

**INTERIM REPORT NO. 16**

**REPORT ON KROLL AND**

**WILLKIE FARR & GALLAGHER BILLING PRACTICES**

**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. INTRODUCTION**

The San Diego City Attorney is issuing this 16<sup>th</sup> Interim Report to illustrate to citizens of the City of San Diego (“City”) how two large corporations took advantage of the City in a dark period of its history.

Thus, this report will present evidence to support the proposition that Kroll Inc. (“Kroll”) and Willkie Farr & Gallagher (“Willkie Farr”) perpetrated a \$20.3 million fraud on the City of San Diego and that the fraud was allowed to continue under the governance of the former-Mayor, former-City Manager, and many members of the current City Council. Specifically, this report will provide evidence that:

- Kroll and Willkie Farr failed in their professional duties to the City of San Diego to completely perform a complete and thorough investigation of all applicable federal, state and municipal laws as required by the American Institute of Certified Public Accountants;
- Kroll and Willkie Farr excluded key pieces of evidence in their analysis of various City officials’ violations of federal securities laws;
- Kroll and Willkie Farr knowingly violated the billing guidelines of the City of San Diego, thereby violating the City’s internal auditing control system;
- Kroll associates charged the City of San Diego hourly rates higher than their normal billing rates;
- Kroll and Willkie Farr unnecessarily expanded the scope of their investigation in order to create a massive amount of billable work which resulted unnecessary hourly charges;
- Kroll and Willkie Farr submitted false claims to the City of San Diego by charging for Kroll and Willkie Farr meetings with local public figures which was not included in the firms’ scope of work;
- City leaders permitted gross overcharging by Kroll and Willkie Farr in exchange for a report that exonerated certain City officials of any culpability in violating the federal, state, and local laws;
- Willkie Farr authored the majority of the report as a defense document for the San Diego City Council, thus Willkie Farr overstepped its contractual duties to Kroll;
- KPMG manipulated the standards of the investigation it required so as to benefit Kroll and Willkie Farr.

The City Attorney believes the evidence supporting these allegations as presented in this report provide the foundation for legal action against Kroll and Willkie Farr & Gallagher

## **II. BACKGROUND**

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

The granting of these benefits is the result of two contingent, *quid pro quo* arrangements between the San Diego City Council and the San Diego City Employees’ Retirement System (SDCERS). The magnitude of the pension debt, or unfunded liability, was discovered in late 2001 and information about the growing nature of the shortfall was communicated to SDCERS and some City officials but hidden from the public.<sup>1</sup> The City subsequently failed to include some of this information on financial statements related to a series of bond offerings.

The City filed voluntary corrections to its Comprehensive Annual Financial Report (“CAFR”) disclosures on 27 January 2004 calling attention to debts that were omitted from previously released financial disclosures.<sup>2</sup> Consequently, the City has not released a CAFR, or audit, since fiscal year 2002. The lack of a financial audit has prevented the City from borrowing money in the public capital markets.

The filing of the voluntary disclosures raised concerns with the U.S. Securities and Exchange Commission (“SEC”) and the U.S. Attorney’s Office (“U.S. Attorney”). Both federal agencies launched investigations of the City. The SEC announced its probe in February 2004 and the U.S. Attorney launched its probe in April 2004.

The City retained Houston-based law firm Vinson & Elkins L.L.P. (“Vinson & Elkins”) on 18 February 2004 to undertake an inquiry into the City’s financial disclosure

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<sup>1</sup> 3 December 2001 E-mail from Assistant City Auditor and SDCERS Board Trustee Teri Webster to SDCERS Administrator Lawrence Grissom and carbon-copied to City Human Resources Director and SDCERS Board Trustee Cathy Lexin. Re: earnings EEEK! (Exhibit 1)

<sup>2</sup> Municipal Secondary Market Disclosure (Exhibit 2)

practices.<sup>3</sup> The firm was to investigate the City's financial control structure to identify any misconduct and practices that allowed the disclosure failures to occur. Vinson & Elkins was tasked with working with accounting firm KPMG to examine the old financial data, ensuring that all issues related to receiving an unqualified audit were addressed and to identify policies to ensure the errors do not occur in the future.

After discovering a series of errors by the auditing firm Caporicci & Larson on the 2002 CAFR, the City severed its business relationship with that firm. Although Caporicci & Larson had completed an audit for fiscal year 2003, the City hired KPMG to, in effect, re-do the 2003 audit.<sup>4</sup> KPMG issued a letter to the City on 9 August 2004 stating that the investigation being performed by Vinson & Elkins must include an analysis of whether any laws were violated.<sup>5</sup> In the letter, KPMG partner Steven DeVetter specifically asked Vinson & Elkins to answer a series of questions that included the following question:

Did the SDCERS Board breach their fiduciary duty by allowing the City to underfund the plan in exchange for additional benefits for current employees and could this action have been in violation of any laws? ... Did the City violate the City Charter by failing to fund its retirement plan as required by the City Charter? ... Did the SDCERS Board and/or the City violate the California Constitution by allowing the City to intentionally underfund the plan?<sup>6</sup>

On 16 September 2004, Vinson & Elkins issued their report titled "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" ("Vinson & Elkins Report").<sup>7</sup> The Vinson & Elkins Report described the events causing

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<sup>3</sup> 18 February 2004 letter from Vinson & Elkins Partner Paul S. Maco to former City Attorney Casey Gwinn. (Exhibit 3)

<sup>4</sup> 13 April 2004 letter from KPMG Partner Steven DeVetter to Lisa Irvine, director of the City's Financial Management Department. (Exhibit 4)

<sup>5</sup> 9 August 2004 letter from KPMG Partner Steven DeVetter to Assistant City Attorney Les Girard. Re: Investigation. (Exhibit 5)

<sup>6</sup> American Institute of Certified Public Accountants AU § 317. Illegal Acts by Clients (Exhibit 6)

<sup>7</sup> 16 September 2004. Vinson & Elkins: Report on Investigations. The City of San Diego, California's Disclosures of Obligations to Fund the San Diego City Employees' Retirement System and

the pension deficit, including two different agreements between the City Council and the SDCERS Board of Administrations (“Board”) as the primary sources of the pension deficit. These agreements provided for the SDCERS Board to accept underfunding of the retirement system in exchange for the City Council’s agreement to grant enhanced pension benefits for City employees. The first deal, commonly referred to as Manager’s Proposal I (“MP I”), was approved in 1996. The second deal, a modification of the first deal, called Manager’s Proposal II (“MP II”), was approved in 2002. The Vinson & Elkins Report found that a series of disclosure violations occurred. The Vinson & Elkins Report, however, made no mention of any individual violations of law by City or SDCERS officials. In fact, no assessment of potentially illegal acts was made by Vinson & Elkins during its investigation.

Thus, not surprisingly, KPMG issued a letter to the City on 11 October 2004 which stated that the Vinson & Elkins Report was insufficient to meet professional auditing standards and that an illegal acts analysis was necessary for the audit to be completed. DeVetter wrote,

[W]e do not believe that the City of San Diego (“City”) has conducted an adequate investigation in order to conclude that likely illegal acts have not occurred, or that appropriate remedial action has been taken. Such an investigation is necessary in order for an auditor to complete an audit in accordance with generally accepted auditing standards and *Government Auditing Standards*.<sup>8</sup>

Importantly, the letter quoted additional language from the American Institute of Certified Public Accountants regarding accounting standards. Clearly, the language was meant to serve as a guideline for a future investigation.

Vinson & Elkins Partner Paul Maco issued a written response to Assistant City Attorney Leslie Girard on 28 October 2004, stating that KPMG “fail[ed] to provide any practical guidance as to what additional investigative procedures [KPMG] would find

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Related Disclosure Practices 1996-2004 with Recommended Procedures and Changes to the Municipal Code. (Exhibit 7)

<sup>8</sup> 11 October 2004. Letter from Steven G. DeVetter to Leslie J. Girard. Re: City of San Diego Fiscal Year 2003 Audit (Exhibit 8)

satisfactory” for the completion of the 16 September 2004 report.<sup>9</sup> In response, KPMG reasserted the need for an “illegal acts” investigation in a 29 October 2004 letter to former Mayor Dick Murphy.<sup>10</sup> In the letter, DeVetter explicitly asked the City to contract a firm other than Vinson & Elkins to complete this work:

If the City is prepared to proceed with an appropriate investigation, then we urge you to consider retaining counsel other than V&E [Vinson & Elkins] to do so. The positions asserted in, and oppositional tone of, Mr. Maco’s letter raises questions about V&E’s willingness or ability in these circumstances to complete the investigation of, and reach conclusion on, the audit-critical questions posed in our prior oral and written communications and to do so with an objective and independent manner.<sup>11</sup>

Despite the specific request, the City extended the contract with Vinson & Elkins to complete the investigation and to provide its analysis in a second report.

A new City Attorney, Michael Aguirre, was elected on 2 November 2004 and took office on 6 December 2004. The new City Attorney immediately announced an investigation<sup>12</sup> into the City and thereafter released a series of Interim Reports outlining alleged illegal acts that occurred in the approval of the Manager’s Proposal I in 1996 and Manager’s Proposal II in 2002. The first Interim Report was issued on 14 January 2005<sup>13</sup> and the second Interim Report was issued on 9 February 2005.<sup>14</sup>

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<sup>9</sup> 28 October 2004. Letter from Vinson & Elkins Partner Paul Maco to Assistant City Attorney Leslie Girard. Re: Additional Investigation. (Exhibit 9)

<sup>10</sup> 29 October 2004. Letter from KPMG Partner Steven DeVetter to Assistant City Attorney Leslie Girard. Re: Follow-up from meeting on August 27, 2004. (Exhibit 10)

<sup>11</sup> 29 October 2004. Letter from KPMG Partner Steven DeVetter to Assistant City Attorney Leslie Girard. Re: Follow-up from meeting on August 27, 2004. (Exhibit 10)

<sup>12</sup> 9 December 2004. Press release from the office of City Attorney Michael Aguirre. “Statement from City Attorney Michael J. Aguirre: Financial Disclosure Practices Investigation, and Decision Not to Join San Diego’s Retirement System.” (Exhibit 11)

<sup>13</sup> 14 January 2005. Interim Report No. 1 Regarding Possible Abuse, Fraud, and Illegal Acts by San Diego City Officials and Employees. Report of the San Diego City Attorney Michael J. Aguirre. (Exhibit 12)

<sup>14</sup> 9 February 2005. Interim Report No. 2 Regarding Possible Abuse, Fraud, and Illegal Acts by San Diego City Officials and Employees. Report of the San Diego City Attorney Michael J. Aguirre. (Exhibit 13)



The City Council then hired Los Angeles-based forensic accounting firm, Kroll Inc., to reconcile the findings of Vinson & Elkins and the City Attorney. Troy Dahlberg, managing director of Kroll, executed a letter of engagement to the City on 10 February 2005. The Kroll scope of services were stated as follows:

The City has requested that Kroll (1) receive, review and evaluate the findings of the investigations by VINSON & ELKINS and the City Attorney. The City has also requested Kroll provide consulting assistance in assessing internal control deficiencies affecting matters discussed in the investigation reports.<sup>15</sup>

The letter also described that Kroll's investigation was intended to satisfy the needs of KPMG. Specifically, Kroll requested unfettered access to personnel and documents of the City, SDCERS, Vinson & Elkins, the City Attorney, and other potentially involved parties.<sup>16</sup> Kroll also retained the authority to hire legal counsel for representation at the City's expense. The City Council approved the Kroll contract at its 14 February 2005 meeting.<sup>17</sup>

The Kroll team was headed up by Troy Dahlberg who billed at \$450 an hour, Lynn Turner at \$750 an hour, and Arthur Levitt at \$900 an hour. The remainder of the Kroll associates worked on the project and billed at rates ranging from \$125 to \$750 per hour.<sup>18</sup> At the 14 February 2005 City Council meeting, Lynn Turner, a consultant for Kroll, explained that Kroll would take the reports issued by the City Attorney and Vinson & Elkins, compare the data and findings, reconcile the differences, and issue its findings to KPMG.<sup>19</sup>

Kroll also outlined a second phase of their work: consulting with City personnel to establish internal controls to ensure that financial transactions are identified and

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<sup>15</sup> 10 February 2005. Letter from Troy Dahlberg to Mayor Richard Murphy and San Diego City Council. Re: Independent Services for the City of San Diego. (Exhibit 14)

<sup>16</sup> 10 February 2005 letter from Troy Dahlberg, managing director of Kroll, to Mayor Richard Murphy and San Diego City Council. Re: Independent Services for the City of San Diego. (Exhibit 14)

<sup>17</sup> 14 February 2005 meeting of the San Diego City Council. (Exhibit 15)

<sup>18</sup> 10 February 2005 letter from Troy Dahlberg to Mayor Richard Murphy and San Diego City Council. Re: Independent Services for the City of San Diego. P 4. (Exhibit 14)

<sup>19</sup> Transcript of Lynn Turner's presentation at the 14 February 2005 meeting of the San Diego City Council. (Exhibit 16)

reported properly in financial reports issued by the City. Kroll stated that this part of their engagement with the City would begin upon completion of its analysis of the work of Vinson & Elkins and the City Attorney.

Turner appeared in front of the City Council on 8 March 2005. At the meeting the City Council authorized representatives of Kroll to establish "the Audit Committee of the City as contemplated by the Sarbanes-Oxley Act of 2002" as discussed below.<sup>20</sup> The majority of City Council members at the meeting also agreed to sign a letter to cease discussing investigative matters with the press. Councilmember Donna Frye and City Attorney Michael Aguirre refused to sign the letter.

Kroll later hired the law firm of Willkie Farr & Gallagher ("Willkie Farr") to represent Kroll and its interest in the completion of an investigative report.<sup>21</sup> The firms spent nearly two years before delivering its final report ("the Report") to the Mayor and City Council on 8 August 2006. After missing more than six self-imposed deadlines, the firms jointly billed the City more than \$20 million for the report.

### **III. BREACH OF PROFESSIONAL DUTIES**

In this section of the report, the City Attorney will present evidence that Kroll and Willkie Farr failed to complete the in-depth and thorough investigation that the companies were hired to perform. More specifically, this section will provide evidence to illustrate that Kroll and Willkie overlooked key pieces of evidence and failed to investigate and analyze potential violations of law at the highest levels of the City bureaucracy, as required by national accounting oversight agencies.

#### **1. DUTIES OF AN AUDIT COMMITTEE TO A MUNICIPALITY**

The format and function of an Audit Committee for a municipality has been outlined by the Government Finance Officers Association ("GFOA"), a professional

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<sup>20</sup> 8 March 2005 meeting minutes of the San Diego City Council. Resolution Number R-300203 (Exhibit 17)

<sup>21</sup> 19 April 2005 letter from Willkie Farr & Gallagher to Kroll Inc. Re: Terms of Engagement as Counsel to the Audit Committee of the City of San Diego. (Exhibit 18)

association of state/provincial and local finance officers in the United States and Canada, and has served the public finance profession since 1906. In applying the standards and practices, the GFOA utilizes accounting and disclosure standards applied to private corporate business in the Sarbanes-Oxley Act of 2002.

The GFOA specifies that three groups are principally responsible for the financial reporting of a municipal body: “the governing body, financial management, and the independent auditors.”<sup>22</sup> The GFOA states that the governing body must maintain its ability to oversee the process.

Of these three, the governing body must be seen as ‘first among equals’ because of its unique position as the ultimate monitor of the financial reporting process.

The GFOA states that the governing body:

[I]nclude any other elected officials (e.g., county auditor, city controller) with legal responsibility for overseeing financial reporting, internal control, and auditing, provided they do *not* exercise managerial responsibilities within the scope of the audit. The term ‘governing body’ also is intended to encompass appointed bodies such as pension boards.

The GFOA further states that the members of an audit committee “...should be members of the governing body. To ensure the committee’s independence and effectiveness, no governing body member who exercises managerial responsibilities that fall within the scope of the audit should serve as a member of the audit committee.”

Once established by the governing body of a municipality, the purpose of the Audit Committee is to provide independent oversight of the completion of a CAFR to ensure that accurate information is disclosed in financial reports. The Audit Committee should submit one written report annually to the governing body. The GFOA states:

The audit committee should present annually to the full governing body a written report of how it has discharged its duties and met its responsibilities. It is further recommended that this report be made public and be accompanied by the audit committee’s charter or other establishing documentation.<sup>23</sup>

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<sup>22</sup> Government Finance Officers Association. “Recommended Practices: Audit Committees” (1997, 2002, and 2006) (CAAFR) (Exhibit 19)

<sup>23</sup> Government Finance Officers Association. “Recommended Practices: Audit Committees” (1997, 2002, and 2006) (CAAFR) (Exhibit 19)

This interim report will illustrate that the formation of the audit committee, that included representatives of Kroll, was not in compliance with standards set for by the GFOA. Moreover, the evidence presented below will also show that Kroll and Willkie Farr failed to complete their responsibilities in acting as an audit committee as prescribed by the GFOA.

## **2. CITY COUNCIL MEMBERS KNEW OF CITY'S IMPENDING FINANCIAL CRISIS IN PENSION SYSTEM**

In order to fully understand the inadequacy of Kroll and Willkie Farr's final report, it is critical to understand the extent of City officials knowledge about the City's oncoming financial crisis and the time frame of key decisions made to cover up this information from the public and financial markets.

The financial stability of the SDCERS pension trust began to unravel significantly towards the end of 2001. City officials realized the declining financial condition of the pension plan almost immediately. That knowledge is illustrated in a communication from then assistant City auditor Terri Webster to Cathy Lexin, former director of human resources for the City, and Larry Grissom, administrator for SDCERS. In the e-mail, Webster warned of future financial troubles in the pension system resulting from the stock market crash. Webster wrote:

Oct statements showed a \$15.4m loss on sale of stocks and a totally monthly loss if \$7 m bringing YTD earning at Oct 31, 2001 to only \$14.1 million compared to \$107 m last year same time. A 87% decrease! EEEK!"<sup>24</sup>

Over the course of the following months the stock market and investment portfolio for SDCERS continued to nose dive. SDCERS officials were warned on numerous occasions about the negative impact the market crash would have on the retirement system. On 11 February 2002, the annual actuarial report for the retirement system was released to SDCERS senior staff and Board trustees. The report showed that the funded ratio – a measure of money on hand to pay what is owed to retirees –

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<sup>24</sup> 11 October 2001 Letter from Terri Webster to Larry Grissom and cc'd to Cathy Lexin re: Sleepless in San Diego re: earnings EEEK! (Exhibit 1)

decreased to 89.9 percent, a decline of 8 percent from the previous year.<sup>25</sup> In other words, SDCERS had 89.9 cents for every dollar owed to retirees.

The timing of the report was critical because the decline in the funded ratio was moving the City dangerously close to breaching a contract it signed with SDCERS in 1996, called Manager’s Proposal I, or MP I. According to MP I, a funding floor of 82.3 percent for the pension system was established as a trigger. If the City fell below that funding level, a one-time lump sum payment by the City would potentially be required to return the funded ratio to that 82.3 percent funded ratio. The pension plan’s funding level fell from 97.3 percent as of 30 June 2000, to 89.9 percent as of 30 June 2001.<sup>26</sup>

City officials appeared in a closed session meeting of the San Diego City Council on 18 March 2002 to brief Council members on the declining financial condition of SDCERS and the damage done by City under funding the pension since MP I in 1996. The presentation focused on the City’s potential of hitting the “trigger.” The following table was presented to the City Council in the meeting:<sup>27</sup>

<b>Earnings Compared with Funding Ratio</b>		
FY 96	\$105.4 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.	\$50 to \$60 m	?

The slide presented information showing the declining funding ratio of the SDCERS system. The slide also stated that the 82.3 percent funding “trigger” was in danger of being hit and could potentially carry “a potential \$40m annual impact”. The table shows that declining earnings were directly proportional to the falling funded ratio of the system. Most importantly, the table illustrates that the estimated earnings for FY02

<sup>25</sup> San Diego City Employees’ Retirement System Annual Actuarial Valuation. 30 June 2001. (Exhibit 20)

<sup>26</sup> San Diego City Employees’ Retirement System Annual Actuarial Valuation. 30 June 2001. (Exhibit 20)

<sup>27</sup> Source: PowerPoint presentation from 18 March 2002 Closed Session meeting of the San Diego City Council. (Exhibit 21)

declined by about \$100 million, leaving the City dangerously close to the trigger, which if violated required the \$40 million payment. The meeting indicates that the Mayor and City Council were given warning by staff that a potentially crippling financial event was on the horizon.

