

INTERIM REPORT NO. 4
REGARDING ADDITIONAL
FUNDING FOR OUTSIDE PROFESSIONALS
REVIEWING ALLEGED ILLEGAL ACTS

REPORT OF THE
SAN DIEGO CITY ATTORNEY
MICHAEL J. AGUIRRE

OFFICE OF
THE CITY ATTORNEY
CITY OF SAN DIEGO

1200 THIRD AVENUE, SUITE 1620
SAN DIEGO, CALIFORNIA 92101-4178
TELEPHONE: (619) 236-6220

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I.

SUMMARY

On 8 March 2005 the San Diego City Council approved hiring three outside professionals to form the City's ad hoc audit committee ("Outside Professionals' Audit Committee"). The Outside Professionals' Audit Committee consists of Arthur Levitt, Lynn Turner, and Troy Dahlberg. In doing so, they intended that the Outside Audit Committee would function "as contemplated by the Sarbanes-Oxley Act of 2002"¹ and provide a key role in helping the City's auditors deliver finalized audits for 2003 and 2004. However, the Outside Professionals' Audit Committee has not yet completed its work, and has recently delivered a four-page "Audit Committee-Investigation Status" report ("Status Report") to the City dated 6 May 2005 which casts serious doubt as to whether the committee will finish its work in an economical and timely manner.²

A primary task of the Outside Professionals' Audit Committee was to reconcile the written illegal acts reports prepared by Vinson & Elkins ("V&E"), the City's outside counsel, with those written by the San Diego City Attorney.³ The reports authored by the City Attorney discussed alleged illegal acts by City officials pertinent to the City's 2003 financial statements. The City's outside auditor, KPMG, found V&E's 15 September 2004 report insufficient and refused to issue an audit opinion until the City conducted an appropriate investigation into alleged illegal acts.⁴

During 2004 the City of San Diego paid nearly \$4 million to V&E to determine "whether the City has failed to meet disclosure obligations concerning its funding of SDCERS" and, in a "second phase," to investigate

¹ Item S404, San Diego City Council Minutes, 3/8/05, p. 13.

² See, "Audit Committee-Investigation Status" report, 5/6/05.

³ Independent Services Agreement between City of San Diego and Kroll Inc., 2/10/05, p. 2 ("The City has requested that Kroll (1) receive, review and evaluate the findings of the investigations by V&E and the City Attorney.").

⁴ See, letter from KPMG to the City of San Diego, 10/11/04 (Ex. 4a) and letter from KPMG to City of San Diego, 10/29/04 (Ex. 4b).

whether City officials had engaged in specified illegal acts.^{5,6} After the City initiated this review, the U.S. Securities & Exchange Commission (SEC) and the United States Grand Jury commenced investigations.

The V&E 16 September 2004 Report stated that City officials did not knowingly violate their disclosure obligations under the federal securities laws.⁷ After KPMG raised concerns about V&E's conclusions, V&E agreed to perform an additional investigation. In addition, the City Attorney agreed to perform a related investigation and issued three Interim Reports making findings that substantial evidence exists that City officials did civilly violate securities and related laws.⁸

It was in this context that the City established the Outside Professionals' Audit Committee to, among other things, reconcile the V&E and City Attorney Reports.⁹ V&E attorney Paul Maco represented to the City Attorney that his final report would be completed by 15 April 2005. He told the City's outside disclosure counsel that 15 April 2005 was a target date. Although the Outside Professionals' Audit Committee was engaged to review the final V&E report, it was not authorized to relieve V&E of the duty to provide a final written report.¹⁰

⁵ Paul S. Maco and Richard C. Sauer, Vinson & Elkins, L.L.P., Washington, D.C., *Report on Investigation The City of San Diego, California's Disclosures of Obligation to Fund the San Diego City Employees' Retirement System and Related Disclosure Practices 1996-2004 with Recommended Procedures and Changes to the Municipal Code*, September 16, 2004, [16 September 2004 Report].

⁶ Vinson & Elkins Work Plan, 11/5/04.

⁷ See, for example, the 16 September 2004 Report, p. 8.

⁸ See, San Diego City Attorney Interim Reports 1 through 3.

⁹ Independent Services Agreement between City of San Diego and Kroll Inc., 2/10/05, p. 2 ("The City has requested that Kroll (1) receive, review and evaluate the findings of the investigations by V&E and the City Attorney.").

¹⁰ See, statement in the Status Report from the Outside Professionals Audit Committee, 5/6/05, that "At this time, Vinson & Elkins's work continues on going with no change in the City's or Audit Committee's relationship." There is an independent agreement between the City and V&E which the audit committee does not the legal authority to alter without the permission of the City Council.

