal securities offerings, with the MSRB's Municipal Securities Information Library.

Finally, information about responsibility for payment for health care benefits and how they are being funded should, in his view, be disclosed. Mr. Webber viewed the obligation to fund these different benefits as similar to the obligation to pay a debt and, while future debt payments are typically sums certain, and projections regarding the categories described above are not, he believed that Aorder of magnitude@ disclosures could be made to give the prospective investor a general sense of the City=s obligations. Mr. Webber believed that the City had a duty to estimate and disclose its anticipated obligations over a reasonable period into the future.¹³⁵

In addition to failing to make these disclosures until the voluntary filing on 27 January 2004 the City misstated that its Acorridor@ funding method was Aexcellent@ when in fact had a long-standing practice of reducing employer and employee contributions to its pension plan thus pushing the liability onto future generations of city employees and taxpayers. The City adopted prolonged amortization schedules and used creative accounting practices, such as adopting a method for computing the unfunded liability (the PUC method) that allowed the City under report the amounts due from the City to the pension plan.

Investors should also have been told about the trigger and balloon payments and about the questionable device of paying increased and special benefits to those on the

¹³⁵ 16 September 2004 Report on Investigation, The City of San Diego, California=s Disclosure of Obligation to Fund the San Diego City Employees= Retirement System and Related Disclosure Practices 1996-2004, pg. 117. (Exhibit 71)

pension board in exchange for an agreement to violate the fiduciary law protecting beneficiaries. The California State Constitution sets forth the basic fiduciary duty that was violated by the Council and Pension Board:

(a) The retirement board of a public pension or retirement system shall have the sole and exclusive fiduciary responsibility over the assets of the public pension or retirement system. The retirement board shall also have sole and exclusive responsibility to administer the system in a manner that will assure prompt delivery of benefits and related services to the participants and their beneficiaries. The assets of a public pension or retirement system are trust funds and shall be held for the exclusive purposes of providing benefits to participants in the pension or retirement system and their beneficiaries and defraying reasonable expenses of administering the system.

(b) The members of the retirement board of a public pension or retirement system shall discharge their duties with respect to the system solely in the interest of, and for the exclusive purposes of providing benefits to, participants and their beneficiaries, minimizing employer contributions thereto, and defraying reasonable expenses of administering the system. A retirement board's duty to its participants and their beneficiaries shall take precedence over any other duty.

(c) The members of the retirement board of a public pension or retirement system shall discharge their duties with respect to the system with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with these matters would use in the conduct of an enterprise of a like character and with like aims.¹³⁶

As stated in the Constitution, the Board must act with care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a

¹³⁶ California Constitution Article 16 Public Finance ' 17. (Exhibit 18)

like capacity and familiar with these matters would use in the conduct of an enterprise of a like character and with like aims.@ Generally, prudent action requires that all relevant facts be examined and evaluated before a decision is made. Decisions must be made in light of the board's goals and responsibilities. The one over-riding goal of the SDCERS Board should be to protect the public funds placed in its care. In reviewing the duty of a retirement board, one court observed that the board had a constitutional mandate to place the needs of the retirement's fund's participants and their beneficiaries above all other duties, and Y to insure the financial integrity of the assets in its care.@ *Corcoran v. Contra Costa County Employees Retirement Board*, 60 Cal.App.4th 89, 94 (1997). Protection of the fund's assets, therefore, should have always been, and should always be, the over-arching goal and responsibility of the SDCERS Board.

In order to avoid the trigger and balloon payment, the Mayor and Council granted general and special benefits to pension board members to induce the board members to waive the trigger and allow the City to escape the balloon payments. Upon these premises, the San Diego City Attorney finds there is substantial evidence consistent with a finding that pension board members failed to hold the funds and assets of the City pension fund Afor the exclusive purposes of providing benefits to participants in the pension or retirement system and their beneficiaries in violation of California State Constitution Article 16 ' 17(a). These actions were not consistent

with the duties imposed upon the City by the 23 July 1996 agreement. The City failed to live up to its commitment to keep the funded ratio at 82.3% and pension board members joined in that failure.¹³⁷ With the City failing to contribute the funds needed to keep the pension plan funding ratio at 82.3% it plunged to 65% as of 2004.¹³⁸

As outlined, the Board was under a constitutional mandate to place the needs of the retirement's fund's participants and their beneficiaries above all other duties, and thus insure the financial integrity of the assets in its care. @ *Corcoran v. Contra Costa County Employees Retirement Board*, 60 Cal.App.4th 89, 94 (1997). By choosing to allow the plan's funding ratio to fall below the floor agreed to in Manager's Proposal I, the Board breached its fiduciary duty to the City and the plan participants to protect the fund's assets.