The presentation to the City Council also included information about the debt created by the City's under funding since the implementation of MP I in 1996 – a liability the City was responsible for and should have been included in the City's financial statements. The following table was presented:

<b>Period</b>	<b>Actual Rate</b>	<b>City Paid Rate</b>	<b>Difference \$</b>
FY96	8.60%	7.08%	\$5.33m
FY97	9.55%	7.33%	\$13.88m
FY98	10.87%	7.83%	\$16.67m
FY99	10.86%	8.33%	\$15.40m
FY2000	11.48%	8.83%	\$14.00m
FY2001	11.96%	9.33%	\$12.45m
FY2002	12.58%	9.83%	\$10.72m
			\$88.45m <sup>28</sup>

The table very clearly illustrated the total debt created by following the payment schedule created as part of the MP I as opposed to paying what the actual actuarial rate was. The table also illustrates the estimated actuarial required contributions for the pension each year in the “actual rate column.” The next column, titled “City Paid Rate,” shows the rate that the City paid into the pension system each year. The third column, titled “Difference \$”, shows the amount of money the City did not pay, which is actuarially determined rate required to maintain the financial integrity of the retirement system. In short, the City Council members were told that as a result of MPI, the City under funded the pension system by \$88.45 million between 1996 through 2002.

In the same meeting, City staff presented a proposed modification to the MP I deal that would allow the City to avoid these increased payments. The deal, which would later become known as Manager's Proposal II, envisioned that the SDCERS Board would allow the City to continue paying less than it was supposed to into the pension system. In return, the City would grant increased retirement benefits for all city employees.

<sup>28</sup> Source: PowerPoint presentation from 18 March 2002 Closed Session meeting of the San Diego City Council. (Exhibit 21)

According to a PowerPoint presentation from the meeting, the Mayor and City Council members were briefed on potential retirement benefit enhancements for City employees. Slide number 36 of the 18 March 2002 presentation listed the new benefits:

- *Presidential Leave and Retirement Issues*
- Funding Ratio Impact on City Contribution
- 2.5% at 55 General Member Formula
- Increases in Employee Pick-ups
- Retiree Health Insurance and Funding<sup>29</sup>

The presentation was given in conjunction with the City entering into the meet-and-confer process<sup>30</sup> with municipal unions where new labor contracts were negotiated. The presentation was given to seek authority for the City's negotiators to be discussing these benefit enhancements with the municipal unions. The City Council members voted 8-to-0 to allow these benefits to be discussed, with District 7 absent.<sup>31</sup>

The minutes of the closed session meeting indicated that the Mayor and City Council were aware of the City's financial troubles, the City's close proximity to violating the trigger set by MP I, and the looming balloon payment due to the pension system. Former Assistant City Attorney Leslie Devaney wrote in the comments of the closed session report that the Mayor and City Council vote showed their "willingness to discuss retirement + trigger..."<sup>32</sup>

The City's negotiating team made another presentation at the 29 April 2002 closed session meeting of the City Council to provide an update about the ongoing meet and confer negotiations. The presentation specifically outlined the deal to increase retirement benefits for City employees. City staff told the Mayor and Council members that the benefits would only be approved if SDCERS removed the trigger and continued

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<sup>29</sup> Slide show presentation from the 18 March 2002 closed session meeting of the San Diego City Council. (Exhibit 21)

<sup>30</sup> The meet and confer process is used for labor negotiations between the City and municipal unions to establish upcoming labor contracts. These contracts include items such as salary increases, benefit changes and other labor related items.

<sup>31</sup> Minutes of the San Diego City Council closed session meeting of 18 March 2002. (Exhibit 22)

<sup>32</sup> Assistant City Attorney Leslie Devaney's handwritten notes of the 18 March 2002 closed session meeting of the San Diego City Council. (Exhibit 22)

to allow the City to underfund the pension system. At this closed session meeting, the negotiating team sought authority to offer the following deal to the City's unions:

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

- A. Eliminate *or Reduce* the "trigger" established in the 1997 Manager's proposal to 75%
- B. If funding ratio "triggers" an increase in City's contribution rate, *phase in over 5 year period*
- C. Absorb Past Liability of the 1.50% at 55 benefit into CERS assets as an unfunded liability  
(this will reduce funding ratio 1% to 1.5%)<sup>33</sup>

This presentation by the City staff introduced two very important concepts to the Mayor and City Council. First, the retirement benefit enhancements would only be approved if SDCERS lowered the trigger. Second, the benefit increases would not be funded and would be calculated into the unfunded liability. In other words, the retroactive benefit increases would be added to the SDCERS debt with no plan for payment. Regardless, the City Council approved allowing the negotiating team to bring this package to the table by a vote of 9-to-0.<sup>34</sup>

It is important to note that at this meeting on 29 April 2002, the City Council also approved the issuance of a \$30 million lease revenue bond offering<sup>35</sup> that failed to include information about the potential financial implications regarding the trigger or the under funding debt resulting from MP I.

The negotiating team appeared back before the City Council in the closed session meeting on 6 May 2002 to discuss a new retirement benefit: a special benefit for the presidents of the municipal unions. The benefit as proposed, would allow a municipal

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<sup>33</sup> Slide 35 from the slide show presentation at the 29 April 2002 closed session meeting of the San Diego City Council. (Exhibit 23)

<sup>34</sup> Closed session report of the 29 April 2002 San Diego City Council closed session meeting. (Exhibit 24)

<sup>35</sup> Minutes of the 29 April 2002 meeting of the San Diego City Council. (Exhibit 25)



union president to receive a pension from the City of San Diego without actually working for the City. A slide presented to the City Council members stated:

Management Team Recommendation:

1. Allow the current Local 145 President to begin a paid Presidential Leave under the terms described in Issue 2 effective July 1, 2002
2. Allow 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.<sup>36</sup>

With this slide the Mayor and City Council members were told that, as part of the MP II deal, a special benefit would be bestowed upon the President of the Local 145 union, Ron Saathoff. The benefit would allow Saathoff to receive a pension from SDCERS while not actually serving as a City employee. The benefit, as proposed, would allow Saathoff to combine his union salary and his former salary as a City employee to calculate his pension. This deal would eventually bump Saathoff's monthly pension by \$2,530 – from \$7,173.43 to \$9,703.66 per month.<sup>37</sup> According handwritten minutes from Assistant City Attorney to Leslie Devaney, the Mayor and City Council approved the presidential benefit by a vote of 9-to-0.<sup>38</sup> The official minutes of the 6 May 2002 closed session meeting of the San Diego City Council also reflect a vote to allow the negotiating team to offer the presidential benefit in the meet and confer was approved by a vote of 9-to-0.<sup>39</sup>

In order for the plan to be put in place, however, several parties representing different interests needed to agree. First, the City and the unions had to agree. Second, the Board of SDCERS then had to approve the funding relief for the City and allow the City to pay less than actuarially required into the pension. Finally, the City would give its final

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<sup>36</sup> Closed session report of the 6 May 2002 San Diego City Council closed session meeting. (Exhibit 26)

<sup>37</sup> 17 May 2005, Declaration in Support of Arrest Warrant, Case No. CD190930-02. (Exhibit 49)

<sup>38</sup> Assistant City Attorney Leslie Devaney's handwritten minutes of the 6 May 2002 closed session meeting of the San Diego City Council. (Exhibit 27)

<sup>39</sup> Minutes of the 6 May 2002 closed session meeting of the San Diego City Council. (Exhibit 26)

approval for the retirement benefit increases. At this point, based on the action of all parties to date, ratification of the deal by all parties seemed assured.

However, on 14 June 2002, Cathy Lexin issued a memo to the Mayor and City Council alerting them that a problem had occurred at the SDCERS Board and the deal had hit a roadblock. Lexin notified the Mayor and Council that the funding plan – as proposed – would not be approved and the City would have to pay more.<sup>40</sup> Lexin wrote:

It is clear that the current arrangement whereby the City's contribution rate increase by a fixed 0.50% per year will not accomplish full funding as contemplated in the plan... We had hoped the SDCERS Board would accept our proposal to lower the funding ratio 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.<sup>41</sup>

In the 14 June 2002 letter, Lexin requested the Council approve a slightly enhanced offer to SDCERS:

Therefore, it is recommended that the City Council authorize the City manager to amend the proposal to be presented on June 21, 2002, by increasing the annual increase in City contribution from 0.50% per year to 1.00% beginning in FY05.... 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.<sup>42</sup>

The proposal stated that if the City violates the trigger, the City would pay more money into the system every year until the funded ratio rises to 90 percent. The City Council approved Lexin's recommendation by a 9-to-0 vote in the closed session meeting on 18 June 2002.<sup>43</sup> Again, this letter and the subsequent vote by the Mayor and City

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<sup>40</sup> 14 June 2002 letter from Cathy Lexin, human resources director, and Elmer Heap, head deputy city attorney, to Honorable Mayor and City Council. Subject: Meet and Confer: Contingent Retirement Benefits – Modified Proposal to San Diego City Employees Retirement System Board of Administration. (Exhibit 28)

<sup>41</sup> 14 June 2002 letter from Cathy Lexin, human resources director, and Elmer Heap, head deputy city attorney, to Honorable Mayor and City Council. Subject: Meet and Confer: Contingent Retirement Benefits – Modified Proposal to San Diego City Employees Retirement System Board of Administration. (Exhibit 28)

<sup>42</sup> 14 June 2002 letter from Cathy Lexin, human resources director, and Elmer Heap, head deputy city attorney, to Honorable Mayor and City Council. Subject: Meet and Confer: Contingent Retirement Benefits – Modified Proposal to San Diego City Employees Retirement System Board of Administration. (Exhibit 28)

<sup>43</sup> Closed session report of the 18 June 2002 meeting of the San Diego City Council. (Exhibit 29)

Council illustrate that they had knowledge of the City's pending financial troubles. More importantly, the vote indicates that they understood the problem well enough to discuss and approve a plan to hide the problem.

The SDCERS Board considered the issue at its 21 June 2002 meeting and continued the matter to a special meeting in July. This outcome was not what Lexin had anticipated. More importantly, it had the potential to unravel the deal that the City had been pushing with municipal unions and the SDCERS Board. This point is illustrated in a 23 June 2002 e-mail that Lexin sent to the Mayor, City Council members, and a number of high ranking City officials. Lexin wrote:

The Board's outside fiduciary counsel focused on the importance of 'process' and adequate time for Trustees to obtain all the information they felt they needed from their actuary and fiduciary counsel, to fully evaluate risk to the Board as fiduciary trustees associated with this proposal. MEA scheduled their ratification vote for next week, anticipating the Board's action on June 21. We have scheduled closed session for meet and confer for Tuesday, June 25 to discuss the implications of this deferral on the City's MOU with MEA, Local 127 and Local 145 ech [sic] if which included benefits contingent upon this action.<sup>44</sup>

Lexin explained the planned process for meeting the contingency requirements of the MP II deal in great detail to the Mayor and City Council. Lexin carefully detailed the importance of SDCERS Board's approval of the funding plan prior to the unions vote to approve the new labor contracts, which included the increased benefits.

Council member Byron Wear sent a reply to Lexin, the Mayor and Council members that illustrated his understanding of the fine details of the contingencies and the under funding elements of the MP II proposal. Wear wrote:

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<sup>44</sup> 23 June 2002 e-mail from Cathy Lexin to Mayor Dick Murphy; Council members Byron Wear, Brian Maienschein, Donna Frye, George Stevens, Jim Madaffer, Ralph Inzunza, Scott Peters, Toni Atkins. Carbon copied: City Attorney Casey Gwinn, Assistant City Attorney Leslie Devaney; Assistant City Attorney Leslie Girard; Deputy City Attorney Elmer Heap; City Manager Michael Uberuaga; and Assistant City Attorney Lamont Ewell. Subject: Retirement Board Action. (Exhibit 30)

Ms. Lexin,

Please be prepared to answer this question:

Why did you advise the City Council to go down this policy path if you did not have some degree of assurance and the timing of the decision making process from the Retirement Board in advance?

BYRON WEAR  
Councilmember<sup>45</sup>

This communication illustrated that Wear and the other Council members had been briefed and appraised of the contingency nature of the deal – that the approval of the increased benefits would only occur if the SDCERS Board allowed the City to under fund the pension system. The e-mail also showed that Lexin kept the Mayor and City Council appraised of the step-by-step process of moving the Manager’s Proposal II through the contingent approvals.

Despite the setback at the SDCERS Board, the plan proceeded forward as planned. On 1 July 2002, officials at MEA sent a “Hotsheet” titled “UPDATE: Members Ratify Contract Contingent on Retirement Board Decisions” to union members that stated that the labor contracts that resulted from the meet-and-confer process – which included the increased retirement benefits and the special “presidential benefit” for Judie Italiano – were approved by the membership. The notification stated:

This vote will be valid **only** if the 3-year contract includes the retirement benefit improvements slated for July 1, 2002. **The availability of these benefit improvements depends on a favorable vote of the Retirement Board of Trustees on the City’s request for a payment plan, which would lower the current ‘trigger’ from 82.3% to 75%.**<sup>46</sup> (Emphasis original)

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<sup>45</sup> 23 June 2002 e-mail from Council member Byron Wear to: Cathy Lexin, Mayor Dick Murphy; Council members Brian Maienschein, Donna Frye, George Stevens, Jim Madaffer, Ralph Inzunza, Scott Peters, Toni Atkins. Carbon copied: City Attorney Casey Gwinn, Assistant City Attorney Leslie Devaney; Assistant City Attorney Leslie Girard; Deputy City Attorney Elmer Heap; City Manager Michael Uberuaga; and Assistant City Attorney Lamont Ewell. Subject: Re: Retirement Board Action. (Exhibit 30)

<sup>46</sup> 1 July 2002. MEA “Hotsheet” sent to MEA members. “UPDATE: Members Ratify Contract Contingent on Retirement Board Decision.” (Exhibit 31)

The MEA “Hotsheet” also called on the membership to show up to the next SDCERS meeting to apply pressure on the SDCERS Board to approve the underfunding.

The Retirement Board of Trustees will meet July 11<sup>th</sup> at 9:00am [sic] at 401 B Street, Suite 400. Please attend this meeting – we need your support.<sup>47</sup>

This information sheet, sent to all MEA employees, illustrates that the membership and MEA officials were aware of the “contingent” nature of the MPII deal. More importantly, the “Hotsheet” specifically shows that the MEA leadership had detailed knowledge that the funded level of the retirement system would fall, as a result of approving MP II. This point is important because it illustrated that Lexin was working to keep everyone who needed to approve the deal informed – including the SDCERS Board, the unions, the Mayor and City Council.

Lexin continued to work behind the scenes to build support on the SDCERS Board to approve its portion of the MPII deal and allow the City to under fund the System. This point is made clear by a 8 July 2002 memorandum issued by Lexin and Heap to Mayor Dick Murphy and the City Council.<sup>48</sup> Lexin notified the Mayor and City Council in the memo that the outside counsel at SDCERS would not approve the under funding plan by the City:

Of major concern to the SDCERS Board contributing to the continuance of this matter was the lack of a final written report from their outside fiduciary counsel. The ‘draft’ report from fiduciary counsel published for the June 21, 2002 meeting was quite negative, clearing erring on the side of caution due to the fact that counsel, from his perspective, did not have time to evaluate the proposal sufficiently to render final advice.<sup>49</sup>

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<sup>47</sup> 1 July 2002. MEA “Hotsheet” sent to MEA members. “UPDATE: Members Ratify Contract Contingent on Retirement Board Decision.” (Exhibit 31)

<sup>48</sup> 8 July 2002. Memorandum from Cathy Lexin, human resources director; and Elmer Heap, head deputy city attorney; to Honorable Mayor and City Council. Subject: Meet and Confer: Contingent Retirement Benefits and Proposal to SDCERS. (Exhibit 32)

<sup>49</sup> 8 July 2002. Memorandum from Cathy Lexin, human resources director; and Elmer Heap, head deputy city attorney; to Honorable Mayor and City Council. Subject: Meet and Confer: Contingent Retirement Benefits and Proposal to SDCERS. (Exhibit 32)

Lexin, however, assured the Mayor and City Council that lobbying the SDCERS Retirement Administrator, Lawrence Grissom, may help the City achieve the approval of the outside counsel.

While we still have not seen the fiduciary counsel's final report, conversations with the Retirement Administrator lead us to be optimistic about a favorable report.<sup>50</sup>

More alarming, Lexin explained that she and the Retirement Administrator and a member of the SDCERS Board, Ron Saathoff, arranged to make a motion at the meeting. The motion would change MPII and remove the proposal to lower the 82.3 percent trigger. The new proposal would keep the trigger but if violated, the City would be given a period of five years to increase payments to the pension system to move the funded level of SDCERS back to 82.3 percent. In other words, if the SDCERS funded level fell below 82.3 percent, instead of the City making a one-time lump sum payment to bring the funded ratio back to 82.3 percent, the City would have a period of five years to make necessary payments to achieve the 82.3 percent funding level. Lexin wrote:

Based on our conversations with the Retirement Administrator, we anticipate a motion from a Board member which would further modify the proposal before the Board, by eliminating the request to lower the funded ratio floor, and including the five year phase-in if the trigger (82.3% funded ratio) is effectuated.

Given the importance of avoiding a 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...

If this modification is acceptable to the Board and Fiduciary Counsel, the practical impact on the City would be no different than the previously authorized City position.<sup>51</sup>

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<sup>50</sup> 8 July 2002. Memorandum from Cathy Lexin, human resources director; and Elmer Heap, head deputy city attorney; to Honorable Mayor and City Council. Subject: Meet and Confer: Contingent Retirement Benefits and Proposal to SDCERS. (Exhibit 32)

<sup>51</sup> 8 July 2002. Memorandum from Cathy Lexin, human resources director; and Elmer Heap, head deputy city attorney; to Honorable Mayor and City Council. Subject: "Meet and Confer: Contingent Retirement Benefits and Proposal to SDCERS." (Exhibit 32)

The letter to Mayor Dick Murphy and City Council provides additional evidence that they had detailed knowledge of the growing debt in the pension system as well as the plan to under fund it.

Mayor Murphy and the City Council held a closed session meeting on 9 July 2002 and considered the recommendation suggested by Lexin. According to the meeting minutes, Mayor Murphy and the City Council unanimously approved Lexin's proposal to:

Authorize modification of proposal – leave trigger at 82% of funding but 1 year grace period to pay (retirement formula), but only as a back-up if original proposal (75% trigger) fails at Retirement Board.<sup>52</sup>

The specificity and detail in the minutes of the 9 July 2002 closed session meeting provides further evidence that the Mayor and City Council had an in depth knowledge of the impending financial crisis facing the retirement system. The meeting minutes also provide further evidence that the Mayor and City Council members had thorough knowledge of the plan – which they approved – to allow the retirement system to slide further into debt by under funding while at the same time increasing retirement benefits.

The SDCERS Board met on 11 July 2002 and the SDCERS counsel did not support lowering the 82.3 percent “trigger” to 75 percent. According to the script described by Lexin, SDCERS Board Trustee Ronald Saathoff made a motion to change MP II. According to a transcript of the meeting, Saathoff said:

I'm going to offer a substitute. I'm just very concerned what we do is appropriate (inaudible) and I believe based on what I've heard today (inaudible) what I'm going to recommend is that in lieu of a substitute motion that we make a modification of the '96 proposal to allow that when the trigger is hit, in other words, I'm not changing the trigger. What I'm changing and proposing a change in the payment schedule upon that trigger being hit and that proposal schedule upon that trigger being hit and that proposal is that the difference between the rate at that time and the PUC rate (inaudible) actuarial assumptions will be phased in between that point and 2009 incrementally per year.<sup>53</sup>

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<sup>52</sup> Minutes of the 9 July 2002 closed session meeting of the San Diego City Council. (Exhibit 33)

<sup>53</sup> Transcript of the 11 July 2002 meeting of the San Diego City Employees' Retirement System Board of Administrators. (Exhibit 34)

The SDCERS Board approved the Saathoff's modification of MP II by a vote of 8-to-3, with Tom Rhodes and David Crow in opposition. SDCERS Trustee David Garnica abstained from the vote.<sup>54</sup>

On the following day, 12 July 2002, the MEA sent out another "Hotsheet" to its membership to announce that the contingencies for the final execution of the Manager's Proposal II had been met by the SDCERS Board's vote and that retirement benefit enhancements would go into effect. The "Hotsheet" stated:

This arrangement will be voted on in a closed session by the City Council but City Manager Michael Uberuaga has informed MEA that the 'motion approved by the Retirement Board was within the authority the Council had given him' and therefore he felt the contingencies of our ratified agreement had been met and we had an agreement. This means the negotiated retirement benefit improvements will be approved retroactive to July 1, 2002.<sup>55</sup>

This evidence clearly illustrates that the Mayor and the City Council members were apprised repeatedly throughout the meet-and-confer process that the debt, or unfunded liability, at the retirement system had substantially increased. The Mayor and City Council members were also apprised that by approving the retroactive retirement benefit enhancements included in the MP II package that the retirement system deficit would increase even more because no source of funding was identified.