In the last several days, representatives of the Outside Professionals' Audit Committee and City officials have stated that the Outside Professionals' Audit Committee has relieved V&E of its legal duty to provide the City of San Diego with V&E's final written report.¹¹ The Outside Professionals' Audit Committee has also indicated that they intend to hire replacement counsel.¹² The Outside Professionals' Audit Committee seeks to replace V&E with the New York law firm Willkie Farr & Gallagher. Specifically two partners from that firm, Michael R. Young and Benito Romano, neither of whom are licensed to practice law in California, will replace V&E.¹³ Furthermore, contrary to ordinary attorney client standards, this new firm seeks indemnity for its acts, to which the City Council appears to have agreed.

The Outside Professionals' Audit Committee's representative has indicated to the City Attorney that V&E lacked the independence to provide the type of report sought by KPMG. A V&E agent, in explaining why the Outside Professionals' Audit Committee was turning away from V&E, told a Voice of San Diego reporter: "Normally your attorney is your advocate for the City. It's hard to say you're an advocate and be independent at the same time."¹⁴ KPMG raised the same issue in its 29 October 2004 letter to Mayor

¹¹ See, Philip J. LaVelle, *Pension investigators criticized anew | Firm is seeking more legal help*, San Diego Union-Tribune, 4/23/05, which reported: "Ewell also said an oral report would be acceptable, according to what he was told by Lynn Turner, a Kroll senior adviser leading the audit team. 'From an auditing investigative report, you're looking at the work product, the methodology of getting there, how you test something,' Ewell said. 'So it's not so much a written report.'"

¹² See, letter dated 4/19/05, Re: "Terms of Engagement as Counsel to the Audit Committee of the City of San Diego." The proposed agreement with Willkie Farr & Gallagher contemplates two of its partners (Michael R. Young and Benito Romano) with hourly rates that range from \$560 to \$825 will do the work V&E was contracted to do for the City. The agreement says that the new lawyers "are serving as counsel to the Audit Committee" the "payment of our bills is to be the responsibility."

¹³ See, Member Search on-line service for Michael R. Young and Benito Romano which found neither are licensed to practice law in California; and website for Willkie Farr & Gallagher lawyer resumes indicating that neither is licensed to practice law in California. This may be a violation of California Rule of Professional Responsibility §1-300.

¹⁴ Andrew Donohue, *Further Questions of City's Law Firm Could Continue Delay of Audits, Investigations*, Voice of San Diego, 4/22/05.

Dick Murphy (“[C]onducting the kind of investigation that is necessary may be in tension with V&E’s ongoing representation of the City in the pending SEC investigation.”)¹⁵ In the 11 October and 29 October 2004 letters, KPMG asserts it lacks confidence in the ability of V&E to complete an independent investigation. KPMG informed the City that KPMG believes that the City, in using V&E, failed to perform the procedures necessary for a proper investigation of the illegal acts. The City Attorney concurs in this judgment.

However, rather than tell the truth about V&E’s reduced role, due to its lack of independence, the Outside Professionals’ Audit Committee has told City officials and the public in its “Status Report” that: “At this time, Vinson & Elkins’s work continues on going with no change in the City’s or Audit Committee’s relationship.”¹⁶ It is the City Attorney’s opinion that the Outside Professionals’ Audit Committee has no authority to relieve V&E of any of its duties. Moreover, the manner in which the Outside Professionals’ Audit Committee has chosen to handle the V&E problem could prejudice the City’s ability to hold V&E accountable for any malpractice it may have committed. It also raises troubling questions about the credibility of the Outside Professionals’ Audit Committee. This group of professionals is supposed to be searching for the truth. It is imperative that they be completely candid about the V&E problem with the Council and the people of San Diego. The Outside Professionals’ Audit Committee’s decision to relieve V&E of its contractual duty to provide the City with a final written report was not authorized by the City Council or the City Attorney. Any change must be brought before the Council with full justifications in writing.

Further, the presentation of this matter to the City Council by a last minute docketing last Friday was inappropriate.¹⁷ The Outside Professionals’ Audit Committee is asking the Council and City Attorney to approve or go along with a major departure from the agreed-upon procedures, with no explanation being offered. This is not a matter that should have been presented to the council with only a few days notice and

¹⁵ See, letter from KPMG to City of San Diego, 10/29/04.

¹⁶ See, “Audit Committee Investigation Status” report, p. 2, 5/6/05.

¹⁷ See, City of San Diego Supplemental Docket Number 4 for the Regular Meeting of Tuesday, 5/10/05.

with no advance notice to the City Attorney. This matter cannot be properly rushed by the City Council. It is also not a matter that should have been arranged behind closed doors. This matter, now scheduled for Tuesday, 10 May 2005, needs extensive discussion. The first question that must be faced is: Where is the written V&E report?