¹³⁷ The impact of the trigger mechanism was interpreted by SDCERS outside fiduciary counsel, as well as by Mr. Maco, as requiring the City to maintain the funded ratio at 82.3%. V&E Report, page 83.

¹³⁸ San Diego City Employees Retirement System 2004 Actuarial Report for as of 30 June 2004.

The City's duty to keep the plan at the 82.3% funding ratio which would required the City to contribute over \$500 million to the pension plan was acknowledged by the plan's fiduciary counsel, board member Ron Saathoff, and the plan's actuary.¹³⁹ The City Auditor and the plan's administrator misinformed the Council that the balloon payment was \$25 million.¹⁴⁰

¹³⁹ 21 June 2002 Minutes of the SDCERS Board Meeting pp. 16-17. (Exhibit 72)

¹⁴⁰ See Meet and Confer Section of this Report, pg. 30, *et seq.*

Investors were kept in the dark about the trigger and balloon payment to the pension plan. They were not timely informed that the plan's funded ratio was crashing. City auditor Webster acknowledged that the funding ratio was a fiscal indicator of the health of the CERS fund which was a major fund of the City.¹⁴¹ She knew a large drop in funding ratio or dropping below certain benchmarks could result in a negative impact to the City's credit rating. A lower bond rating, according to Ms. Webster, was vital to keep borrowing costs down for future issuances on the horizon such as for fire stations, main library, and branch libraries, etc.¹⁴²

The City should have disclosed that the payment of retiree health care benefits with pension funds, the allowing of non-participant union employers to participate in the plan, and the payment of special benefits to union presidents in exchange for their agreement to violate or aid in the violation of fiduciary obligations threatened the tax exempt status of the pension plan.¹⁴³ The City should have informed investors that pension plan participants were granted the right to buy pension credits at deep discounts when there was no identified funding source. Investors also should have

¹⁴¹ 18 March 2002 Email from Terri Webster to Rgarnica@unitedcalbank.com on the subject of CERS. (Exhibit 13)

¹⁴² 18 March 2002 Email from Terri Webster to Rgarnica@unitedcalbank.com on the subject of CERS. (Exhibit 13)

¹⁴³ 29 October 2004 Memorandum from Plan Administrator Lawrence Grissom to City Manager Lamont Ewell. (Exhibit 54)

been told that the City had granted pension benefits retroactively without providing a funding source.

The City should not have falsely represented in financial statement documents used in later bond offering documents that:

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.¹⁴⁴

C. THE CITY COUNCIL WAS TOLD OF ITS DISCLOSURE DUTIES

City officials who issue investment bonds have ultimate authority to approve the issuance of securities and related disclosure documents have responsibilities under the federal securities laws as well.¹⁴⁵

On 6 November 2001 the Mayor and City Council, in writing and orally during a briefing by its outside securities law experts, were informed of their duties under the federal securities law.¹⁴⁶ The Mayor and City Council were reminded that the County

¹⁴⁴ See, 5 September 2003 Email from Diann Shipione to Plan Administrator documenting that the false statement was included in the August 2002 Wastewater \$505 million bond offering (Exhibit 73); 6 February 2001 SDCERS Business & Procedures Minutes p. 4 (Exhibit 74).

¹⁴⁵ *Report of Investigation in the Matter of County 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). (Exhibit 75)

¹⁴⁶ 6 November 2001 Closed Session Minutes. (Exhibit 69)

Board of Supervisors in neighboring Orange County had been found to have violated federal securities laws in connection with bond offerings in 1996.

The federal securities law standard under which the Mayor and Council were to conform their conduct was provided in writing:

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. 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.¹⁴⁷

Despite the clear duty to disclose the material facts about both the trigger and balloon payment and the financial condition of the pension and its impact on the City's overall financial condition, the council failed to take reasonable steps to ensure proper disclosure in the following City bond offerings:¹⁴⁸

- 1.**
29 April 2002
\$25,070,000

¹⁴⁷ 6 November 2001 Closed Session Minutes. (Exhibit 69)

¹⁴⁸ The beginning date of 18 March 2002 marks the date that the Mayor and Council were provided a PowerPoint presentation showing the actuarial funding ratio had dropped to 89.9%.