Mayor Murphy and the City Council were also advised in a 29 October 2001 letter – prior to the start of the meet and confer process detailed above -- that a liability of this magnitude must be disclosed on the City's financial statements when money is borrowed from capital markets through the issuance of bonds. A letter from Gerald Boltz and Matthew Anhut, attorneys from Bryan Cave LLC, clearly outlined the City's responsibilities to disclose financial obligations to financial markets. The letter states:

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<sup>54</sup> Minutes of the 11 July 2002 meeting of the San Diego City Employees' Retirement System Board of Trustees. (Exhibit 35)

<sup>55</sup> 12 July 2002. MEA "Hotsheet" sent to MEA union membership. Subject: "News Flash!!" (Exhibit 36)



In light of the application of provisions of the federal securities laws, and in particular the obligation imposed on issuers in connection with the offering and sale of securities (as described below), and the allegations made in the September letter, each member of the City Council and Board of Commissioners must read the POS [public offering statement] (and when completed the Official Statement), ask questions as to any area or matter that may seem unclear or need clarification, actively seek information from the official of the City or Authority and professionals retained in connection with the proposed offering, and conduct follow-up as to the information supplied.<sup>56</sup>

The attorneys from Bryan Cave LLP also gave a precise explanation of the securities laws applicable to the Mayor and City Council's approval of financial documents to support the sale of municipal bonds. The letter stated:

While Congress exempted offerings of municipal securities, such as the 2001 Bonds, from the registration requirements of the Securities Act of 1933, and the system of periodic reporting under the Securities Exchange Act of 1934, it did not exempt transactions in municipal securities from the anti-fraud provisions of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5 thereunder. These provisions prohibit any person, including municipal issuers, from making a false or misleading statement of material fact, or omitting any material facts necessary to make statements made by that person not misleading, in connection with the offer, purchase or sale of any security.<sup>57</sup>

The letter from the Bryan Cave firm further outlined the roles and responsibilities of the City Council to ensure accurate information is included in the financial statements they approve:

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<sup>56</sup> 29 October 2001. Letter from Gerald Boltz and Matthew Anhut, counsel for Bryan Cave LLP, to Leslie Girard, assistant city attorney. Re: "Review of Disclosure Documents as to Lease Revenue Bonds 2001". (Exhibit 37)

<sup>57</sup> 29 October 2001. Letter from Gerald Boltz and Matthew Anhut, counsel for Bryan Cave LLP, to Leslie Girard, assistant city attorney. Re: "Review of Disclosure Documents as to Lease Revenue Bonds 2001". (Exhibit 37)

[I]t is critical that the City Council and the Board of Commissioners exercise all due care in reviewing and evaluating the information contained in the POS. As to that information, the statements in the POS ‘must be viewed as part of a ‘mosaic’ to see if those statements, in the aggregate, created a misleading impression....The proper test is not the literal truth or the materiality of each positive statement, but the overall misleading impression that it combines to create.<sup>58</sup>

This statement is crucial toward pinpointing the culpability of the Mayor and City Council because the letter clearly states that an in-depth financial analysis is not needed. Rather, the analysis must only recognize “misleading impressions.” It is also crucial because the Mayor and City Council were repeatedly told throughout the early parts of 2002 that City was facing an impending escalation of pension liabilities. The City’s outside auditor, KPMG, and more recently the SEC, pointed out that the financial statements reflecting the City’s pension liability were misstated.

The Bryan Cave letter also pulled from the experience of the SEC’s enforcement action against Orange County, just north of San Diego. The letter stated:

The importance of the review of municipal securities disclosure was highlighted in connection with an SEC report that was critical of the supervisors of Orange County, California for shortcomings relating to their review of such documents... **‘In authorizing the issuance of securities and related disclosure documents, a public official may not authorize disclosure that the official knew 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....**In this matter, such steps could have included becoming familiar with the disclosure documents and questioning the issuer’s officials, employees or other agents about the disclosure of those facts.’(Emphasis added.)<sup>59</sup>

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<sup>58</sup> 29 October 2001. Letter from Gerald Boltz and Matthew Anhut, counsel for Bryan Cave LLP, to Leslie Girard, assistant city attorney. Re: “Review of Disclosure Documents as to Lease Revenue Bonds 2001”. (Exhibit 37)

<sup>59</sup> 29 October 2001. Letter from Gerald Boltz and Matthew Anhut, counsel for Bryan Cave LLP, to Leslie Girard, assistant city attorney. Re: “Review of Disclosure Documents as to Lease Revenue Bonds 2001”. This particular portion of the letter was a quote from the SEC enforcement action and cease-and-desist order against Orange County. (Exhibit 37)

Again, the Bryan Cave firm explicitly clarified to the Mayor and City Council – illustrated with a highly publicized event that took place less than 100 miles away – that the board of directors of a municipality must review and ensure that no misleading impressions were made in the financial documents. The letter provided the most precise explanation of the Mayor and City Council duties:

The message communicated by the statements of the SEC in the forgoing report is that members of the body approving disclosure documents cannot simply ‘rubber-stamp’ the documents. Rather, each member has the responsibility to demonstrate that he or she was actively involved in the process – that is, each person must review the disclosure documents, inquire as to the source of the information, ask questions of the City officials and other professionals who provided the information..., and follow-up to ascertain whether the information makes sense in the circumstances. In short, the members of the City Council and the Board of Commissioners must demonstrate that they have satisfied themselves, after diligently inquiry that all material facts have been accurately disclosed, that the POS [public offering statement] is not misleading.<sup>60</sup>

The evidence presented in this letter makes is perfectly clear that the Mayor and City Council were, in easy to understand language, educated on their responsibility to review, question and analyze the financial disclosure documents. The Mayor and City Council members were educated about the law and were provided with contextual examples of how the laws were applied to a highly publicized SEC action involving a municipality neighboring San Diego.

Based on the evidence provided in this section of the report, the City Attorney believes that the Mayor and City Council were repeatedly educated on the impending skyrocketing liabilities facing the pension system and knowingly failed to ensure the proper disclosure of such information on the financial documents they approved. Based on the briefings that the Mayor and City Council received and approval votes given to attempt to address the oncoming financial trouble, the City Attorney believes that these public officials had sufficient knowledge to recognize that the pension liabilities were understated in the financial statements they approved. It is therefore the opinion of the City Attorney that evidence exists to support the allegation that the Mayor and City

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<sup>60</sup> 29 October 2001. Letter from Gerald Boltz and Matthew Anhut, counsel for Bryan Cave LLP, to Leslie Girard, assistant city attorney. Re: “Review of Disclosure Documents as to Lease Revenue Bonds 2001”. (Exhibit 37)

Council acted with scienter in the approval of the misleading financial documents. The SEC defined scienter in their enforcement action against Orange County as:

Scienter is a necessary element of a violation of Section 17(a)(1) of the Securities Act, Section 109b) of the Exchange Act, and Rule 10b-5 thereunder. Proof of scienter need not be direct, but may be ‘a matter of inference from circumstantial evidence.’ Scienter has been defined by the Supreme Court as ‘a mental state embracing intent to deceive, manipulate, or defraud.’ A showing of recklessness or actual knowledge can satisfy the scienter requirement.<sup>61</sup>

The Bryan Cave firm provided the Mayor and City Council with a more understandable definition of scienter when they defined it as, “recklessness or an intent to deceive, manipulate, or defraud.”<sup>62</sup>

### **3. CITY COUNCIL MEMBERS KNEW OF CITY’S IMPENDING FINANCIAL CRISIS IN PENSION SYSTEM**

#### **A. Kroll fails to resolve Mayor and City Council approval of inadequate financial disclosures from early in 2002**

In the portion of the report titled, “Disclosure Failures Related to the MP-1 Trigger,” Kroll and Willkie Farr identified “[t]hree bond offerings the Mayor and City Council approved during the first half of 2002...”<sup>63</sup> Kroll and Willkie Farr used these specific bond offerings to explore and identify individual responsibility for the City’s failure to disclose accurate information on financial statements. These three bond offerings included:

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<sup>61</sup> 24 January 1996. Securities and Exchange Commission; Administrative Proceeding, Order Instituting Cease-and-Desist Proceedings, Making Findings, and Imposing a Cease and Desist Order. (Exhibit 38)

<sup>62</sup> 29 October 2001. Letter from Gerald Boltz and Matthew Anhut, counsel for Bryan Cave LLP, to Leslie Girard, assistant city attorney. Re: “Review of Disclosure Documents as to Lease Revenue Bonds 2001”. (Exhibit 37)

<sup>63</sup> 8 August 2006. “Report of the Audit Committee of the City of San Diego: Investigation into the San Diego City Employees’ Retirement System and the City of San Diego Sewer Rate Structure.” P. 189-190. (Exhibit 39)

1. Public Facilities Financing Authority of the City of San Diego Lease Revenue Bonds, Series 2002 for the Ballpark Project for \$169,685,000 on 14 February 2002;
2. City of San Diego, California 2002-03 Tax Anticipation Notes Series A for \$92,200,000 on 4 June 2002; and
3. Public Facilities Financing Authority of the City of San Diego Lease Revenue Bonds Series 2002 B for Fire and Life Safety Facilities Project for \$25,070,000 on 12 June 2002.<sup>64</sup>

In its discussion of events surrounding MP II, Kroll and Willkie Farr first focused on the bond for the Ballpark Project, which was issued on 14 February 2002. The financial statements assembled by City staff and approved by the Mayor and City Council did not include accurate information about the City's financial condition. Specifically, the City did not disclose the debt created by years of under funding the pension and the looming liability for a violation of the trigger. Based upon this, the SEC found that the City violated federal securities laws because of the inaccurate information.<sup>65</sup> Kroll and Willkie Farr stated that the failure to include accurate information regarding the City's looming pension obligation in connection with issuing the Ballpark bonds was solely the fault of high-ranking City officials. Kroll wrote:

The Ballpark Bond offering was particularly significant. In August and September 2004 [sic] [should be 2001], Terri Webster had explicitly expressed her concern about this offering, noting that the BRC [Blue Ribbon Committee] Report should not 'mess w/ballpark bonds,' *i.e.*, the BRC Report, which would negatively describe the City's pension funding, should be delayed so it would not harm the Ballpark Bond offering. She was well aware that the disclosure of a potential large drop in the funded ratio would negatively impact the City's credit rating, and chose not to disclose this negative information...She was well aware that the disclosure

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<sup>64</sup> 8 August 2006. "Report of the Audit Committee of the City of San Diego: Investigation into the San Diego City Employees' Retirement System and the City of San Diego Sewer Rate Structure." P. 189-190. (Exhibit 39)

<sup>65</sup> 14 November 2006. Securities and Exchange Commission; Administrative Proceeding; Order Instituting Cease-and-Desist Proceedings, Making Findings, and Imposing a Cease-and-Desist Order Pursuant to Section 8A of the Securities Act of 1933 and Section 21C of the Securities Act of 1934. (Exhibit 40)

of a potential large drop in the funded ration would negatively impact the City's credit rating, and chose not to disclose this negative information.<sup>66</sup>

Kroll and Willkie Farr continued its focus specifically on "City officials" in its analysis of events leading to the approval of two additional financial disclosures which contained inaccurate information. Kroll and Willkie Farr concluded the following about the additional bond offerings for \$92 million in Tax Anticipation Notes Series A on 4 June 2002 and an additional \$25 million for Lease Revenue Bonds on 12 June 2002:

The City issued two additional bond offerings in June 2002. By this time, City and SDCERS officials had obtained additional information that projected the trigger would be breached as of June 30, 2002, and began discussing alternative funding proposals to either change or remove the trigger. By not disclosing the risk of the MP-1 trigger or even its existence in these bond offerings, City officials concealed material information from the investing public and violated the requirements to disclose factors that significantly affect the identification of trends in amounts reported under GASB 27.<sup>67</sup>

It is important to stress that Kroll and Willkie Farr specifically stated in the report: "By this time, City and SDCERS officials had obtained additional information...[and] City officials concealed material information from the investing public."<sup>68</sup> In other words, Kroll and Willkie Farr admitted that "City officials" were aware of the declining financial condition of the information in financial disclosure documents. Inexplicably, the analysis either deliberately concealed or was reckless to disregard a deeper analysis to determine the Mayor and City Council's culpability.

In fact, Kroll and Willkie Farr based the conclusions that "City and SDCERS officials had obtained additional information...[and] City officials concealed material information from the investing public" about the growing debt in the pension system on three pieces of evidence. These pieces of evidence include:

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<sup>66</sup> 8 August 2006. "Report of the Audit Committee of the City of San Diego: Investigation into the San Diego City Employees' Retirement System and the City of San Diego Sewer Rate Structure." P. 189-190. (Exhibit 39)

<sup>67</sup> 8 August 2006. "Report of the Audit Committee of the City of San Diego: Investigation into the San Diego City Employees' Retirement System and the City of San Diego Sewer Rate Structure." P. 189-190. (Exhibit 39)

<sup>68</sup> 8 August 2006. "Report of the Audit Committee of the City of San Diego: Investigation into the San Diego City Employees' Retirement System and the City of San Diego Sewer Rate Structure." P. 189-190. (Exhibit 39)

1. An e-mail from Lawrence Grissom to Terri Webster sent on 15 April 2002;
2. An e-mail from Ed Ryan to Terri Webster on 15 April 2002; and
3. An e-mail from Terri Webster to Elmer Heap and Michael Rivo and carbon-copied to Cathy Lexin sent on 17 April 2002.

Therefore, incredulously, using just three pieces of evidence, Kroll and Willkie Farr placed the culpability on a handful of City officials for the failure to include the accurate information about the City's potential liability for a lump-payment for the trigger in the financial statements. It is important to note that Kroll and Willkie Farr had access to more than one million documents collected by the firm as well as documents collected by Vinson & Elkins LLP, and documents collected in response to subpoenas issued by the FBI, the U.S. Attorney's Office, and the SEC.

The City Attorney believes that Kroll and Willkie Farr's analysis – in light of hundreds of additional exhibits used throughout its report, Vinson & Elkins reports, and eight City Attorney Interim Reports – is woefully inadequate particularly in view of the fact that it cost the City over \$20 million. More importantly, Kroll and Willkie Farr chose to exclude many pieces of information that support allegations that the Mayor and City Council were repeatedly educated about the impending financial debts being placed on the City as a result of the MP-1 trigger violation and the SDCERS investment losses.

In the report, Kroll and Willkie Farr stated that the Mayor and City Council were told that the trigger was going to be violated as early as 18 March 2002.<sup>69</sup> City officials appeared in a City Council closed session meeting on 18 March 2002 which focused on the City's potential violation of the "trigger." The following table was presented to the City Council at that meeting:<sup>70</sup>

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<sup>69</sup> 8 August 2006. "Report of the Audit Committee of the City of San Diego: Investigation into the San Diego City Employees' Retirement System and the City of San Diego Sewer Rate Structure." P. 233-5. (Exhibit 41)

<sup>70</sup> 8 August 2006. "Report of the Audit Committee of the City of San Diego: Investigation into the San Diego City Employees' Retirement System and the City of San Diego Sewer Rate Structure." P. 67. (Exhibit 42)

<b>Earnings Compared with Funding Ratio</b>		
FY 96	\$105.4 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.	\$50 to \$60 m	?

The PowerPoint slide, which Kroll and Willkie Farr referenced in their report, showed the declining funding ratio of the SDCERS system. The slide which was shown to the Mayor and City Council at a 18 March 2002 meeting also stated that the 82.3 percent funding “trigger” was in danger of being hit and could carry “a potential \$40m annual impact.”<sup>71</sup> Kroll and Willkie Farr wrote:

Any elected City official who did not know of this danger [of violating the trigger] learned of it on March 18, 2002, in a memorandum discussing the 2002 ‘meet and confer,’ when the Mayor and City Council were officially informed by the Labor Relations Manager Daniel Kelley that the funded ratio had significantly declined, approaching 85.6% or 83.1% ...and that if it fell below the MP-1 trigger, the City would be required to pay the ‘full rate,’ which was estimated to be ‘a potential \$40 [million] annual impact.’<sup>72</sup>

The table above clearly shows the declining funded ratio of the system. Thus, Kroll and Willkie Farr specifically stated that this information should have been included in financial documents and was material to investors. The report stated:

In the period leading up to MP-2, the sharp decline in SDCERS’s investment earnings and the imminent risk of blowing through the trigger were material facts that should have been disclosed. ...[T]he risks to the City’s fiscal health, inherent in MP-1, would have taken additional significance as the funded ratio dropped toward the floor.<sup>73</sup>

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<sup>71</sup> PowerPoint presentation to the San Diego City Council at the closed session meeting of 18 March 2002. (Exhibit 21)

<sup>72</sup> 8 August 2006. “Report of the Audit Committee of the City of San Diego: Investigation into the San Diego City Employees’ Retirement System and the City of San Diego Sewer Rate Structure.” P. 64. (Exhibit 43)

<sup>73</sup> 8 August 2006. “Report of the Audit Committee of the City of San Diego: Investigation into the San Diego City Employees’ Retirement System and the City of San Diego Sewer Rate Structure.” P. 190. (Exhibit 39)



Kroll and Willkie Farr specifically stated that information about the trigger should have been included in financial statements.<sup>74</sup> The report also stated:

The risk that the City would have to make a large balloon payment within a short period of time posed a threat to the City's ability to generate enough revenue in the year the balloon payment was due to satisfy all of its obligations for the year. That risk would have been material to an investor contemplating a purchase of the City's bonds.<sup>75</sup>

Kroll and Willkie Farr acknowledged in their report that the Mayor and the City Council were specifically told in the 18 March 2002 closed session City Council meeting that the trigger would likely be hit. The Mayor and City Council, however, approved the financial disclosures for the June 2002 bond offerings that failed to include this information. Conspicuously, Kroll and Willkie Farr failed to include this point in its analysis despite the fact that the PowerPoint of 18 March 2002 was referenced in the report.<sup>76</sup>

Kroll and Willkie Farr also included in their report a 15 April 2002 closed session meeting of the San Diego City Council meeting where the Mayor and City Council were presented information regarding the potential financial ramifications of violating the trigger. Kroll and Willkie Farr wrote:

[T]he City management team apparently presented a PowerPoint slide show to the City Council advancing an interpretation that a breach of the trigger would only require a return to the full actuarial rate. One of the slides in the presentation states: 'If CERS funding ratio drops below 82.3% (currently 89.9%) City must pay full actuarial rate, \$25m more annually.'<sup>77</sup>

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<sup>74</sup> 8 August 2006. "Report of the Audit Committee of the City of San Diego: Investigation into the San Diego City Employees' Retirement System and the City of San Diego Sewer Rate Structure." P. 190. (Exhibit 39)

<sup>75</sup> 8 August 2006. "Report of the Audit Committee of the City of San Diego: Investigation into the San Diego City Employees' Retirement System and the City of San Diego Sewer Rate Structure." P. 190. (Exhibit 39)

<sup>76</sup> 8 August 2006. "Report of the Audit Committee of the City of San Diego: Investigation into the San Diego City Employees' Retirement System and the City of San Diego Sewer Rate Structure." P. 234. (Exhibit 43)

<sup>77</sup> 8 August 2006. "Report of the Audit Committee of the City of San Diego: Investigation into the San Diego City Employees' Retirement System and the City of San Diego Sewer Rate Structure." P. 65. (Exhibit 44). This portion of the Kroll and Willkie Farr report references the PowerPoint presentation to the Mayor and City Council in the 18 March 2002 closed session meeting. (Exhibit 21).