The City Attorney will have extensive questions for the Outside Professionals' Audit Committee. The City Attorney recommends that this matter be discussed at the 10 May 2005 Council meeting but that no action be taken. Instead, the Council should thoroughly discuss all of its options. Moreover, representatives from V&E should be invited to report in public session to the Council.

II.

INVESTIGATION STATUS REPORT

As noted above, the Kroll firm submitted a four page letter dated 6 May 2005 entitled, "Audit Committee Investigation Status" ("Status Report") to the City Manager.¹⁸ The Status Report is ambiguous about exactly what the Outside Professionals' Audit Committee has accomplished thus far. The Status Report provides that: "[T]he Audit Committee has or is currently performing" seven different functions.¹⁹ Thus, the reader is left to guess whether the Audit Committee has or is reviewing the V&E and City Attorney reports.

The Kroll Status Report contains a statement inconsistent with statements made by representatives of the Outside Professionals' Audit Committee. The statement in question is: "At this time, Vinson & Elkins's work continues on going with no change in the City's or Audit Committee's relationship."²⁰ The Status Report then goes on to describe a substantial change: "The Audit Committee will use the work completed by Vinson & Elkins, including documents and evidence retrieved, to the extent possible as

¹⁸ See, "Audit Committee-Investigation Status" report, 5/6/05.

¹⁹ See, "Audit Committee-Investigation Status" report, 5/6/05 [emphasis added].

²⁰ See, "Audit Committee-Investigation Status" report, 5/6/05.

set forth in our engagement letter.”²¹ There is no mention of the written report V&E was required to provide setting forth its findings related to the alleged illegal acts.

The Kroll firm, through the Status Report, is apparently attempting to sweep under the rug the issue of whether V&E will be providing a written report by stating: “The independent auditors have not specifically requested that from the Audit Committee.”²² However, this requirement pre-dated the Outside Professionals’ Audit Committee and is a requirement of the agreement between V&E and the City. In fact, KPMG has made it clear to the City Attorney and to the City that it believes V&E is unable to conduct a credible investigation. Yet, the Outside Professionals’ Audit Committee has failed to candidly bring this information to the City’s attention. It should be noted that members of the Outside Professionals’ Audit Committee have a prior existing relationship with the attorneys at V&E who performed the inadequate investigation. It is imperative that full disclosure be made publicly about this matter.

Further, the Outside Professionals’ Audit Committee members should disclose any and all prior and existing relationships with those lawyers at V&E who prepared the 16 September 2004 report. The Outside Professionals’ Audit Committee’s effort to relieve V&E of its contractual duty to provide the City with a written report may substantially prejudice the City’s rights to recover losses sustained by the City caused by V&E. This is not a matter that should be ignored. The City Attorney will have substantial questions of the representatives of the Outside Professionals’ Audit Committee regarding this matter.

Compounding this problem is the announced intention by the Outside Professionals’ Audit Committee to essentially hire replacement counsel for V&E. Again, in less than candid terms the author of the “Status Report” states that a decision has been made “to retain their own independent legal counsel to obtain guidance on matters of law.”²³ Then the Status Report goes on to state that the new attorneys (intended to be Willkie, Farr &

²¹ See, “Audit Committee-Investigation Status” report, 5/6/05.

²² See, “Audit Committee-Investigation Status” report, 5/6/05.

²³ See, “Audit Committee-Investigation Status” report, 5/6/05.

Gallagher) will be “investigating certain illegal acts as appropriately requested by the independent auditors and required by generally accepted auditing standards....”²⁴ The Status Report begins by stating that these new lawyers will provide “guidance on matters of law” and ends by saying they will be “investigating certain illegal acts.”²⁵ Investigating illegal acts was V&E’s job assignment. Thus, the Outside Professionals’ Audit Committee is substituting the new counsel for V&E. The Status Report then refers to an illegal acts audit practice bulletin which had previously been provided to the City by letter dated 29 October 2004 from KPMG.²⁶ This practice guide was used by the City Attorney to conduct the illegal acts investigations reported in the City Attorney’s Interim Reports 1 through 3. The City Attorney’s office advises the City Council that there is no legal authority that would allow the City Council to delegate to the Outside Professionals’ Audit Committee the power to contract with V&E substitute counsel. The City Attorney’s office would also note that neither of the lawyers the Outside Professionals’ Audit Committee seeks to hire is admitted to practice law in the state of California.²⁷

The Kroll Status Report then addresses the issue of remedial actions that need to be taken. The City Attorney has already made it clear that such remedial action needs to include a nationwide search for a new City Manager. It must also include the dismissal of the former City Auditor, former City Treasurer, the former Human Resources Director, the City employees who served on the City’s pension board, and certain Deputy City Managers. The City Attorney is of the settled judgment that the City Council is in the best position to assess the personnel changes that need to be made. Further, it is imperative as part of the remedial action that all illegal benefits be rescinded and that the Council direct the City Auditor to discontinue paying the illegal benefits as set forth in the City Attorney’s Third Interim Report. In addition, the City Council must take immediate steps to honestly and accurately determine the actuarially-required net pension contribution.