Public Facilities Financing Authority of the City of San Diego
Lease Revenue Bonds Series 2002 B
(Fire and Life Safety Facilities Project)
Ordinance No. O-19054 - Adopted April 29, 2002
Districts 1, 2, 3, 4, 5, 6, 7, 8, and Mayor - Yea

2.

14 May 2002

\$93,200,000

City of San Diego, California

2002-03 Tax Anticipation Notes Series A

3.00% Interest Rate @ 101.382% Price to Yield 1.70%

Resolution No. R-296500 - Adopted May 14, 2002

Districts 1, 2, 3, 4, 5, 6, 7, 8, and Mayor - Yea

3.

16 September 2002

16 September 2002

\$286,945,000

Public Facilities Financing Authority of the City of San Diego

Subordinated Water Revenue Bonds, Series 2002

(Payable Solely From Subordinated Installment Payments Secured by Net System
Revenues of the Water Utility Fund)

Resolution No. R-297070 - Adopted September 16, 2002

Districts 1, 2, 3, 4, 6, 7, 8, and Mayor - Yea

District 5 - Not Present

4.

3 March 2003

\$15,255,000

City of San Diego/MTDB Authority

2003 Lease Revenue Refunding Bonds

(San Diego Old Town Light Rail Transit Extension Refunding)

R-297693 - Adopted March 3, 2003

Districts 1, 2, 3, 4, 5, 6, 7, 8, and Mayor - Yea

5.

3 March 2003

\$17,425,000

City of San Diego
2003 Certificates of Participation
(1993 Balboa Park/Mission Bay Park Refunding)
Evidencing Undivided Proportionate Interests in Lease Payments to be
Made by the City of San Diego Pursuant to a Lease with the
San Diego Facilities and Equipment Leasing Corporation
Resolution No. R-297692 - Adopted March 3, 2003
Districts 1, 2, 3, 4, 5, 6, 7, 8, and Mayor - Yea

6.

20 May 2003
2003-04 Tax Anticipation Notes Series A
\$110,900,000
City of San Diego, California
1.75% Interest Rate @ 100.939% Price to Yield .800%
Resolution No. R-297969 - Adopted May 20, 2003
Districts 1, 2, 3, 4, 5, 6, 7, 8, and Mayor - Yea

7.

30 June 2003
\$505,550,000
Public Facilities Financing Authority of the City of San Diego
Subordinated Sewer Revenue Bonds, Series 2003A and Series 2003B
(Payable Solely From Subordinated Installment Payments Secured by Wastewater
System Net Revenues
Resolution No. R-298133 - Adopted June 30, 2003
Districts 1, 2, 3, 4, 5, 6, 7, and Mayor - Yea
District 8 - Not Present¹⁴⁹

IV.

CONCLUSION

¹⁴⁹ See Chart of Bond Offerings from 29 April 2002 to 30 June 2003.
(Exhibit 77)

Based upon these premises, the San Diego City Attorney concludes that there is substantial evidence consistent with a finding that the Mayor and Council authorized the issuance of City bond offering and related disclosure documents, identified above, that the Mayor and City Council Members knew to be false, as set forth above.

Moreover, the San Diego City Attorney concludes that there is substantial evidence consistent with a finding that the Mayor and Council authorized bond offering documents and related disclosure offering documents, for the bond offerings identified above, while they recklessly disregarded facts indicating a risk that the disclosures might be misleading, as set forth above.

The San Diego City Attorney further concludes that there is substantial evidence consistent with a finding that the Mayor and Council had knowledge of facts set forth herein that brought into question the City's ability to repay the bonds sold by the City of San Diego, identified above. The City Attorney of San Diego finds that under these circumstances there is substantial evidence supporting a finding that it was reckless for the Mayor and City Council, with regard to the bond offerings identified above, to approve the related disclosures to investors without taking steps to prevent the dissemination of materially false or misleading information regarding those bonds. In this matter, such steps should have included becoming familiar with the disclosure documents and questioning the City's officials, employees, or other agents about the

disclosure of the material facts.¹⁵⁰

Upon these premises the San Diego City Attorney concludes that there is substantial evidence consistent with a finding that the Mayor and City Council engaged in civil violations of federal securities laws. There is no finding of any wrongdoing by Council Member Tony Young. He was not elected to represent the Fourth Council District until 4 January 2005 and therefore there is no evidence of his involvement in any of the alleged securities law violations.