Kroll and Willkie Farr included this information in their report and illustrated that the Mayor and City Council were repeatedly educated on the pending debt facing the pension system. However, the report failed to explain why the Mayor and City Council failed to ensure that this information was included on the financial statements which they approved.

The report stated that City staff appeared back before the City Council in the closed session meeting of 29 April 2002 to discuss the financial implication of the impending violation of the trigger. City staff presented a plan to actually remove the trigger and permit the SDCERS debt to grow. Kroll and Willkie Farr wrote of the meeting:

It was in the context of these discussions that the Mayor and City Council, in closed sessions in April and May 2002, agreed to a proposal which would condition certain retirement benefits on the SDCERS Board's agreement to eliminate the MP-1 trigger. In exchange, the City agreed to increase the basic multiplier...for retirement benefits for general employees to 2.5% from 2.25%.<sup>78</sup>

Kroll and Willkie Farr, however, stated that the Mayor and City Council approved allowing the negotiating team to bring this package to the table by a vote of 9-to-0.<sup>79</sup> The PowerPoint presentation given by City staff to the Mayor and City Council on 29 April 2002 was included in the report on pages 67 and 68.<sup>80</sup>

Kroll and Willkie Farr's report also stated that City staff appeared in a closed session meeting on 6 May 2002 to discuss the MP II package and the status of meet and

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<sup>78</sup> 8 August 2006. "Report of the Audit Committee of the City of San Diego: Investigation into the San Diego City Employees' Retirement System and the City of San Diego Sewer Rate Structure." P. 67. (Exhibit 42)

<sup>79</sup> Closed session report of the 29 April 2002 San Diego City Council closed session meeting. (Exhibit 24)

<sup>80</sup> 8 August 2006. "Report of the Audit Committee of the City of San Diego: Investigation into the San Diego City Employees' Retirement System and the City of San Diego Sewer Rate Structure." P. 66-67. (Exhibit 45)

confer.<sup>81</sup> The report, however, included no specifics of the information presented in the meetings.

Interestingly, Kroll and Willkie Farr discussed the implications of these meetings in their discussion of the passage of the retirement deals. The firms, however, excluded any analysis of culpability of the Mayor and City Council in analyzing their knowledge of the City's financial conditions in contrast to the incorrect information included in the financial disclosures. The report stated:

Early on in the meet and confer process, it was understood by City officials that there were serious financial consequences to the City if the MP-1 trigger was breached...It was in the context of these discussions that the Mayor and City Council, in closed sessions in April and May 2002 agreed to a proposal which would condition certain retirement benefits on the SDCERS Board's agreement to eliminate or reduce the MP-1 trigger.<sup>82</sup>

Here, once again, Kroll and Willkie Farr specifically acknowledged that the Mayor and City Council were repeatedly educated about the declining financial condition of SDCERS and, more importantly, that the City was facing a large financial payment.

Kroll and Willkie Farr, in the report, also provide a brief outline of how the bond information is presented to the Mayor and City Council members.

During the process of approving a bond offering resolution or ordinance, City Council members were generally provided with the applicable Preliminary Official Statement and back-up information about the offering under cover of a 'Form 472' (Request for Council Action). The Council members voted on the issuance in an open session, after the bond ordinance or resolution had been discussed at least once and a representative of Financing Services had briefed the City Council about the background of and issues relating to the bond issuances.<sup>83</sup>

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<sup>81</sup> 8 August 2006. "Report of the Audit Committee of the City of San Diego: Investigation into the San Diego City Employees' Retirement System and the City of San Diego Sewer Rate Structure." P. 67-68. (Exhibit 45)

<sup>82</sup> 8 August 2006. "Report of the Audit Committee of the City of San Diego: Investigation into the San Diego City Employees' Retirement System and the City of San Diego Sewer Rate Structure." P. 66-67. (Exhibit 45)

<sup>83</sup> 8 August 2006. "Report of the Audit Committee of the City of San Diego: Investigation into the San Diego City Employees' Retirement System and the City of San Diego Sewer Rate Structure." P. 171. (Exhibit 46)

Kroll and Willkie Farr had already stressed in its report that the information presented to the Mayor and City Council about the declining financial condition of SDCERS should have been included in the financial disclosure statements – which the Mayor and City Council approved. However, in Kroll and Willkie Farr’s final analysis, the Mayor and City Council were excluded from any culpability in the creation and approval of inaccurate and misleading financial disclosure documents. The report stated:

By not disclosing the risk of the MP-1 trigger or even its existence in these bond offerings, City officials concealed material information from the investing public and violated the requirements to disclose factors that significantly affect the identification of trends in amounts reported under GASB 27.<sup>84</sup>

Kroll and Willkie Farr’s analysis of the evidence regarding the financial condition of the City clearly failed to include the Mayor and City Council’s knowledge. Kroll and Willkie Farr clearly left out evidence in parts of its analysis to protect the Mayor and City Council who, at the time, authorized millions of dollars in payment despite numerous delays and incomplete billing. Indeed, Kroll and Willkie Farr’s cursory analysis of City officials’ culpability does not appear in the report until more than 150 pages later in the section titled, “Parties Responsible for Disclosure-Related Deficiencies and Violations of Law,” under the subsection titled, “City Council’s Responsibility for the City’s Disclosure Failures: Pension and Wastewater.” Two of the most vital pieces of evidence illustrating that the Mayor and City Council knowingly failed to include financial information in the financial disclosure appeared in this section for the first time.

The first items discussed in this section of the report were regulatory clarifications that resulted from the Orange County bankruptcy proceedings in 1996. The report stated:

Elected officials who authorize the issuance the of municipal securities have an obligation to satisfy themselves that the disclosures made in connection with those issuances accurately disclose significant risks to the investing public. In the wake of the bankruptcy of Orange County , the SEC issued a well publicized Report of Investigation ‘to emphasize the

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<sup>84</sup> 8 August 2006. “Report of the Audit Committee of the City of San Diego: Investigation into the San Diego City Employees’ Retirement System and the City of San Diego Sewer Rate Structure.” P. 190. (Exhibit 39)

responsibilities under the federal securities laws of local government officials who authorize the issuance of municipal securities and related disclosure documents and the critical role such officials play with respect to the representations contained in the Official Statements for those securities.’<sup>85</sup>

Kroll and Willkie Farr relied on another excerpt from the “Report on Investigation in the Matter of County of Orange, California as It Relates to the Conduct Members of the Board of Supervisors” to further emphasize the important role played by the public officials of a municipality to ensure accurate information is included in financial disclosures:

[T]he antifraud provisions of the federal securities laws impose responsibilities on a public official who authorizes the offer and sale of securities. A public official who approves the issuance of securities and related disclosure documents may not authorize disclosure that the public official knows to be materially false or misleading; nor may the public official authorize disclosure while recklessly disregarding facts that indicate that there is a risk that the disclosure may be misleading.<sup>86</sup>

Kroll and Willkie Farr also included in their report a letter sent to the City on 29 October 2001 from the Los Angeles-based law firm, Bryan Cave LLP to illustrate that the Mayor and City Council were told of their responsibilities under federal scienter laws. The letter laid out in careful detail the responsibilities of the Mayor and City Council to ensure that accurate financial information is included in bond disclosure documents. As discussed by the City Attorney in previous sections of this report, the Bryan Cave letter specifically outlined the duties of the Mayor and City Council to ensure correct information appears on financial documents and approving those financial disclosures. Kroll and Willkie Farr wrote:

Not only was the Orange County Report the subject of news reports that should have been followed closely by any leader of municipal government, its lessons were directly communicated to San Diego’s

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<sup>85</sup> 8 August 2006. “Report of the Audit Committee of the City of San Diego: Investigation into the San Diego City Employees’ Retirement System and the City of San Diego Sewer Rate Structure.” P. 232. (Exhibit 41)

<sup>86</sup> 8 August 2006. “Report of the Audit Committee of the City of San Diego: Investigation into the San Diego City Employees’ Retirement System and the City of San Diego Sewer Rate Structure.” P. 232. (Exhibit 41)

Mayor and City Council both orally and in writing. In advance of the Council's approval of the Ballpark Bonds, the Mayor and City Council members received the Bryan Cave memo, which warned that Council members 'cannot simply 'rubber stamp' the [disclosure] documents.'<sup>87</sup>

Kroll and Willkie Farr therefore explained that the Mayor and City Council should have been aware of the Orange County report by the SEC and that the Mayor and the City Council were briefed on their duties by the Bryan Cave law firm. Kroll and Willkie Farr went even further in their analysis:

As an initial matter, the language of the memorandum broadly describes the Council's obligation in authorizing bond issuances; it does not limit the description of the Council's legal obligations to any one issuance. With respect to what was communicated by Mr. Boltz in the closed session presentation, both Messrs. Girard and [Matthew] Anhut [co-author of memo from Bryan Cave LLP] recalled that Mr. [Gerald] Boltz [co-author of memo from Bryan Cave LLP] generally explained duties imposed upon the Council by the securities laws. Mr. Anhut recalled hearing that, according to Mr. Girard, Council members had asked questions suggesting they had been somewhat shaken by Mr. Boltz's presentation.<sup>88</sup>

In these passages, Kroll and Willkie Farr presented the fact that the Mayor and City Council were educated about the future financial crisis facing the City as well as their responsibility to ensure the inclusion of complete and accurate information in financial disclosure statements. Kroll and Willkie Farr reasserted that the Mayor and City Council were presented with detailed information about the pending financial problems. The report stated:

In the months following this advice, the Council learned of several instances where the City faced significant potential liability, but made no inquiry as to whether these potential threats to the City's finances were disclosed to the investing public.<sup>89</sup>

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<sup>87</sup> 8 August 2006. "Report of the Audit Committee of the City of San Diego: Investigation into the San Diego City Employees' Retirement System and the City of San Diego Sewer Rate Structure." P. 232. (Exhibit 41)

<sup>88</sup> 8 August 2006. "Report of the Audit Committee of the City of San Diego: Investigation into the San Diego City Employees' Retirement System and the City of San Diego Sewer Rate Structure." P. 233. (Exhibit 41)

<sup>89</sup> 8 August 2006. "Report of the Audit Committee of the City of San Diego: Investigation into the San Diego City Employees' Retirement System and the City of San Diego Sewer Rate Structure." P. 234. (Exhibit 44)

At this point, using only a portion of the evidence available, Kroll and Willkie Farr had presented sufficient evidence to support the allegation that the Mayor and City Council at least knowingly failed their obligations established by federal securities laws. In fact, Kroll and Willkie Farr provide this summation:

As the legislative branch of government, the City Council was a key party in the enactment of MP-1 and MP-2 and again in 2002, the City Council voted to approve pension funding arrangements that violated the California Constitution, the City Charter, and the Municipal Code. Despite the plain language of the controlling statutes, and their obligation as elected officials to uphold the laws of the City and State, there is no evidence the Council members ever bothered to inquire whether these agreements were permissible under California law....[T]he Council's vote in approving both MP-1 and MP-2 resulted in an illegally funded pension system.<sup>90</sup>

Instead of moving forward with an analysis of the culpability relying on the facts presented, Kroll and Willkie Farr changed direction and began to formulate a defense for the Mayor and City Council. The report stated:

In fairness to the Council, several facts must be noted. First, the Council members clearly did not view ensuring the accuracy of the bond disclosures as part of their duties, and aside from the Bryan Cave Memorandum, no one told them that they were charged with that obligation.<sup>91</sup>

Here, it is clear that Kroll and Willkie Farr's message is contradictory. Kroll and Willkie Farr explained, in detail, the ramifications of the securities laws resulting from the Orange County bankruptcy and the detailed explanation from the Bryan Cave law firm. Therefore, based on the evidence that Kroll and Willkie Farr presented, the Mayor

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<sup>90</sup> 8 August 2006. "Report of the Audit Committee of the City of San Diego: Investigation into the San Diego City Employees' Retirement System and the City of San Diego Sewer Rate Structure." P. 129. (Exhibit 47)

<sup>91</sup> 8 August 2006. "Report of the Audit Committee of the City of San Diego: Investigation into the San Diego City Employees' Retirement System and the City of San Diego Sewer Rate Structure." P. 235. (Exhibit 44)

and City Council should have been perfectly clear on their responsibility and duty to review the financial disclosures.

Kroll and Willkie Farr's only defense for the Mayor and City Council regarding the securities laws laid out in the Orange County Report is that the Mayor and City Council were not sufficiently cognizant the extent of their responsibility.<sup>92</sup> This point is also clearly disproved by the Bryan Cave letter, which Kroll and Willkie Farr referenced repeatedly.

Kroll and Willkie Farr, however, continued to formulate the defense for the Mayor and City Council in the report:

Although, the SEC asserted in the Orange County Report that such reliance does not absolve local officials of their duty to take 'appropriate steps' when they know of facts indicating a risk that a disclosure may be misleading, the facts to the Orange County Supervisors were very different than the facts known to the Council...San Diego's City Manager form of government placed far less power and responsibility with the City Council. The City Manager was responsible for the activities of all City departments, including those tasked with preparing the bond disclosures.<sup>93</sup>

Kroll and Willkie Farr's assertion that the City Manager is more culpable than the Mayor and City Council is completely unfounded. The City Manager's duties to prepare the financials were a legal issue separate and apart from the Mayor and City Council's duty to perform an adequate review of the information and approve it. Both the Orange County case and the Bryan Cave memo clearly explained that fact. Indeed, it is crucially important to note that Kroll and Willkie Farr repeatedly acknowledged throughout the report that City staff briefed the Mayor and City Council about the declining financial condition of the pension system – none of which was included in the June 2002 financial documents.

In their analysis, Kroll and Willkie Farr found that the City Council acted with the lowest form of securities violation: negligence. Kroll wrote:

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<sup>92</sup> 8 August 2006. "Report of the Audit Committee of the City of San Diego: Investigation into the San Diego City Employees' Retirement System and the City of San Diego Sewer Rate Structure." P. 231-236. (Exhibit 44)

<sup>93</sup> 8 August 2006. "Report of the Audit Committee of the City of San Diego: Investigation into the San Diego City Employees' Retirement System and the City of San Diego Sewer Rate Structure." P. 235. (Exhibit 44)



The Council's awareness of potentially significant liabilities in advance of several of those [bond] issuances should have caused the Council to take appropriate steps to make sure the City was not disseminating inaccurate or misleading information about these liabilities, by reading the disclosures or even just asking questions. It took no such steps. As such, the Mayor and City Council must share the responsibility for some of the City's disclosure failures due to their negligent behavior.<sup>94</sup>

This statement sets the stage for Kroll's final finding as to the Mayor and City Council members which stated:

As to members of the City Council, we believe the evidence supports a determination that the following Council members were negligent in fulfillment of their bond offering disclosure responsibilities: Mayor Richard Murphy[;] Councilmember Toni Atkins [;] Councilmember Donna Frye [;] Councilmember Ralph Inzunza [;] Councilmember Jim Madaffer [;] Councilmember Brian Maienschein [;] Councilmember Scott Peters [;] Councilmember George Steven [;] Councilmember Byron Wear.<sup>95</sup>

The evidence as presented by Kroll and Willkie Farr clearly illustrated that the Mayor and City Council knew of the City's declining financial condition and growing pension debt. The evidence, as presented by Kroll and Willkie Farr, also clearly illustrated that the Mayor and City Council were educated in writing and verbally about their responsibility to ensure accurate information. Kroll and Willkie Farr even referenced a statement from Bryan Cave that the Mayor and City Council were alarmed by this responsibility. Thus, Kroll's analysis was not only inadequate, but was also incorrect.

The City Attorney believes that evidence exists to support a conclusion that the Mayor and City Council were, in fact, educated repeatedly as to the City's impending violation of the MP I trigger and accompanying debts and chose to support bond offering documents which failed to include the accurate financial information.

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<sup>94</sup> 8 August 2006. "Report of the Audit Committee of the City of San Diego: Investigation into the San Diego City Employees' Retirement System and the City of San Diego Sewer Rate Structure." P. 236. (Exhibit 44)

<sup>95</sup> 8 August 2006. "Report of the Audit Committee of the City of San Diego: Investigation into the San Diego City Employees' Retirement System and the City of San Diego Sewer Rate Structure." P. 239. (Exhibit 44)

## **B. Kroll Failed to Include Key Evidence of City Council Knowledge**

The City Attorney believes that Kroll and Willkie Farr's conclusion that the Mayor and City Council were only negligent is misleading and inaccurate because many pieces of key evidence were excluded from the discussion of culpability in the approval of inaccurate financial statements to investors. In its analysis of City officials' knowledge and culpability regarding inaccurate or misleading information on financial disclosures, Kroll and Willkie Farr immediately identified that City staff were aware of the City's declining financial condition. Kroll stated:

Early on in the meet and confer process, it was understood by City officials that there were serious financial consequences to the City if the MP-1 trigger was breached.<sup>96</sup>

Kroll and Willkie Farr also identified that the Mayor and City Council were made aware of the potentially difficult financial situation the City faced if the trigger was hit. The report stated:

By March, it was clear to the Council it was likely that the City could owe up to an extra \$40 million to the pension the next year.

It was in the context of these discussions that the Mayor and City Council, in closed sessions in April and May 2002 agreed to a proposal which would condition certain retirement benefits on the SDCERS Board's agreement to eliminate or reduce the MP-1 trigger. In exchange, the City agreed to increase the basic multiplier...for retirement benefits for general employees to 2.5% from 2.25%.<sup>97</sup>

Kroll and Willkie Farr then turned the focus away from what exactly the Mayor and City Council learned about the City's financial condition that was not disclosed in two bond disclosure statements in April and June 2002.

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<sup>96</sup> 8 August 2006. "Report of the Audit Committee of the City of San Diego: Investigation into the San Diego City Employees' Retirement System and the City of San Diego Sewer Rate Structure." P. 66. (Exhibit 45)

<sup>97</sup> 8 August 2006. "Report of the Audit Committee of the City of San Diego: Investigation into the San Diego City Employees' Retirement System and the City of San Diego Sewer Rate Structure." P. 67. (Exhibit 45)

The task of determining what the Mayor and the City Council were educated about and when is at the heart of determining whether any illegal acts took place.<sup>98</sup> In these meetings, as illustrated above by Kroll and Willkie Farr and in this report, the Mayor and the City Council were shown a number of PowerPoint presentations that included detailed information about the City’s growing debts and generally declining financial condition.

Kroll and Willkie Farr pointed out that in the 18 March 2002 closed session meeting of the City Council, City staff presented a PowerPoint slide showing “a potential \$40 million annual impact” or liability if the MP-1 trigger was violated.<sup>99</sup>

Kroll and Willkie Farr, however, failed to mention more conclusive information from the meeting that clearly illustrated that the Mayor and City Council were aware of another large debt facing the pension system. As stated above, the City Council was presented the following information in a PowerPoint slide:

<b>Period</b>	<b>Actual Rate</b>	<b>City Paid Rate</b>	<b>Difference \$</b>
FY96	8.60%	7.08%	\$5.33m
FY97	9.55%	7.33%	\$13.88m
FY98	10.87%	7.83%	\$16.67m
FY99	10.86%	8.33%	\$15.40m
FY2000	11.48%	8.83%	\$14.00m
FY2001	11.96%	9.33%	\$12.45m
FY2002	12.58%	9.83%	\$10.72m
			\$88.45m

The table shows the debt created by following the payment schedule created as part of MP I. The City Council members were clearly told that as a result of MPI, the City under funded the pension by \$88.45 million between 1996 through 2002 – leaving the City liable for a \$88.45 million debt in the pension system. This information was excluded from Kroll and Willkie Farr’s analysis of the Mayor and City Council’s culpability and knowledge of the City’s financial declining condition.