²⁴ See, “Audit Committee-Investigation Status” report, 5/6/05.

²⁵ See, “Audit Committee-Investigation Status” report, 5/6/05.

²⁶ See, letter from KPMG to City of San Diego, 10/29/04.

²⁷ This may violate California Rule of Professional Conduct § 1-300.

The outside New York law firm the Outside Professionals' Audit Committee seeks to retain has made a number of statements about how internal investigations should be conducted that seem to be in conflict with how the Outside Professionals' Audit Committee is proceeding.²⁸ For example, one of the lawyers has written that the investigation should be undertaken by a law firm that "has no prior history of reporting to management." In this case, the law firm conducting the investigation (V&E) did previously report to management (the City) about disclosure issues (from November 2003) and also reported to management as the city's SEC defense counsel.²⁹

Another point put forth by the proposed new firm was a requirement that the lawyers conducting the investigation "consult with the auditor at the outset to ensure that the proposed scope of the investigation will be sufficient to be relied upon for audit purposes."³⁰ V&E failed to take these steps and did not even mention the applicable auditing standards (AU § 317) in the 16 September 2004 report.

The proposed new firm is in conflict with the Outside Professionals' Audit Committee in other ways as well. The new firm states that the "audit committee should consider the need to put in place procedures to ensure that executives or employees potentially involved in misconduct are not informed or updated as to investigative progress or tentative results."³¹ Contrary to this position, representatives of the Outside Professionals' Audit Committee regularly meet with those who were "potentially involved in misconduct" to keep them informed and updated.

Another point raised by the proposed new counsel that stands in contradiction to how the investigation has been conducted is the need for the

²⁸ See, Michael R. Young, *Eighteen Safeguards to Corporate Self-Investigation*, The Metropolitan Corporate Counsel, 12/04.

²⁹ See, letter from KPMG to City of San Diego, 10/29/04; amendment to original agreement between V&E and the City of San Diego.

³⁰ See, Michael R. Young, *Eighteen Safeguards to Corporate Self-Investigation*, The Metropolitan Corporate Counsel, 12/04.

³¹ See, Michael R. Young, *Eighteen Safeguards to Corporate Self-Investigation*, The Metropolitan Corporate Counsel, 12/04.

investigation to proceed “with all available dispatch.”³² This investigation began over 15 months ago. Moreover, under the current plan the investigation will not be completed for several more months. It appears to the City Attorney that the investigation has been held up to protect those suspected of wrongdoing.

Again, the new proposed firm, Willkie, Farr & Gallagher, states that the auditor will not accept the attorney client privilege as an excuse for not gaining access to needed documents.³³ The Outside Professionals’ Audit Committee failed to use its best efforts to obtain a waiver of the attorney client privilege from the City Retirement Board, which has refused to turn over documents to the auditor based upon the assertion of the attorney client privilege.

A member of the proposed new firm served as defense counsel for KPMG in the case *Effron v. KPMG Peat Marwick* (No. 11107/91) (N.Y.S. Ct). He represented KPMG in a four-week jury trial arising out of an action to recover damages allegedly caused by an improper audit of financial statements.³⁴

Full disclosure must be made about any pre-existing relationship between Willkie and KPMG or Kroll.

³² Michael R. Young, *Eighteen Safeguards to Corporate Self-Investigation*, The Metropolitan Corporate Counsel, 12/04.

³³ Michael R. Young, *Eighteen Safeguards to Corporate Self-Investigation*, The Metropolitan Corporate Counsel, 12/04.

³⁴ See, On-Line Resume for Michael R. Young: www.Willkie.com/attorneys/bio_detail.aspx?iEmployee_ID=323144605.

III.

CONCLUSION

The San Diego City Attorney recommends that the Council not approve any additional funds for the new outside law firm of Willkie Farr & Gallagher or any other firm until a full review of the facts set forth above has been made.

MICHAEL J. AGUIRRE, City Attorney

By _____
Michael J. Aguirre
City Attorney

By _____
Don McGrath II
Deputy City Attorney