There is no finding of any wrongdoing by Council Member Michael Zucchet. He did not take office until 2 December 2002. He was not a Council Member during the period of time in which the information about the trigger and balloon payment was provided to the Council. On 3 December 2002 Mr. Zucchet did vote in favor of Item-50 (Ordinance O-2003-67), which granted Fire Fighters Local 145 members additional benefits. Those benefits consisted of (1) allowing Fire Fighters Local 145 members to "convert Annual Leave accrued after July 1, 2002 to service credit in SDCERS or extend their participation in the System's Deferred Retirement Option Plan ("DROP");" and (2) allowing the purchase of creditable service to apply towards the ten year vesting requirement. Mr. Zucchet also voted to approve municipal bond disclosure documents for some offerings. There is no finding of wrongdoing by Mr.

¹⁵⁰ 6 November 2001 Closed Session Minutes. (Exhibit 69)

Zucchet.

The remaining council members fall along a continuum. The Mayor and Council Member Scott Peters have the most relevant training for understanding the underlying complex facts and circumstances. Both are Phi Beta Kappa graduates with economic degrees. Mayor Murphy holds a Masters of Business Administration Degree from the Harvard Business School. Council Member Peters is a graduate of Duke University. Mayor Murphy has a law degree from Stanford University; Council Member Peters has a law degree from New York University.

Mayor Murphy was an associate in the law firm of Luce, Forward, Hamilton & Scripps. Council Member Peters was an associate at the firm of Baker & McKenzie. Mayor Murphy served as a Municipal and Superior Court Judge for 15 years. He was admitted to practice 16 December 1975. Mr. Peters had considerably less experience than Mayor Murphy, having practiced in the field of environmental law before his election to the Council in December 2000. He was admitted to practice in California on 6 June 1989.

At the other end of spectrum is Council Member Donna Frye. Council Member Frye has no advanced degrees in business or law. She has no expert training in law or business. Although she voted in earlier Closed Sessions to extend more benefits and to continue the underfunding she was the only council member to vote against extending those benefits when it went to a later public vote. She also voted against the ballpark

bonds offering documents.

Council Member Toni Atkins also has no expert training in law or business. However, Ms. Atkins voted to underfund the pension system and to exchange benefits for a waiver of the trigger and balloon payments.

Between these two points stand Council Members Brian Maienschein, Jim Madaffer, and Ralph Inzunza. Council Member Maienschein is an attorney but he had a community based practice. Council Members Madaffer and Inzunza have no relevant expert training. Council Member Madaffer attended Grossmont College and San Diego State University. Council Member Inzunza is a graduate of San Diego State University but his area of expertise is Latin American Studies.

Two former Council persons participated in the matters addressed in this report. They are former Council Members Byron Wear and George Stevens. Neither of these Council Members had expert training in law or business.

KPMG has cited to the conclusion reached in the 16 September 2004 report of the City's outside counsel that "Any attempt to conceal the SDCERS funding situation would have been an exercise in futility."¹⁵¹ The San Diego City Attorney concludes in this Second Interim Report that there is substantial evidence consistent with a finding that the Mayor and City Council did attempt to conceal and did conceal the

¹⁵¹ 11 October 2004 and 29 October 2004 KPMG letters to San Diego Assistant City Attorney re: City of San Diego Fiscal Year 2003 Audit. (Exhibit 76)

granting of pension benefits in exchange for the waiver of the trigger and balloon payments. The City Attorney of San Diego further concludes that there is substantial evidence consistent with a finding that the Mayor and City Council concealed the other aspects of the underfunding, trigger, balloon payments, wrongful accounting and funding practices as set forth in this report. Finally, the San Diego City Attorney concludes that there is substantial evidence consistent with a finding that the Mayor and City Council engaged in the alleged wrongful conduct either knowingly or recklessly.

The San Diego City Attorney has investigated the issues raised by KPMG in their correspondence of 11 October 2004 and 29 October 2004 and related writings. This investigation has been conducted to resolve the federal securities law issues raised in those writings. Additional City Attorney reports will address other possible illegal acts and other responsible parties, if and when requested by KPMG.

Finally, it should be stressed that much of the evidence set forth in this report was made available to the investigation only because the Mayor and

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Council made the honorable decision to waive the confidentiality privileges held by the City. They did this knowing that it would put them at risk.

MICHAEL J. AGUIRRE, City Attorney

By _____
Michael J. Aguirre
City Attorney