<sup>98</sup> American Institute of Certified Public Accountants – AU § 317, “Illegal Acts by Clients.” (Exhibit 6)

<sup>99</sup> 8 August 2006. “Report of the Audit Committee of the City of San Diego: Investigation into the San Diego City Employees’ Retirement System and the City of San Diego Sewer Rate Structure.” P. 235. (Exhibit 44)

Another important piece of evidence that was not included in Kroll and Willkie Farr’s analysis of the Mayor and City Council’s culpability was a handwritten note by Assistant City Attorney Leslie Devaney that illustrates exactly what the Mayor and City Council discussed. Devaney wrote that the Mayor and City Council vote reflected their “willingness and desire to discuss retirement + trigger...”<sup>100</sup> The note illustrates that the Mayor and City Council were told about the declining financial health of the pension system and were aware that action needed to be taken to deal with the impending liabilities resulting from violating the trigger.

Kroll and Willkie Farr also omitted from their analysis a series of PowerPoint slides from the 29 April 2002 closed session meeting of the San Diego City Council where the Mayor and City Council were told again that the City was dangerously close to hitting the trigger established by MP I. The City Council was alerted to the potential detrimental financial repercussions of violating the trigger. The Mayor and the City Council were shown the following slide at the meeting:

<b>Earnings Compared with Funding Ratio</b>		
FY 96	\$105.4 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.	\$50 to \$60 m	?

The Mayor and the City Council were thereby put on alert that the potential for a large financial burden could be facing the City. More importantly, the Mayor and Council were told of the financial problems prior to authorizing the misleading financial disclosures.

Perhaps most alarming, Kroll and Willkie Farr missed a crucial connection. The firms’ report showed that the Mayor and City Council had been notified that the City was liable for \$88.45 million from pension underfunding related to MP 1. Kroll and Willkie Farr, however, failed to effectively bring home the fact that, the Mayor and City Council approved a bond sale in the 29 April 2002 City Council meeting which failed to include

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<sup>100</sup> Assistant City Attorney Leslie Devaney’s handwritten notes of the 18 March 2002 closed session meeting of the San Diego City Council. (Exhibit 22)

that \$88.45 million liability in the financial statement. In short, the Mayor and City Council approved the bond sale on the very same day that they were informed about the \$88.45 million liability. Kroll and Willkie Farr, however, excluded this highly relevant information from the supposedly highly comprehensive report.

Kroll and Willkie Farr included in their report a PowerPoint presentation that City staff presented to the Mayor and City Council on 6 May 2002.<sup>101</sup> Evidence was included to support the claim in the report that “[i]t was in the context of these discussions that the Mayor and City Council, in closed sessions...agreed to a proposal which would condition certain retirement benefits on the SDCERS Board’s agreement to eliminate or reduce the MP-1 trigger.”<sup>102</sup> Kroll and Willkie Farr, however, left out key pieces of evidence that illustrate what the Mayor and City Council were told about the City’s pension liabilities.

As Kroll and Willkie Farr pointed out repeatedly throughout its report, numerous changes were made to the MP II proposal from the time it was presented to the Mayor, City Council and SDCERS Board until it was finally approved on 18 November 2002. Kroll and Willkie Farr diligently identified many of the meetings in which changes to the proposal were presented to the SDCERS Board by City officials.<sup>103</sup>

Kroll and Willkie Farr, however, misrepresented a series of crucial communications from City staff and subsequent votes by the Mayor and City Council in June 2002. As explained in detail above, Cathy Lexin issued a memo to the Mayor and City Council on 14 June 2002 alerting them that a problem occurred at the SDCERS

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<sup>101</sup> 8 August 2006. “Report of the Audit Committee of the City of San Diego: Investigation into the San Diego City Employees’ Retirement System and the City of San Diego Sewer Rate Structure.” P. 67. (Exhibit 45)

<sup>102</sup> 8 August 2006. “Report of the Audit Committee of the City of San Diego: Investigation into the San Diego City Employees’ Retirement System and the City of San Diego Sewer Rate Structure.” P. 67. (Exhibit 45)

<sup>103</sup> Kroll and Willkie Farr cited to the following documents: E-mail from Terri Webster to Ed Ryan and Dan Kelley cc to Bob Lawrence, Bob Wilson, and Elmer Heap (May 21, 2002); Memorandum from Daniel E. Kelley, Labor Relations Manager, to Management Team (May 17, 2002); Memorandum from Michael T. Uberuaga, City Manager, to Lawrence B. Grissom, Retirement Administrator (May 15, 2002); Proposal from City of San Diego to San Diego City Firefighters Local 145 (May 20, 2002); San Diego Closed Session Report, with attached PowerPoint Presentation, San Diego City Council Meet and Confer 2002 Closed Session (May 6, 2002); PowerPoint Presentation, San Diego City Council Meet and Confer 2002 Closed Session (May 6, 2002); PowerPoint Presentation; San Diego City Council Meet and Confer 2002 Closed Session (Apr. 29, 2002)

Board and the MP 2 deal had hit a roadblock. Lexin notified the Mayor and Council that the funding plan as proposed would not be approved.<sup>104</sup> Lexin requested the Council to approve a slightly enhanced offer to SDCERS. The new proposal stated that if the City violates the trigger, the City would pay more money into the system every year until the funded ratio rises to 90 percent. The City Council approved Lexin's recommendation by a 9-to-0 vote in the closed session meeting on 18 June 2002.<sup>105</sup>

The SDCERS Board considered the issue at its 21 June 2002 meeting and continued the matter to a special meeting in July. This outcome was not what Lexin had anticipated and had the potential to unravel the deal that the City had been pushing with municipal unions and the SDCERS Board. This point is illustrated in a 23 June 2002 e-mail that Lexin sent to the Mayor, City Council members, and a number of high ranking City officials. Lexin wrote:

The Board's outside fiduciary counsel focused on the importance of 'process' and adequate time for Trustees to obtain all the information they felt they needed from their actuary and fiduciary counsel, to fully evaluate risk to the Board as fiduciary trustees associated with this proposal. MEA scheduled their ratification vote for next week, anticipating the Board's action on June 21. We have scheduled closed session for meet and confer for Tuesday, June 25 to discuss the implications of this deferral on the City's MOU with MEA, Local 127 and Local 145 ech [sic] if which included benefits contingent upon this action.<sup>106</sup>

Lexin, in the e-mail, explained the planned process for meeting the contingency requirements of the MP II deal in great detail to the Mayor and City Council. Lexin went into careful detail about the importance of SDCERS Board's approval of the funding plan before the unions vote to approve the new labor contracts, which included the increased benefits.

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<sup>104</sup> 14 June 2002 letter from Cathy Lexin, human resources director, and Elmer Heap, head deputy city attorney, to Honorable Mayor and City Council. Subject: Meet and Confer: "Contingent Retirement Benefits – Modified Proposal to San Diego City Employees Retirement System Board of Administration." (Exhibit 28)

<sup>105</sup> Closed session report of the 18 June 2002 meeting of the San Diego City Council. (Exhibit 29)

<sup>106</sup> 23 June 2002 e-mail from Cathy Lexin to Mayor Dick Murphy; Council members Byron Wear, Brian Maienschein, Donna Frye, George Stevens, Jim Madaffer, Ralph Inzunza, Scott Peters, Toni Atkins. Carbon copied: City Attorney Casey Gwinn, Assistant City Attorney Leslie Devaney; Assistant City Attorney Leslie Girard; Deputy City Attorney Elmer Heap; City Manager Michael Uberuaga; and Assistant City Attorney Lamont Ewell. Subject: Retirement Board Action. (Exhibit 30)

This memo from Lexin appeared in Kroll and Willkie Farr's report twice. The first time, on page 135 in footnote 710, to illustrate that Elmer Heap, a deputy city attorney, was a part of the City's negotiating team in the meet and confer process. The second, on page 191 in footnote 1017, to show that City staff believed that the 82.3 percent funding trigger for the pension fund had been triggered. Kroll and Willkie Farr, however, never made the connection that the memo served as yet another update to the Mayor and City Council to establish their knowledge of growing pension liabilities facing the City.

The City Attorney believes that these pieces of evidence that Kroll and Willkie Farr excluded and mischaracterized in the report serve to illustrate that the Mayor and City Council were told repeatedly of the increased pension liabilities facing the City which were absent from financial disclosures that the Mayor and City Council approved.

#### **IV. KROLL FAILS TO ANSWER QUESTIONS REGARDING POTENTIAL SECURITIES FRAUD**

On 9 August 2004, the City's outside auditing firm, KPMG, issued a letter to the City that stated that numerous concerns have been raised illustrating potential illegal acts in the issuance of "more than \$2.3 billion in municipal bonds using financial statements believed to contain certain errors or omissions."<sup>107</sup> Specifically, KPMG noted the following potential problems:

1. In September 2003, Ms. Diann Shipione, a San Diego City Employees' Retirement System (SDCERS) Board Member and Trustee, notified city officials and underwriters of errors and omissions in the City's financial statements dating back to 1996 and asserted the errors falsely improved the City's financial condition and were done intentionally to misstate and hide the real condition of the pension system...
  
4. Ms. Shipione has alleged in various communications with the City Council, Mayor and other top city officials, that the steps taken to deliberately underfund the plan are illegal, violate the City Charter, and are at odds with statutes and court cases of the State of California.

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<sup>107</sup> 9 August 2004 letter Steven G. DeVetter, partner at KPMG, to Leslie Girard, assistant city attorney for the City of San Diego. Subject: "Re: Investigation". (Exhibit 5)

5. Ms. Shipione has alleged that the decision to allow the underfunding was reached through a corrupt process in which the required funding was deferred to garner benefits for current employees.<sup>108</sup>

KPMG, in no uncertain terms, directed the City to investigate these allegations of potentially illegal acts and reach conclusions before KPMG would issue an audit. KPMG also advised that the accounting profession had specific rules on how these investigations were to proceed and included American Institute of Certified Public Accountants (AICPA) section AU 317 which states:

When the auditor becomes aware of information concerning a possible illegal act, the auditor should obtain an understanding of the nature of the act, the circumstance in which it occurred, and sufficient other information to evaluate the effect on the financial statements. In doing so, the auditor should inquire of management at a level above those involved, if possible. If management does not provide satisfactory information that there has been no illegal act, the auditor should –

- a. Consult with the client’s legal counsel or other specialists about the application of relevant laws and regulations to the circumstances and the possible effects on the financial statements. Arrangement for such consultation with client’s legal counsel should be made by the client.
- b. Apply additional procedures, if necessary, to obtain further understanding of the nature of the acts.<sup>109</sup>

KPMG also included in the letter a list of questions that should be answered in an investigative report. The questions included:

1. Whether or not the financial statement and or the disclosures in the financial statement were intentionally misleading and, if yes, what individuals were involved and what, if any, remedial action is recommended?
2. Did the City enter into any agreement, including the “Managers Two” agreement, or otherwise take any actions that resulted in the underfunding

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<sup>108</sup> 9 August 2004 letter Steven G. DeVetter, partner at KPMG, to Leslie Girard, assistant city attorney for the City of San Diego. Subject: “Re: Investigation”. (Exhibit 5)

<sup>109</sup> 9 August 2004 letter Steven G. DeVetter, partner at KPMG, to Leslie Girard, assistant city attorney for the City of San Diego. Subject: “Re: Investigation”. (Exhibit 5)



or misuse of pension funds that is a violation of State, City or other laws?<sup>110</sup>

In an effort to comply, the City contracted Houston-based law firm Vinson & Elkins to complete the investigation. KPMG also stated in its 9 August 2004 letter that “we will not issue our auditors’ report until a determination is made that the investigation being completed by [Vinson & Elkins] is sufficient and complete.”<sup>111</sup>

Vinson & Elkins submitted a final report to the City of San Diego on 16 September 2004. The report found that a series of disclosure violations occurred. The report found “no evidence of affirmative deception,” noting that those “individuals responsible for the City’s disclosure lacked both motive and opportunity to mislead.”<sup>112</sup> Vinson & Elkins further found “no evidence that any City employees were personally enriched as a result of the disclosure decisions in which they participated.”<sup>113</sup>

In the report’s conclusion, Vinson & Elkins found it “difficult to attribute the City’s failure to fully and accurately describe [this] matter to intentional misconduct on the part of individualized employees.”<sup>114</sup> In essence, Vinson & Elkins cleared all individuals from purposefully committing any illegal activities but failed in any meaningful way to substantiate the basis for its conclusion.

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<sup>110</sup> 9 August 2004 letter Steven G. DeVetter, partner at KPMG, to Leslie Girard, assistant city attorney for the City of San Diego. Subject: “Re: Investigation”. (Exhibit 5)

<sup>111</sup> 9 August 2004 letter Steven G. DeVetter, partner at KPMG, to Leslie Girard, assistant city attorney for the City of San Diego. Subject: “Re: Investigation”. (Exhibit 5)

<sup>112</sup> 16 September 2004. Vinson & Elkins: Report on Investigation: The City of San Diego, California’s Disclosure Obligations to Find the Can Diego City Employees’ Retirement System and Related Disclosure Practices 1996-2004 with Recommended Procedures and Changes to the Municipal Code. P. 169. (Exhibit 7)

<sup>113</sup> 16 September 2004. Vinson & Elkins: Report on Investigation: The City of San Diego, California’s Disclosure Obligations to Find the Can Diego City Employees’ Retirement System and Related Disclosure Practices 1996-2004 with Recommended Procedures and Changes to the Municipal Code. P. 169. (Exhibit 48)

<sup>114</sup> 16 September 2004. Vinson & Elkins: Report on Investigation: The City of San Diego, California’s Disclosure Obligations to Find the Can Diego City Employees’ Retirement System and Related Disclosure Practices 1996-2004 with Recommended Procedures and Changes to the Municipal Code. P. 169. (Exhibit 48)

KPMG immediately voiced concerns about the quality, depth and independence of the investigation and the resulting conclusions.<sup>115</sup> The firm issued a letter to the City on 11 October 2004 which stated that the report was insufficient to meet professional auditing standards and that an “illegal acts” analysis was necessary for the audit to be completed. KPMG partner, DeVetter wrote:

[W]e do not believe that the City of San Diego (“City”) has conducted an adequate investigation in order to conclude that likely illegal acts have not occurred, or that appropriate remedial action has been taken. Such an investigation is necessary in order for an auditor to complete an audit in accordance with generally accepted auditing standards and *Government Auditing Standards*.<sup>116</sup>

More specifically, KPMG pointed out that the Vinson & Elkins investigation failed to answer the question of whether the City Council took “actions that resulted in the underfunding or misuse of pension funds that is a violation of State, City or other laws.”<sup>117</sup> Specifically, KPMG laid out the type of analysis required to be completed regarding the City Council:

[Government Accounting Standards Board] standards require governments to disclose certain violations of compliance requirements. [National Council on Government Accounting]...states that the notes to the financial statements should disclose material violations of finance-related legal and contractual provisions. In addition, material violations, or potential violations, of finance-related and contractual provisions should be considered for recording a loss contingency...<sup>118</sup>

KPMG included a specific disclosure which the Mayor and City Council approved in 2002 that raised questions of potentially illegal acts and required investigation. KPMG stated:

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<sup>115</sup> 11 October 2004. Letter from Steven G. DeVetter to Leslie J. Girard. Re: “City of San Diego Fiscal Year 2003 Audit.” (Exhibit 8)

<sup>116</sup> 11 October 2004. Letter from Steven G. DeVetter to Leslie J. Girard. Re: “City of San Diego Fiscal Year 2003 Audit.” (Exhibit 8)

<sup>117</sup> 11 October 2004. Letter from Steven G. DeVetter to Leslie J. Girard. Re: “City of San Diego Fiscal Year 2003 Audit.” (Exhibit 8)

<sup>118</sup> 11 October 2004. Letter from Steven G. DeVetter to Leslie J. Girard. Re: “City of San Diego Fiscal Year 2003 Audit.” (Exhibit 8)

The reported June 30, 2002 \$39 million net pension obligation was misstated due to the payment of retiree healthcare benefits from the pension plan. At KPMG's suggestion, The City has calculated the corrected June 30, 2002 net pension obligation to be \$103 million. The considerations in AU § 317.6 needs to be addressed in the context of this question. The City needs to investigate and determine the relationship of the perpetration and concealment, if any, of likely illegal acts to specific control objectives and the level of management, employees, or consultants involved.<sup>119</sup>

KPMG issued a follow-up letter to the City on 29 October 2004 to stress the importance of undertaking a full investigation. KPMG stated:

In our correspondence, we not only discussed relevant auditing literature, but also explicated for the City some of the applicable principles that require the City in its financial statement to make disclosures of any violations of finance-related laws and regulations.<sup>120</sup>

According to the evidence, KPMG discounted the Vinson & Elkins' report because the firm failed to analyze the issues related to potential violations of law. Vinson & Elkins, as stated by KPMG, failed to adequately investigate all potential illegal acts thereby rendering the report not in compliance with accounting and auditing guidelines.

#### **1. Kroll Fails to Include Securities Laws Analysis of City Council members**

V & E having failed to produce an adequate report, despite the detailed direction provided by KPMG that the new investigation include an illegal acts investigation into knowledge the Mayor and City Council members had about the false information on financial statements, this task was not completed. Rather, Kroll and Willkie Farr collected \$20 million in taxpayer monies to create a series of explanations for why the analysis could not be done. The City Attorney will illustrate in this section that Kroll and Willkie Farr knowingly avoided completing this analysis. The report will also provide evidence to support the City to use all legal means to recover these monies.

#### **The Securities Act of 1933**

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<sup>119</sup> 11 October 2004. Letter from Steven G. DeVetter to Leslie J. Girard. Re: "City of San Diego Fiscal Year 2003 Audit." (Exhibit 8)

<sup>120</sup> 29 October 2004. Letter from Steven G. DeVetter to Mayor Dick Murphy and Lamont Ewell, city manager of the City of San Diego. (Exhibit 10)

The Securities Act of 1933 provides the law which requires a municipality to include accurate information on financial statements when selling bonds to investors. Specifically, Section 17 – Fraudulent Interstate Transactions states:

a. Use of interstate commerce for purpose of fraud or deceit

It shall be unlawful for any person in the offer or sale of any securities or any security-based swap agreement...by use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly –

1. to employ any device, scheme, or artifice to defraud, or
2. to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statement made, in light of the circumstances under which they were made, not misleading; or
3. to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

b. Use of interstate commerce for purpose of offering sale

It shall be unlawful for any person, by the use of any means or instruments or transportation or communication in interstate commerce or by the use of the mails, to publish, give publicity to, or circulate any notice, circular, advertisement, newspaper, article, letter, investment service, or communication which, though no purporting to offer a security for sale, describes such security for a consideration received or to be received, directly or indirectly, from an issuer, underwriter, or dealer, without fully disclosing the receipt, whether past or prospective, of such consideration and the amount thereof.<sup>121</sup>

The law is designed to prohibit an entity from distributing false or misleading financial information to the investing public. The reason, explained throughout the Securities Act of 1933, is to give investors the most accurate information about the financial status of the institution in which an investor may invest.

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<sup>121</sup> Securities Act of 1933, Section 17 (a) (b). (Exhibit 50)

## **The Exchange Act of 1934**

The Exchange Act of 1934 regulates the sale of securities and includes prohibiting the trading of securities “on the basis” of non-public information, which comprises information not released or presented to the general public in financial offering documents. The specific portion of law that lays out these prohibitions is Section 10(b) of the Exchange Act which states:

It shall be unlawful for any person, directly or indirectly, by the use of any means of instrumentality of interstate commerce or of the mails, or of any facility of any national security exchange...

- (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement..., any manipulative or deceptive device or contrivance of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors. Rules promulgated under subsection (b) that prohibit fraud, manipulation, or insider trading..., and judicial precedents decided under this subsection (b) and rules promulgated thereunder that prohibit fraud manipulation, or insider trading, shall apply to security-based swap agreements...to the same extent as they apply to securities.<sup>122</sup>

The bonds sold by the City were subject to federal securities laws. Yet, Kroll failed to include any analysis of this section of the Securities Exchange Act despite ample evidence – as described in prior sections of this report – that the Mayor and City Council were presented information about increased pension liabilities which were not included on financial disclosure statements in connection to a series of bond offerings.

As described in the letters from KPMG, evidence existed that showed that financial disclosures approved by the Mayor and City Council members included data that was false and misleading to investors. KPMG made clear, in no uncertain terms, that whether the Mayor and City Council members knowingly included the false information in the financial statements—in violation of Section 10(b) of the Exchange Act and

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<sup>122</sup> Securities Exchange Act of 1934. (Exhibit 51)

Section 17 (a) and 17 (b) of the Securities Act of 1933 – needed to be fully investigated prior to the completion of the 2003 CAFR.<sup>123</sup>

The report that Kroll and Willkie Farr presented to the City Council on 8 August 2006 contained no analysis of these laws with respect to the Mayor and City Council. Incredibly, at the meeting, representatives of Kroll and Willkie Farr explained that the legal analysis was not completed in their investigation because they did not think it was necessary. The following exchange occurred between City Attorney Michael Aguirre and Benito Romano, counsel to the Audit Committee and partner at Willkie Farr & Gallagher:

AGUIRRE: Alright. So, now did you determine that the City Council violated Section 17 of the Securities Fraud?

ROMANO: We really did not. What we did was that we looked at, as I said in my opening remarks, we looked at the conduct that was used to determine what level of culpability, of mental culpability, were we comfortable assigning to the Council members who approved those offering documents....Me, and, eh, to conclude that the violated Section 17 (a) would have required an analysis that we didn't regard as absolutely necessary for the report. We were focusing on whether, and the standard applied was whether there was evidence which supports the charge, and there is, but that doesn't mean that the evidence that we found fully makes it out it.

Romano, in this statement, admits that Kroll and Willkie Farr did not complete an analysis of illegal acts as required by KPMG and the AICPA auditing standards. Compounding the admission, Romano states that evidence existed which supports a charge that Section 17 of the Securities Act of 1933 was violated.<sup>124</sup>

Romano goes on to state that the investigation was undertaken to satisfy the needs of KPMG. However, KPMG's audit must meet the investigative and disclosure standards as identified by the AICPA, which created the accounting professional standards for

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<sup>123</sup> 11 October 2004. Letter from Steven G. DeVetter to Leslie J. Girard. Re: "City of San Diego Fiscal Year 2003 Audit." ; 29 October 2004. Letter from Steven G. DeVetter to Mayor Dick Murphy and Lamont Ewell, city manager of the City of San Diego. (Exhibit 8)

<sup>124</sup> Benito Romano testimony at 8 August 2006 meeting of the San Diego City Council. (Exhibit 52)

illegal acts investigations. Yet, Romano stated at the meeting that the investigation did not meet that level of standards set forth by the AICPA and Romano discounted the need for more comprehensive investigation:

AGUIRRE: You were supposed to do an illegal acts analysis, right?

ROMANO: Well, we were supposed to do an analysis of sufficient independent scope to satisfy KPMG's needs. We did not understand that to require us to establish to the satisfaction of some third party whether a statute was violated in all of its elements in that, or whether a crime has been committed...[That] wasn't necessary for the purpose of what we were engaged to perform...its kind of complicated, we found evidence of consistent with and would support such a charge, we didn't feel that it was necessary to establish all the elements.<sup>125</sup>

Romano's statement here is incorrect. The series of letters that KPMG issued to the City required that the investigation must meet the standards of a third party: the standards established by the AICPA. KPMG could not have made this clearer in its letters to the City on 9 August 2004 and 11 October 2004. It is also important to the note that these standards – which KPMG outlined in the letters – are the accepted standard for the accounting industry and each holder of a Certified Public Accountant's (CPA) license must pass a rigorous test that includes the AICPA standards.

In the meeting, Romano also explained that an evaluation of the potential violations of the Securities Act was not completed, as required:

AGUIRRE: [B]ut you were unable to decide if there was a section 17 (a) violation when it came to the City Council?

ROMANO: We were not unable to decide.

AGUIRRE: Why couldn't you do it then?

ROMANO: Because we didn't need to do it. We didn't feel it was necessary to reach that conclusion to render a conclusion that would be relevant to the auditors.

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<sup>125</sup> Benito Romano testimony at 8 August 2006 meeting of the San Diego City Council. (Exhibit 52)

AGUIRRE: Why did you...

ROMANO: Whether the other elements of the 17(a) violation could be made out, could conceivably be made out, could someone prove it, I don't, we didn't regard it as necessary for us to go that far to satisfy what we felt what we needed to do in order to meet our obligation in the report.<sup>126</sup>

It is crucially important to stress that Kroll and Willkie Farr's opinion as to which investigative standards are arbitrary because they were to supposed to follow the rules set by the AICPA. As KPMG pointed out repeatedly in the 9 August 2004 and 11 October 2004 letters, the standards that need to be satisfied are those of the AICPA. The text of the standards and the description of the proper methodology to achieve the standards were also included in the KPMG letters.<sup>127</sup>

During the 8 August 2006 City Council meeting, DeVetter, a partner for KPMG, stated that an evaluation of the securities laws was necessary:

AGUIRRE: [N]ow, Mr. DeVetter, can you please go to your October 11, 2004 letter, if you wouldn't mind. This is another letter that you sent to the City of San Diego, correct?

DE VETTER: Correct.

AGUIRRE: And in this letter, you further elaborated in what had to be found by the law firm or group that was going to do the illegal acts investigation, correct?

DE VETTER: Correct.

AGUIRRE: And in that letter on page 8 you said, quote, "The City needs to determine whether the City's public disclosures including its financial statements likely violate the anti-fraud provisions of the securities laws, correct? That's on page 8?"

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<sup>126</sup> Transcript of the 8 August 2006 meeting of the San Diego City Council. (Exhibit 52)

<sup>127</sup> 11 October 2004. Letter from Steven G. DeVetter to Leslie J. Girard. Re: "City of San Diego Fiscal Year 2003 Audit." ; 29 October 2004. Letter from KPMG Partner Steven DeVetter to Assistant City Attorney Leslie Girard. Re: "Follow-up from meeting on August 27, 2004." (Exhibit 8)



DE VETTER: Correct.<sup>128</sup>

DeVetter's comment echoed what had been said in the letter, that the Mayor and City Council's role in approving the fraudulent financial disclosures in connection with hundreds of million of dollars of sales in municipal bond offerings needed to be analyzed for potential violations of securities laws.

However, in the face of DeVetter's concurrence of confirmation about what KPMG needed from the investigation, Romano maintained the position that for Kroll and Willkie Farr to complete an analysis of the securities laws was unnecessary:

AGUIRRE: Okay, so Mr. Romano, does your report determine whether the City's public disclosures including the financial statements likely violated the anti-fraud provisions of the securities laws?

ROMANO: We did with respect, yes we did.

AGUIRRE: What did you determine?

ROMANO: We determined that the disclosures were deficient and...

AGUIRRE: No, no. I'm asking you, it says here [in KPMG's 11 October 2004 letter] "likely violated the securities laws". Did you make a determination that the [City] Council likely violated the securities laws?

ROMANO: The Council?

AGUIRRE: Yes.

ROMANO: No we didn't. We did not make that determination. We focused on the element that we felt was most important to KPMG.

AGUIRRE: And who gave you that understanding?

ROMANO: Um, I don't know if anyone gave me that understanding. That was the premise that we proceeded on.<sup>129</sup>

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<sup>128</sup> Transcript of the 8 August 2006 meeting of the San Diego City Council. (Exhibit 52)

<sup>129</sup> Transcript of the 8 August 2006 meeting of the San Diego City Council. (Exhibit 52)

Once again, Romano admits that Kroll and Willkie Farr failed to conduct the illegal acts investigation and analysis under the specific parameters specified by KPMG and created by the AICPA. Further, Romano specifically states that Kroll and Willkie Farr ignored the industry-accepted standards and conducted the illegal acts investigation on their self-conceived “premise”.

At this point of the City Council meeting, Michael Young, partner at Willkie Farr, stated that Section 17 (a) was not an “anti-fraud provision” and was therefore of little interest to KPMG:

YOUNG: I just wanted to answer the question as to the dis, you were talking about the anti-fraud provisions of the securities laws, with regard to the City Council. The negligence based elements, the negligence based aspects of Section 17(a) are not antifraud provisions...<sup>130</sup>

The City Attorney believes that Young’s testimony is incorrect. In fact, the Mayor and City Council members were given advice by the Los Angeles-based Bryan Cave law firm prior to selling the ballpark bonds. The firm issued a letter to the Mayor and City Council on 29 October 2001 which stated clearly that Section 17(a) of the Securities Act of 1933 and Section 10b-5 of the Securities Exchange Act of 1934 were, in fact, antifraud provisions. The letter stated:

Overview of the Applicable Federal Securities Laws

While Congress exempted offering of municipal securities, such as the 2001 Bonds, from the registration requirements of the Securities Act of 1933, and the system of periodic reporting under the Securities Exchange Act of 1934, it did not exempt transactions in municipal securities from the antifraud provisions of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5 promulgated thereunder. These provisions prohibit any person, including municipal issuers, from making a false or misleading statement of material fact, or omitting any material facts necessary to make statements made by that person not misleading, in connection with the offer, purchase or sale of any security.<sup>131</sup>

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<sup>130</sup> Transcript of the 8 August 2005 meeting of the San Diego City Council. (Exhibit 52)

<sup>131</sup> 29 October 2001. Letter from Gerald Boltz and Matthew Anhut, counsel for Bryan Cave LLP, to Leslie Girard, assistant city attorney. Re: “Review of Disclosure Documents as to Lease Revenue Bonds 2001”. (Exhibit 37)

This text clearly illustrates that these provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934 are interpreted as anti-fraud provisions to ensure that accurate financial information is presented to the public interested in purchasing municipal securities.

Young, at the City Council meeting, stated that auditors are not interested in an analysis of laws set forth in the Securities Act of 1933 and the Securities Exchange Act of 1934 because “people make mistakes all the time”:

YOUNG: [A]nd the reason that the auditor is less interested in the negligence is that people make mistakes all the time, and if somebody makes a mistake it doesn't mean that they have to be fired, it doesn't mean that they have to resign, so an auditor is less interested in that. And that's why KPMG was careful to talk about the anti-fraud provisions, that's why we came to the determination as to the fraud provisions of the securities holds and that's why we didn't need to.<sup>132</sup>

In short, Young said that KPMG and auditors, generally, are not interested in completing an illegal acts investigation and analyzing the securities laws because “people make mistakes all the time.”<sup>133</sup>

The advice from the Bryan Cave law firm that was presented to the Mayor and City Council is also in sharp contrast to the comments of Michael Young, partner at Willkie Farr. The Bryan Cave letter specifically stated that negligence or mistakes may, in fact, constitute a violation of federal securities codes. The letter stated:

Although as to certain antifraud provisions, the SEC must show that the person acted with “scienter” – that is recklessness or an intent to deceive, manipulate, or defraud – the SEC need only demonstrate that the person acted negligently to establish a violation of other antifraud provisions. To establish negligence, the SEC must show that the defendants failed to conform with the standard of care that a reasonable person would have exercised in like circumstances and position. Of course, there must first be

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<sup>132</sup> Transcript of the 8 August 2006 meeting of the San Diego City Council. (Exhibit 52)

<sup>133</sup> Transcript of the 8 August 2006 meeting of the San Diego City Council. (Exhibit 52)

a misstatement or omission of material fact; however, the lower threshold of negligence provides greater enforcement flexibility to the SEC.

In light of the foregoing, it is critical that the City Council and the Board of Commissioners exercise all due care in reviewing and evaluating information contained in the POS.<sup>134</sup>

In short, if there is material information missing from a financial statement or incorrect information included in a financial statement, the SEC can establish violations of anti-fraud using a finding of negligence as a foundation. It is important to reemphasize that KPMG specifically pointed out the materially false information that was included on the financial documents the Mayor and City Council reviewed and approved for the June 2002 Municipal Bond offerings.

Indeed, there is ample evidence presented above to support the allegation that Kroll and Willkie Farr knowingly failed to complete the illegal acts investigation as required by KPMG and the rules of professional accounting as set by the AICPA.

Most importantly, Kroll and Willkie Farr failed to perform one of the most vital function of the investigation for which it was hired: answer whether the Mayor and the City Council acted with intent to mislead investors by approving inaccurate financial disclosure documents. According to the SEC's "Commission Opinion: the City of Miami, Florida; Release No. 33-8213; March 21, 2003",

Scienter is a necessary element of a violation of Section 17(a)(1) of the Securities Act, Section 109b) of the Exchange Act, and Rule 10b-5 thereunder. Proof of scienter need not be direct, but may be 'a matter of inference from circumstantial evidence.' Scienter has been defined by the Supreme Court as 'a mental state embracing intent to deceive, manipulate, or defraud.' A showing of recklessness or actual knowledge can satisfy the scienter requirement.<sup>135</sup>

Nowhere in the report issued by Kroll and Willkie Farr is there an analysis of scienter. The City Attorney believes that this lack of analysis renders the report incomplete and

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<sup>134</sup> 29 October 2001. Letter from Gerald Boltz and Matthew Anhut, counsel for Bryan Cave LLP, to Leslie Girard, assistant city attorney. Re: "Review of Disclosure Documents as to Lease Revenue Bonds 2001". (Exhibit 37)

<sup>135</sup> Commission Opinion: the City of Miami, Florida; Release No. 33-8213; March 21, 2003; P. 10. (Exhibit 53)

illustrates that Kroll and Willkie Farr failed to conduct an adequate analysis to satisfy AU § 317.

## **2. Romano Distorts Record at Press Conference**

Following the 8 August 2006 City Council meeting, Romano and the members of the Audit Committee held a press conference with the San Diego press corps. At the press conference, Romano told reporters that the SEC had never taken an enforcement action against elected officials. Romano said:

Negligence in certain standards, I should tell you the SEC has never to our knowledge, brought an action for negligence against an elected official. They have against City employees. [The City Council] acted negligently in connection with the issuance of securities. Whether that constitutes a complete violation is something that the SEC will have to address.<sup>136</sup>

This statement is clearly inaccurate and was meant to deceive the gathered media.

There have, in fact, been a series of enforcement actions taken by the SEC that single out elected officials for negligence in approving the issuance of financial disclosure statements that contain inaccurate information. The SEC ruling against Orange County issued in 1996 specifically named the Orange County Board of Supervisors. The report stated:

This Order concerns false and misleading statements in the offer and sale of over \$2.1 billion in municipal securities issued in 1993 and 1994 by Orange County, the Flood Control District and a school district located in Orange County (the "School District")...

...the Board variously made material misstatements in the disclosure documents for the offerings (the "Official Statements") or authorized the use of Official Statements that were either false or misleading by omitting to state material facts regarding... the offer and sale of certain of the municipal securities, misrepresentations were made to certain national securities rating agencies (the "Rating Agencies")... These material misstatements were made in violation of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder...

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<sup>136</sup> Romano's comment to the San Diego press corps on 8 August 2006 following the release of the report to the San Diego City Council. (Exhibit 54)

Accordingly, based on the foregoing, the Commission finds that Orange County, the Flood Control District and the Board violated Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.<sup>137</sup>

The SEC order also specifically points out the duties and responsibilities of the elected City officials to review and approve the financial documents to the investing public. The order states:

The Board had final authority to authorize and approve each of the municipal securities offerings by Orange County and the Flood Control District. The Board approved each of the County and the Flood Control District offerings discussed below, which raised over \$2 billion. The Board's resolutions authorizing the issuance of the County's municipal securities specifically recited the approval of drafts of the Official Statements and authorized their completion and correction by a County official...<sup>138</sup>

The Kroll and Willkie Farr report repeatedly cited the SEC enforcement action against Orange County. The SEC order explicitly points to the roles the Orange County Commissioner had in ensuring the accuracy of the financial information and that the Commissioners knowingly disclosed false and misleading information to investors.

The SEC came to a similar finding in a ruling issued on March 21, 2003, in the case involving the City of Miami. Similar to Orange County, city officials and elected officials were aware of the Miami's declining financial condition and of current liabilities that were not disclosed to investors. The SEC stated:

[W]e find that Miami willfully violated Sections 17(a)(1)-(3) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder in connection with the offer and sale of the three bond issues. We further find that Miami willfully violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder in connection with its

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<sup>137</sup> 14 November 2006. Securities and Exchange Commission; Administrative Proceeding, Order Instituting Cease-and-Desist Proceedings, Making Findings, and Imposing a Cease and Desist Order. (Exhibit 55)

<sup>138</sup> 14 November 2006. Securities and Exchange Commission; Administrative Proceeding, Order Instituting Cease-and-Desist Proceedings, Making Findings, and Imposing a Cease and Desist Order. (Exhibit 55)

outstanding bonds by making materially false and misleading statements and omitting material information in its 1994 CAFR.<sup>139</sup>

Miami's actions were not the result of an isolated incident but were recurrent and stretched from one fiscal year into the next. In the three bond issues, the City used financial statements that failed to warn investors about its ongoing financial stress; falsely certified that there had been 'no material adverse change' in its financial condition since FY 1994, even though Miami faced a cash shortfall of over \$30 million; and depicted a balanced budget, knowing that \$12 million of revenue would not be forthcoming. These violations were committed with at least recklessness.<sup>140</sup>

The SEC also specifically outlined the role of the City officials and elected City officials:

Primary responsibility for the accuracy of information filed with the Commission and disseminated among investors rests upon the municipality. A city does not discharge this obligation by the employment of independent public accountants or other professionals. As we have repeatedly emphasized, issuers of municipal securities 'are primarily responsible for the content of their disclosure documents and may be held liable under the federal securities laws for misleading disclosure.'

Municipal issuers gave an affirmative obligation to know the contents of their securities disclosure documents, including their financial statements.<sup>141</sup>

Kroll and Willkie Farr also cited to this SEC order throughout the report but failed to convey this information in a truthful and accurate way to the people of San Diego.

The City Attorney believes that Romano had in-depth knowledge of both of these cases but misrepresented the SEC's Orange County and City of Miami rulings to falsely bolster the inaccurate and incomplete analysis and conclusion in the Kroll and Willkie Farr report.

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<sup>139</sup> Commission Opinion: the City of Miami, Florida; Release No. 33-8213; March 21, 2003; P. 11. (Exhibit 53)

<sup>140</sup> Commission Opinion: the City of Miami, Florida; Release No. 33-8213; March 21, 2003; P. 11. (Exhibit 53)

<sup>141</sup> Commission Opinion: the City of Miami, Florida; Release No. 33-8213; March 21, 2003; P. 10. (Exhibit 53)

**V.**  
**KROLL AND WILLKIE FARR FRAUDENTLY BILL CITY OF SAN DIEGO**

The evidence collected over the course of the investigation uncovered that Kroll and Willkie Farr provided fraudulent billings to the City of San Diego. More specifically, the representatives of Kroll and Willkie Farr were aware of the City’s billing guidelines, and knowingly failed to comply. The evidence will also illustrate that representatives of Kroll lied to the San Diego City Council when they stated that Kroll did not have the capability to provide complete detailed bills. Thus, the evidence presented in this section will illustrate the evidence that supports the position of the City Attorney that representatives of Kroll lied to the City Council and continued to provide inadequate billing. The evidence presented in this section will also illustrate that Kroll and Willkie Farr had detailed knowledge of the California false claims law and that the firms knowingly violated false claims laws by submitting fraudulent bills to the City of San Diego.

**1. PAYMENT OF KROLL INVOICES VIOLATE INTERNAL FINANCIAL CONTROL RULES OF THE CITY OF SAN DIEGO**

The American Institute of Certified Public Accountants (“AICPA”) outlines auditing and professional standards in their Codification of Statements on Auditing Standards. Specifically, AU § 319 outlines the roles and responsibilities of the hiring agency as well as the Professional Code of Conduct of auditors and accountants. It is the role of both the City and the consultant to ensure that work is being done properly by instituting information and communication standards, and control processes to ensure efficient and quality work.<sup>142</sup>

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<sup>142</sup> American Institute of Certified Public Accountants’ handbook titled: Codification of Statements on Auditing Standards. Section: AU § 319 – Consideration of Internal Control in a Financial Statement Audit. (Exhibit 56)



The City of San Diego also maintains guidelines for billing by outside consultants and contractors. Specifically, City of San Diego Administrative Regulations state that all consulting agencies that contract with the City must:

[E]xpressly warrant that the work is based upon its expertise and shall be done in accordance with good (audit, professional, etc.) practices. Where approval by the City, or representatives of the City is indicated, it is understood to be conceptual approval only and does not relieve the consultant of responsibility for complying with all laws, codes and good (audit, professional, etc.) practices.<sup>143</sup>

The San Diego City Attorney's Office had established a set of internal controls to be used when reviewing attorney and consultant billings. The City Attorney uses specific billing guidelines that require detailed billing. The guidelines require that the invoice shall be accompanied by a separate invoice briefly describing each task performed, the time spent on the task, the identity of the person who performed the work, and itemized reimbursable expenses.<sup>144</sup>

**A. Kroll and Willkie Farr & Gallagher's Invoice Prove Inadequate Detail**

Throughout Kroll's two year investigation, the company sent 42 invoices on a bi-weekly basis to the City of San Diego without providing any details of the work performed or time the employee spent on each task.

Kroll sent eight invoices to the City between the time it was hired on 14 February 2005 and the first update to the City Council on 14 June 2005. The total charge for those eight invoices was \$1.2 million.<sup>145</sup> Those bills were allocated among three classifications: "Internal Investigations," "Research Pension Board Nominees," and "For Professional Services Rendered."<sup>146</sup> The bills included the names of more than 20

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<sup>143</sup> City of San Diego Administrative Regulation. Appendix B-1. A Consultant is an Independent Contractor. (Exhibit 57)

<sup>144</sup> San Diego City Attorney's Office Billing Guidelines for Outside Counsel. (Exhibit 58)

<sup>145</sup> Source: Kroll Invoices from 30 March 2005, 5 April 2005, 18 April 2005, 27 April 2005, 9 May 2005, 20 May 2005, 3 June 2005. (Exhibit 59)

<sup>146</sup> Source: Kroll Invoices from 30 March 2005, 5 April 2005, 18 April 2005, 27 April 2005, 9 May 2005, 20 May 2005, 3 June 2005. (Exhibit 59)

individuals, each billing for a specific numbers of hours at rates ranging from \$85 to \$900 per hour. The bills do not, however, include any information about what tasks each individual performed.

During the same period, Willkie Farr sent a total of 17 invoices without details of work performed to the City at a rate of one bill per month. The lack of accurate billing has rendered the City unable to properly audit the engagement to ensure that work was completed at a proper cost.

Willkie Farr submitted its first bill to the City on 17 May 2005, for a sum of \$25,406.<sup>147</sup> The bill included a breakdown of services, in half-hour increments and the initials of the employees working on the task. The description on the invoice included items such as “review reports and correspondence” and “begin reading Luce, Forward report.” The invoices complied with the City’s billing requirements for describing attorneys’ work. That bill, however, would be the last detailed invoice by the firm. The new billings – the first of which arrived on 22 June 2005<sup>148</sup> – included the same invoice format as those submitted by Kroll.

Kroll senior officials sent a status report to the City Council on 10 June 2005. The report stated that Kroll employees had been working with Vinson & Elkins employees to gather information; communicate with law enforcement agencies; collect additional documents; prepare correspondence with the SDCERS Board; and coordinate with KPMG, the City’s outside auditor. The status report outlined some of the work that had been completed, such as the review of documents collected in response to U.S. Attorney’s Office and SEC subpoenas. But rather than identify areas for more in-depth analysis, Kroll and Willkie Farr notified the City Council that another City-wide document production was necessary.

Representatives of Kroll appeared before the City Council on 14 June 2005 to give a presentation on their progress and answer questions from City officials. At the meeting, Arthur Levitt told the City Council that Kroll and Willkie Farr’s work – which

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<sup>147</sup> Willkie Farr & Gallagher invoice from 19 May 2005. (Exhibit 60)

<sup>148</sup> Willkie Farr & Gallagher invoice from 22 June 2005. (Exhibit 61)

included comparing the City Attorney and Vinson & Elkins investigations, writing and issuing an investigative report, and drafting remediation steps – would be completed before the end of the calendar year. Levitt said, “I would be very disappointed if I wasn’t out of here by the end of the year.”<sup>149</sup>

At this point, neither Kroll nor Willkie Farr would provide any detailed billing or a written work plan. Obviously, the lack of details in the Kroll invoices prevented the City from determining what, if any, work was being done. A list of detailed bills would have allowed the City to ensure that Kroll and Willkie Farr were completing the tasks they claimed and in a timely manner.

The City Attorney asked Arthur Levitt at the 14 June 2005 City Council meeting if such a work plan could be drafted and delivered. Levitt said, “I see no reason why we can’t give you a written report on our action.”<sup>150</sup> No written work plan was provided to the City. The City Attorney also requested that Kroll and Willkie Farr provide detailed invoices of its work. This request was also ignored.

One week later, on 24 June 2004, another bill from Kroll for \$194,194 was received by the City. The invoice was broken into two classifications: “For Professional Services Rendered” and “Out-of-Pocket Disbursements.” The invoice covered 12 employees and indicated their hourly rates and charges, but lacked any information about the work being performed.<sup>151</sup> Another invoice from Willkie Farr was received by the City on 15 July 2005; for a total of \$347,429.<sup>152</sup> The invoice included charges for \$18,125 for “Disbursements and other charges” and \$329,304 for “Professional Services.”

At the 28 June 2005 meeting of the City Council, an item was docketed to allocate an additional \$708,825 to Kroll to proceed with their work on the investigation and perform background research on appointees to the SDCERS Board. The City Council

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<sup>149</sup> Transcript of Arthur Levitt’s comments at the 14 June 2005 meeting of the San Diego City Council. (Exhibit 62)

<sup>150</sup> Transcript of Arthur Levitt’s comments at the 14 June 2005 meeting of the San Diego City Council. (Exhibit 63)

<sup>151</sup> 24 June 2005 invoice from Kroll to City of San Diego. (Exhibit 64)

<sup>152</sup> 15 July 2005. Invoice from Willkie Farr & Gallagher to City of San Diego. (Exhibit 65)

passed the item 7 to 0, with Council member Ralph Inzunza absent.<sup>153</sup> The next day, 29 June 2005, Kroll sent an invoice to the City for \$236,281.<sup>154</sup> The invoice was broken into two categories: “For Professional Services” and “Out-of-Pocket Disbursement.” Again, the invoice included only names, hourly rates, and the total billed.

Kroll representatives appeared before the City Council on 9 August 2005, to provide another status report and to receive additional funds. Outlining work completed to date, Levitt said:

First, we have engaged in extensive dialogue with the City’s investigators at Vinson & Elkins and evaluated the extent of additional work necessary, so that the investigation may be brought to a conclusion. Second, we have met with the City’s outside auditors at KPMG, discussed with them at great length the investigative material and are in the process of implementing an agreed upon plan which at its conclusion would allow KPMG to issue an audit report on the City’s financial statements. Third, we have begun to work on remediation efforts including the removal of the retirement system’s actuary and working with a new City Auditor and controller who are appropriately improving internal controls. Fourth, we have organized and are overseeing the production of documents that both the SEC and the U.S. Attorney subpoenaed more than a year ago. Fifth, over the course of our work these last five months we’ve had several discussions and meetings with the independent auditors [KPMG] who support our approach and our efforts.<sup>155</sup>

Levitt also stressed that the expected completion date for Kroll’s work was December 2005.<sup>156</sup> At that meeting the Council approved the allocation of \$1.2 million for the Kroll investigation and another \$1.2 million for Willkie Farr, both on a 6 to 0 votes.<sup>157</sup> At the meeting, the City Attorney displayed the Kroll billings and stated that without any line item detail, the City was unable to document what work had actually

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<sup>153</sup> Minutes of the 28 June 2005 meeting of the San Diego City Council. (Exhibit 66)

<sup>154</sup> 29 June 2005 Kroll invoice to City of San Diego. (Exhibit 67)

<sup>155</sup> Transcript of Arthur Levitt’s comments at the 9 August 2005 meeting of the San Diego City Council. (Exhibit 68)

<sup>156</sup> Transcript of Arthur Levitt’s comments at the 9 August 2005 meeting of the San Diego City Council. (Exhibit 68)

<sup>157</sup> Minutes for the San Diego City Council meeting on 9 August 2005. (Exhibit 69)

been completed. The City Attorney requested the City Council to demand more detailed billing from both consultants at the meeting.<sup>158</sup> The City Council made no such request.

That same day, 9 August 2005, the City Attorney wrote a memo to San Diego City Auditor John Torell seeking support to require detailed bills. The City Attorney wrote, “It is impossible for the Auditor to verify whether these amounts are justified without sufficient documentation. In order to protect taxpayers’ monies, we request that the Auditor demand and review more detailed documentation before paying any further invoices.”<sup>159</sup>

On 11 August 2005 the City Attorney wrote another letter to Kroll officials requesting detailed billings. The City Attorney wrote, “[t]he City Attorney again requests that Kroll and its legal counsel provide detailed billings for all amounts thus far billed to or paid by the City of San Diego. Although such billings are required under applicable City contract provisions and policies, they have not been provided.”<sup>160</sup>

The City Attorney issued another letter to Troy Dahlberg, managing partner at Kroll, on 6 September 2005 requesting detailed billings.<sup>161</sup> The letter, which included a copy of the City’s billing guidelines for consultants, stated:

It is critical that your firm provide detail bills to the City. I have attached a sample of the summary type of billings that we have recently received from Kroll. This style of billing is unacceptable...I have also attached an example of an acceptable billing format from your colleague Vinson & Elkins. These billings allow the reader to know what tasks have been performed...I am sure your firm tries to accommodate the desires of its clients, with respect to billing form. Your adherence to the Billing Guidelines will provide needed transparency and avoid costly litigation.<sup>162</sup>

Officials at Kroll and Willkie Farr did not respond to either letter.

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<sup>158</sup> Transcript of 9 August 2005 meeting of the San Diego City Council. (Exhibit 68)

<sup>159</sup> 9 August 2005 memorandum from City Attorney Michael Aguirre to City Auditor John Torell. Carbon-copied to P. Lamont Ewell. Subject: Insufficiency of Documentation for Payments to Kroll and Willkie, Farr. (Exhibit 70)

<sup>160</sup> 11 August 2005. Letter from City Attorney Michael Aguirre to Arthur Levitt, Troy Dahlberg, and Lynn Turner. (Exhibit 71)

<sup>161</sup> 6 September 2005 letter from City Attorney Michael Aguirre to Troy Dahlberg. (Exhibit 72)

<sup>162</sup> 6 September 2005 letter from City Attorney Michael Aguirre to Troy Dahlberg. (Exhibit 72)

Kroll sent another invoice to the City on 23 September 2005, totaling \$231,912. Willkie Farr submitted an invoice on 13 September 2005 for \$488,040. Despite the repeated requests from the City Attorney, the sole detail listed by Kroll for the work was “For Professional Services Rendered.”<sup>163</sup>

Representatives of Kroll and Willkie Farr appeared before the City Council on 26 September 2005 to provide an update on its progress. At the meeting, Troy Dahlberg said that detailed billings were not provided to the City because City Manager P. Lamont Ewell said it was not necessary. Dahlberg and Ewell both stressed that the City maintained the right to audit the work of Kroll and at any time. During this conversation, the City Attorney said the City Manager does not possess the authority to relieve a consultant of the requirement to comply with the City’s billing guidelines or AICIPA requirements set forth in AU § 319.<sup>164</sup> Aguirre said:

What is inappropriate is the City Manager not doing his job. He has no legal authority, no legal authority, no legal authority to relieve [Kroll] of the obligation to provide a detailed billing that I have requested you for and as every other firm with the exception of Kroll..., every other firm has provided detailed billing.<sup>165</sup>

At the meeting, the City Attorney asked Dahlberg why detailed billings were not being provided. Dahlberg replied that the information was not included for three reasons. Dahlberg stated that detailed bills were not being submitted by Kroll because accountants don’t bill “that way.”<sup>166</sup> Furthermore, Dahlberg stated that Kroll does not have the technology to compile the bills on a half-hourly basis. Dahlberg also said that the bills are vague to protect those being investigated. Dahlberg said:

We are basically accounting. I am an accountant, okay. We don’t even have a system that does this. Attorneys bill that way. Accountants tend to bill more on tasks... We don’t really have the billing records to set this up. It would be a titanic economic expense for us to do it... I’ve done lots of

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<sup>163</sup> 23 September 2005 Kroll invoices to P. Lamont Ewell. (Exhibit 73)

<sup>164</sup> Transcript of the 26 September 2005 meeting of the San Diego City Council. (Exhibit 74)

<sup>165</sup> Transcript of the 26 September 2005 meeting of the San Diego City Council. P. 63. (Exhibit 74)

<sup>166</sup> Transcript of the 26 September 2005 meeting of the San Diego City Council. (Exhibit 74)

investigations before and we do not show in the investigation in the bills that we are doing the investigative work on because, unfortunately, there is sometimes a presumed level of guilt if you just look at somebody's stuff... When we did these kinds of investigations we never went into the kind of detail about whose e-mail we were looking at, whose documents we were looking at.<sup>167</sup>

At the meeting, Dahlberg specifically admitted that the Kroll had not turned over more detailed information from their billings when requested by the City Attorney.

AGUIRRE: If we look at what you did between March 16 and March 30 of 2005, we see that you spent 67.5 hours and it costs us \$30,000. How do we audit what you did if you don't give us any more detail than that to find out if in fact you did the work you are claiming that you did?

DAHLBERG: Well, you can ask us. If we have anything else, we can share that with you.

AGUIRRE: Well, I did ask you and you didn't provide anything else did you?

DAHLBERG: That's correct.<sup>168</sup>

Representatives of Willkie Farr chose not to discuss their reluctance to submit detailed bills to the City despite their original bill submitted on 17 May 2005 contained the required detail. The firm did, however, submit another invoice to the City on 19 October 2005 for another \$980,181 – the largest monthly invoice at that point.

The City Attorney sent a letter to Deputy Mayor Toni Atkins and City Council members on 24 October 2005 that repeated the need for detailed invoices to ensure that work was progressing. The letter stated:

The City Attorney's Office has repeatedly requested all invoices for Kroll ... Those requests have been met with resistance. The public's funds and confidence in government are seriously compromised by the practice of bypassing the City Attorney's Office to review these expenses. The invoices submitted by Kroll for their work are wholly inadequate and contrary to best, let alone acceptable billing practices.<sup>169</sup>

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<sup>167</sup> Transcript of the 26 September 2005 meeting of the San Diego City Council. (Exhibit 74)

<sup>168</sup> Transcript of 26 September 2005 meeting of the San Diego City Council. P. 83. (Exhibit 74)

<sup>169</sup> 24 October 2005. Letter from City Attorney Michael Aguirre to Deputy Mayor Atkins and City Council. (Exhibit 75)

Also on 24 October 2005, another Kroll invoice was received by the City for \$465,862.<sup>170</sup> Despite the numerous requests from the City Attorney for a line item accounting of what work was being done, the time spent on each task, and which employee was completing the work, the invoice arrived with no detail other than cost.

In total, Kroll sent 19 invoices to the City between the time the firm was hired on 14 February 2005 and 24 October 2005.<sup>171</sup> The total charge for those 18 invoices was \$3,734,202 for work completed by Kroll representatives and another \$395,731.43 for expenses. These bills provide no indication of what work, if any, was being performed by the firm.

Willkie Farr, from the time it was engaged through 16 November 2005, sent six<sup>172</sup> invoices to the City for a total of more than \$2.49 million. These invoices included charges for \$150,000 for “Disbursements and Other Charges” and more than \$2.3 million for “Professional Services.”<sup>173</sup>

New evidence supports the allegation that Dahlberg blatantly lied to the City Council about its inability to submit more detailed invoices. Specifically, Dahlberg sent a set of detailed bills to Mayor Dick Murphy’s office on 13 July 2005 – more than 2 months before making that statement to the City Council. In the e-mail, Dahlberg attached a line item billing for work that Kroll completed on background checks. The e-mail stated:

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<sup>170</sup> 24 October 2005 Kroll invoice to P. Lamont Ewell. (Exhibit 76)

<sup>171</sup> Kroll invoices dated 30 March 2005; 5 April 2005; 5 April 2005; 18 April 2005; 27 April 2005; 9 May 2005; 20 May 2005; 3 June 2005; 24 June 2005; 29 June 2005; 27 July 2005; 1 August 2005; 16 August 2005; 30 August 2005; 9 September 2005; 23 September 2005; 13 October 2005; 20 October 2005; and 24 October 2005. (Exhibit 77)

<sup>172</sup> Willkie Farr invoices dated 19 May 2005; 17 May 2005; 22 June 2005; 15 July 2005; 18 July 2005; 18 August 2005; 31 August 2005; 13 September 2005; 19 September 2005; and 19 October 2005. (Exhibit 78)

<sup>173</sup> Willkie Farr & Gallagher invoices sent to the City on 22 June 2005; 15 July 2005; 18 August 2005; 13 September 2005; and 19 October 2005. (Exhibit 78)



Per your request attached is the description for the invoice related to the investigative background work that Kroll performed for the Mayor's office.

Please feel free to contact me with any other questions and requests.<sup>174</sup>

The invoice included a detailed line item breakdown of the work which specified the individual's name, that individual's billing rate, the number of hours spent on a task and a description of the task. For example, the invoice included numerous entries for Brandon Sprague which stated:

Date	Initials	Name/Invoice Number	Hours	Amount	Description
03/10/2005	005185	Brandon Sprague	0.50	110.00	Read clips on Patrick Shea, analyzed data on him to determine if the same Shea in article was our subject's husband.
03/11/2005	005185	Brandon Sprague	4.00	880.00	Tracked down corporate affiliations of Ignell using Accurint, Autorack and the probe as well as secretary of state websites. Talked to sub about looking for connections between Ignell's company Avalon Capital and another more shady Avalon Capital based in Boca Raton, FL; ran probe on Ignell's maiden name, Loiacono. <sup>175</sup>

This is exactly the type of detail the City needed on all invoices from Kroll and Willkie Farr to audit the work and determine that work was actually being done. There were many more listing for Kroll employees that included this level of detail. For example, Arnold Contreras included very detailed billing. A sample of his entries included:

<sup>174</sup> 13 July 2005 e-mail from Troy Dahlberg, managing partner at Kroll Inc., to Ravila Ruderman, staff for form Mayor Dick Murphy. Subject: "Invoice Detail." Carbon copied: Tom Story, former chief of staff to Mayor Dick Murphy. (Exhibit 79)

<sup>175</sup> 13 July 2005 e-mail from Troy Dahlberg, managing partner at Kroll Inc., to Ravila Ruderman, staff for form Mayor Dick Murphy. Subject: "Invoice Detail." Carbon copied: Tom Story, former chief of staff to Mayor Dick Murphy. (Exhibit 79)

Date	Initials	Name/Invoice Number	Hours	Amount	Description
03/02/2005	000678	Arnold G. Contreras	4.50	1,080.00	Conducted database research for public records on five individuals on a RUSH basis per Ken Mate, Conducted searches for company affiliations, litigation, and internet mentions.
03/03/2005	000678	Arnold G. Contreras	6.00	1,440.00	Conducted additional follow up research on five individuals. Conducted database research on a new individual per K. Mate. Coordinated field research in San Diego County.
03/05/2005	000678	Arnold G. Contreras	3.00	720.00	Conducted follow up research on specific entities tied to several individuals. <sup>176</sup>

In this detailed invoice, there were also entries pertaining to Kroll's investigation into the City of San Diego including:

Date	Initials	Name/Invoice Number	Hours	Amount	Description
03/02/2005	243397	David Callaghan	8.00	2,320	Preparation for and attendance at a meeting with city officials SEC US Attny <sup>177</sup>

It is crucial to note that this was specifically the kind of detail Dahlberg told the City Council on 21 September 2005 that could not be completed. More alarmingly, the e-mail was sent and the bill was delivered to the City before Dahlberg stated that Kroll was unable to complete detailed bills. This provides clear evidence that Dahlberg was blatantly dishonest in his comments to the City Council on 21 September 2005.

There is ample evidence to support the claim that Kroll and Willkie Farr had the ability to submit detailed invoices to include information requested by the City Attorney. The City Attorney believes that representatives intentionally misrepresented their ability

<sup>176</sup> 13 July 2005 e-mail from Troy Dahlberg, managing partner at Kroll Inc., to Ravila Ruderman, staff for form Mayor Dick Murphy. Subject: "Invoice Detail." Carbon copied: Tom Story, former chief of staff to Mayor Dick Murphy. (Exhibit 79)

<sup>177</sup> 13 July 2005 e-mail from Troy Dahlberg, managing partner at Kroll Inc., to Ravila Ruderman, staff for form Mayor Dick Murphy. Subject: "Invoice Detail." Carbon copied: Tom Story, former chief of staff to Mayor Dick Murphy. (Exhibit 79)

to complete such detailed bill and submitted more than 25 vague invoices in the effort to mislead City officials and members of the public.

These 26 invoices submitted by Kroll and Willkie Farr violated the internal controls of the City of San Diego. The lack of detail left the City unable to audit the work of the firms to ensure the proper review of documents was completed before expending public funds. Worse, it prevented City officials from adequately monitoring the progress of the firms.

**B. KROLL AND WILLKIE FARR & GALLAGHER’S NEW BILLING DETAIL REMAINS INADEQUATE**

Kroll and Willkie Farr began sending invoices with a slightly modified format in November 2005. The new invoices included a list of tasks and a separate list that showed the number of hours each employee worked and the hourly charge. The new billing format represented Kroll and Willkie Farr’s attempted appeasement of the City Attorney’s request to provide more detailed billing. The bills, however, remained in a format that could not be audited for quality and cost control. The City Attorney maintains that these invoices are insufficient to meet the internal controls of the City.

The new billing format submitted by Kroll included a list of individual employees’ tasks but the number of hours spent on that task are not provided in one list. In a separate table, Kroll listed the names of each employee, their billing rate, hours worked, and total charge. The following table is the list presented in Kroll’s 10 August 2006 invoice:

For Professional Services Rendered		
Lynn Turner	13.00 hrs @ \$750.00 per hour	[\$]9,750.00
Troy Dahlberg	31.00 hrs @ \$450.00 per hour	[\$]13,950.00
David Cogan	2.00 hrs @ \$350.00 per hour	[\$]700.00
Jennifer Arnini	62.50 hrs @ \$350.00 per hour	[\$]21,875.00
Jeffery Klien	13.10 hrs @ \$350.00 per hour	[\$]4,585.00
Jenny Dominguez	40.00 hrs @ \$350.00 per hour	[\$]14,000
Thomas Keller	1.25 hrs @ \$350.00 per hour	[\$]437.50
David Callaghan	71.00 hrs @ \$400.00 per hour	[\$]28,400.00
Arthur Levitt	18.00 hrs @ \$900.00 per hour	[\$]16,200.00
		<u>\$109,897.50</u>

In a separate table, Kroll listed categories of tasks performed and the total charge for that category of tasks for the billing period. The following is the corresponding table from the 10 August 2006 invoice:

<b>Task</b>		<b>Current Fees</b>
1)	Obtain an understanding of overall investigative procedures performed prior to the retention of Kroll and the creation of the Audit Committee	\$ -
2)	Review and assess V&E binders containing evidential matter supporting draft analyses and conclusions	-
3)	Review of the Summary Memoranda and supporting documentation prepared by V&E to identify areas for additional investigation and/or analyses.	-
4)	Prepare investigative workplan covering (1) issues identified in the analyses prepared by V&E and the City Attorney and (2) allegations and records outside those considered by V&E and the City Attorney	-
5)	Review and analyze Michael Aguirre's Interim Reports to identify allegations to consider and investigate.	-
6)	Identify additional allegations to consider and investigate (e.g., Diann Shipione and KPMG letters).	-
7)	Oversee the ongoing documents production to the SEC and U.A. Attorney.	-
8)	Accounting and other research related to investigation.	-
9)	Complete background checks for Pension Board nominees.	1,137.50
10)	Prepare communications with City employees, City Council, other elected officials, and SDCERS.	-
11)	Audit Committee oversight and management of investigation	39,900.00
12)	Address investigative workplan procedures related to electronic discovery, outside vendors, City affiliates, and other Audit Committee responsibilities.	-
13)	Perform accounting analysis related to investigative workplan.	-
14)	Perform electronic forensic procedures and analyses.	-
15)	Review selected hardcopy documents turned over by City Employees and Elected Officials in response to the various SEC, USAO, and DAO subpoenas.	-
16)	Review electronic documents.	-
17)	Prepare for and conduct interviews of key City employees, City Council members, other elected officials, and other key individuals.	-
18)	Analyze facts contained in emails, documents, and other records pursuant to ongoing investigations.	-
19)	Prepare investigative report.	68,860.00

Total Professional Fees      \$109,897.50

Because the hours and the tasks were separated from the names of the person performing the tasks, the City could not adequately determine which level of employee was spending time on each task. The bills detailed that work was being done, but provided no

indication of how long each task took or who performed the task. Under Kroll's modified billing practices, the City still remained unable to perform an adequate assessment to ensure that tasks listed were in fact being completed or even being done cost effectively.

The analysis of the more detailed bills submitted by Kroll also provides evidence to support allegations that internal controls of the City were being violated. Specifically, Kroll submitted a series of 10 invoices from 1 November 2005 through 18 August 2006 for \$6,503,307. None of these invoices detailed what task was being performed, by whom, and the time spent. The first invoice Kroll sent to the City that included a line item of tasks and hours per employee was delivered on 16 November 2005 for \$685,408.<sup>178</sup> Of the tasks included in the bills, Kroll charged the most money for the review of electronic documents, a total of \$2.5 million from the period beginning in November 2005 through August 2006. It is important to note that the \$2.5 million for documents review was spent in the second half of the investigation, after the firm billed the City \$3.5 million for nine months of work.

The following is a computation of task charges as they appeared on Kroll bills to the City from 18 November 2005, when Kroll submitted the modified format, through 18 August 2006, the final invoice:

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<sup>178</sup> 16 November 2005 Kroll invoice to P. Lamont Ewell. (Exhibit 80)

<b>TASK IN BILLS FROM 18 NOVEMBER 2005 THROUGH 17 AUGUST 2006</b>	<b>TOTALS</b>
(16) Review Electronic documents	\$2,554,148.50
(11) Audit Committee oversight and management of investigation.	\$868,665.00
(13) Perform accounting analysis related to investigative workplan.	\$623,865.00
(19) Prepare investigative report.	\$599,852.50
(14) Perform electronic forensic procedures and analyses.	\$554,547.50
(12) Address investigative workplan procedures related to electronic discovery, outside vendors, City affiliates, and other Audit Committee responsibilities.	\$515,300.00
(18) Analyze fact contained in e-mails, documents, and other records pursuant to ongoing investigation.	\$496,762.50
(15) Review selected hardcopy documents turned over by City Employees and Elected officials in response to various SEC, USAO, and DAO subpoenas.	\$117,425.00
(17) Prepare for and conduct interviews of key City employees, City Council members, other elected officials, and other key individuals.	\$90,950.00
(7) Oversee the ongoing document production to the SEC and U.S. Attorney.	\$19,740.00
(10) Prepare communications with City employees, City Council, other elected officials, and SDCERS.	\$ 30,500.00
(8) Accounting and other research related to investigation.	\$ 9,887.50
<b>TOTALS</b>	<b>\$ 6,481,643.50</b>

The first Willkie Farr invoice sent to the City that included the new line item of tasks and the total number of hours billed by employees was delivered on 16 November 2005 for a total of \$849,157.

Identical to the Kroll bills, the Willkie Farr invoices consisted of two tables. The invoices first listed the name of the employee, their billing rate per hour, and the total

billed that period. For example, the following table appeared on the 21 September 2006 invoice from Willkie Farr:

<b>Professional</b>	<b>Hours Billed</b>	<b>Hourly Rate</b>	<b>Total</b>
Jack Nusbaum	5.80 hours	\$865 per hour	\$5,017.00
Benito Romano	103.80 hours	\$850 per hour	\$88,230.00
Michael Young	77.50 hours	\$850 per hour	\$65,875.00
Michael Schachter	41.20 hours	\$590 per hour	\$24,308.00
Sharon Blaskey	141.90 hours	\$505 per hour	\$71,659.50
Brian Turetsky	84.40 hours	\$450 per hour	\$37,980.00
Michael Shaprio	108.20 hours	\$435 per hour	\$47,067.00
Jessica Ruiz del la Torre	127.80 hours	\$325 per hour	\$41,535.00
Raymond Sarola	103.50 hours	\$325 per hour	\$33,637.50
Brian Faerstein	133.60 hours	\$255 per hour	\$34,068.00
Ann Calle	192.50 hours	\$140 per hour	\$26,950.00
Caitlin Williams	2.00 hours	\$140 per hour	\$280.00
<b>Total Billed Time</b>	<b>1,122.20 hours</b>		<b>\$476,607.00</b>

In a separate table, on a separate page in the invoice, Willkie Farr included a list of tasks and the total billed for that period – without any indication of which employee was working on the task for what period. For example, the following table appeared on the 21 September 2006 invoice from Willkie Farr:

<b>Task</b>	<b>Current Invoice</b>
1) Efforts directed to seeking compliance by the City with all regulatory and government subpoenas and document requests.	\$0.00
2) Review of hardcopy documents turned over by City employees and Elected Officials in response to various regulatory and governmental subpoenas and document requests.	\$0.00
3) Review of City e-mail and electronic documents.	\$0.00
4) Discussions with law enforcement authorities and auditors as to progress on investigative efforts.	\$0.00
5) Review and processing of information collected by Vinson & Elkins as part of its investigation including examination of witness memoranda, exhibits, and related materials.	\$0.00
6) Preparation for witness interviews, interviews of key witnesses, and follow-up regarding the same.	\$13,715.50
7) Formulation of program for preparation of written report including consideration of issues to be addressed in report, assessment of currently available information, legal research, and identification of areas requiring additional activity.	\$314,583.00
8) Projects concerning the Board of the San Diego City Employees' Retirement System.	\$0.00
9) Activities related to oversight and management of investigative team.	\$148,308
Total Professional Fees	\$476,607.00

The City Attorney believes that these invoices are insufficient to meet the internal controls of the City because an audit review of the work is not possible given the inadequate separation of employees, hours, and duties. Willkie Farr submitted 11 invoices under this billing format for a total of \$8.6 million. It is important to re-emphasize that the first invoice submitted to the City included a line item breakdown on what each employee was doing, the time spent, the task, and the cost. However, that level of detail – required by the City of all consultants like Kroll -- was inexplicably stopped.

The following is a cumulative list of tasks and related charges compiled from the Willkie Farr invoices received by the City from 16 November 2005 through 13 September 2006:



<b>TASK IN BILLS FROM 16 NOVEMBER 2005 THROUGH 13 SEPTEMBER 2006</b>	<b>TOTAL</b>
Formulation of program for preparation of written report including consideration of issues to be addressed in report, assessment of currently available information, legal research, and identification of areas requiring additional activity.	\$3,092,237.40
Preparation for witness interviews, interviews of key witnesses, and follow-up regarding the same.	\$2,045,086.20
Review of City e-mail and electronic documents.	\$862,433.10
Activities related to oversight and management of investigative team.	\$858,332.10
Review of hardcopy documents turned over by City employees and Elected Officials in response to various regulatory and governmental subpoenas and document requests.	\$227,045.80
Discussions with law enforcement authorities and auditors as to progress on investigative efforts.	\$93,595.00
Review and processing of information collected by Vinson & Elkins as part of its investigation including examination of witness memoranda, exhibits, and related materials.	\$42,419.50
Projects concerning the Board of the San Diego City Employees' Retirement System.	\$36,418.40
Efforts directed to seeking compliance by the City with all regulatory and government subpoenas and document requests.	\$8,493.00
<b>TOTAL</b>	<b>\$9,759,918.25</b>

The City Attorney believes that the City's duty to ensure that work is being done properly by instituting and enforcing information and communication standards, and control processes to ensure efficient and quality work was clearly circumvented by Kroll and Willkie Farr refusals to submit detailed bills to the City of San Diego.

More importantly, it is crucial to re-emphasize that Dahlberg, managing partner at Kroll, submitted a bill with the adequate level of detail on 13 July 2005 only to a staff

member in the Mayor’s Office.<sup>179</sup> Three months later, Dahlberg stood in front of the City Council and stated that Kroll does not bill that “way.” Kroll then continued to submit vague billing practices despite numerous requests from the San Diego City Attorney for more detailed invoices.

### **C. Temporary Personnel Bills Violate Internal Controls**

Throughout the course of Kroll and Willkie Farr’s engagement with the City of San Diego, both firms billed more than \$960,000 to hire consultants to complete document review. In other words, the City paid nearly \$1 million for consultants to hire consultants. The City Attorney believes that internal controls of the City of San Diego were violated by Kroll and Wilkie Farr in their engagement of outside consultants because both firms refused to provide hourly logs, pay rates, and task sheets for these consultants’ work.

Kroll used more than 73 associates to work on its investigation.<sup>180</sup> These associates billed between \$250 and \$900 per hour and billed more than 29,948 hours. Kroll billed more than \$2.6 million in the final 11 months of the investigation for document review. Kroll was selected by the City specifically for to their expertise in conducting illegal acts investigations as requested by the City’s outside auditor, KPMG. Unfortunately for the City, Kroll’s landed experience was neither cheap nor efficient.

Kroll billed the City \$27,332 for “Temporary Personnel”<sup>181</sup> under the “Out-of-Pocket Disbursements” section on a series of invoices throughout its contractual relationship with the City. On the 8 March 2006 invoice, the listing for “Temporary Personnel” was accompanied by a \$416 charge and was also accompanied by a footnote which stated, “Temporary Personnel include costs for a temporary employee engaged

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<sup>179</sup> 13 July 2005 e-mail from Troy Dahlberg, managing partner at Kroll Inc., to Ravila Ruderman, staff for form Mayor Dick Murphy. Subject: “Invoice Detail.” Carbon copied: Tom Story, former chief of staff to Mayor Dick Murphy. (Exhibit 79)

<sup>180</sup> Table including the names and hourly rates of Kroll associates. Source of the information: the Kroll invoices. (Exhibit 81)

<sup>181</sup> Kroll charged the City for “Out-of—Pocket Disbursements” on invoices submitted to the City of San Diego dated 8 March 2006, 4 April 2006, 19 April 2006, 18 May 2006, 20 June 2006, 6 July 2006, 13 July 2006, 21 July 2006, and 3 August 2006. (Exhibit 82)

through AppleOne Employment Services to assist in the review of City email and electronic documents.”<sup>182</sup>

The bills, however, provide no information of the rates paid to the temporary staffing companies or how many hours these individuals worked on which project.

Willkie Farr’s invoices showed that 43 different employees billed for the work on the investigation between \$65 to \$865 per hour.<sup>183</sup> The firm billed more than \$1.13 million for document review in the final 11 months of the investigation. The firm, however, billed the City more than \$939,400 for “outside consultants” that “includes temporary attorneys engaged through Update Legal to assist in the review of City email and electronic documents...Outside Consultants also include temporary legal assistants/administrative professionals to support the investigation...”<sup>184</sup> Willkie Farr’s billings also failed to provide any information on the cost per hour of the temporary attorneys and paralegals and how many hours the individuals worked. This makes it impossible for the City to either audit the work of the temporary employees or perform a quality analysis of the firm’s reputation or the work it does.

## **V. KROLL AND WILLKIE FARR POSSESS DETAILED KNOWLEDGE OF FALSE CLAIMS ACT**

Representatives of Kroll and Willkie Farr presented the final version of its \$20 million report to the San Diego City Council on 8 August 2006.<sup>185</sup> Included in the Report was substantial legal information regarding the California Penal Code and the legal analysis of false claims statutes.

The Report outlined the law, what constitutes a false claim and potential penalties, if prosecuted:

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<sup>182</sup> Kroll invoice No. 1311529 sent to the City of San Diego on 8 March 2006. (Exhibit 82)

<sup>183</sup> Spreadsheet including Willkie Farr & Gallagher employees listed in the company’s invoices to the City of San Diego. (Exhibit 83)

<sup>184</sup> 22 June 2005. Willkie Farr & Gallagher invoice to City of San Diego. (Exhibit 78)

Most prominently, the officials and employees of the City Attorney's Office may be held criminally liable under the California Penal Code pursuant to either Section 72 ("Presenting False Claims") or Section 424 ("Embezzlement and Falsification of Accounts"). The latter provision has been applied to the specific context of the falsification of employee time records. While in that particular case the defendant profited from the falsification of time cards, a violator of Section 424 does not necessarily have to personally benefit from the false claim or transaction or have direct control over the funds at issue.<sup>186</sup>

Kroll and Willkie Farr included in the Report a detailed analysis of the applicable penal codes:

Cal. Penal Code § 72 (West 2006); Cal. Penal Code § 424 (West 2006). Section 72 prohibits 'every person...with intent to defraud' from making 'any false or fraudulent claim, bill, account, voucher, or writing' to a public board or office. Section 424 prohibits public 'officers' from, among other things, knowingly making false entries into any account or fraudulently altering an account. As a general intent crime, Section 424 only requires a showing that a violator had a general intent to commit a false act and is easier to prove than Section 72, a specific intent to defraud...('A violation of Penal Code section 72 cannot be accomplished without the requisite intent to defraud. No such intent, however, is required of a violation of section 424').<sup>187</sup>

In that passage of the Report, Kroll and Willkie Farr specifically address California Penal Code § 424 which discusses fraudulent billing practices:

California Penal Code Section 424...(a) Each officer of the this state, or any county, city, town, or district of this state, and every other person charged with the receipt, safekeeping, transfer, or disbursement of public moneys, who...[k]nowingly keeps any false account or makes any false entry or erasures in any account of or relating to the same; or, 4. Fraudulently alters, falsifies, conceals, destroys or obliterates any

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<sup>186</sup> "Report of the Audit Committee of the City of San Diego | Investigation into the San Diego City Employees' Retirement System and the City of San Diego Sewer Rate Structure." Kroll and Willkie Farr & Gallagher LLP. P. Q-4, Q-5. (Exhibit 84)

<sup>187</sup> "Report of the Audit Committee of the City of San Diego | Investigation into the San Diego City Employees' Retirement System and the City of San Diego Sewer Rate Structure." Kroll and Willkie Farr & Gallagher LLP. P. Q-4, Q-5. (Exhibit 84)

account;...[i]s punishable by imprisonment in the state prison for two, three, or four years...<sup>188</sup>

This passage illustrates that representatives at Kroll and Willkie Farr had in-depth knowledge of California laws regarding what actions qualify as false billing and also the potential penalties involved.

In the Report, Kroll and Willkie Farr also illustrated knowledge of the City of San Diego’s billing requirements and the need to include detailed tasks and hourly reporting. Kroll specifically cited<sup>189</sup> San Diego Municipal Code § 11.0401:

§ 11.0401 Furnishing False or Incomplete Information Prohibited

- (a) Purpose and intent. It is the purpose and intent of the Council that every applicant for City licenses, permits, certificates, employment or other City actions under the provisions of the San Diego Municipal Code should be required to furnish true and complete information.<sup>190</sup>

The inclusion of the ordinance illustrates that Kroll had complete knowledge of the City’s billing requirements including the requirement that entities billing the City “should be required to furnish true and complete information.”<sup>191</sup>

The Report also includes the San Diego Municipal Code section that outlines the penalties for violating the billing requirements. Specifically, Kroll and Willkie Farr included Municipal Code Section 12.0102:

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<sup>188</sup> California Penal Code § 424. (Exhibit 85)

<sup>189</sup> “Report of the Audit Committee of the City of San Diego | Investigation into the San Diego City Employees’ Retirement System and the City of San Diego Sewer Rate Structure.” Kroll and Willkie Farr & Gallagher LLP. P. Q-5. (Exhibit 84)

<sup>190</sup> San Diego Municipal Code § 11.0401. (Exhibit 86)

<sup>191</sup> San Diego Municipal Code § 11.0401. (Exhibit 86)

§12.0202 Civil Violations -- Injunctions and Civil Penalties

- (a) In addition to any other remedy provided by this Code, any provision of this Code may be enforced by injunction issued by the Superior Court upon a suit brought by The City of San Diego.<sup>192</sup>

This information, all referenced in the Kroll and Willkie Farr report, illustrate that these firms had detailed knowledge of the applicability of the City of San Diego's and the State of California's billing guidelines prohibiting fraudulent billing practices.

Finally, the American Institute of Certified Public Accountants (AICPA) outlines auditing and professional standards in their Codification of Statements on Auditing Standards. Specifically, AU § 319 outlines the roles and responsibilities of the hiring agency as well as the Professional Code of Conduct of auditors and accountants. It is the role of both the City and the consultant to ensure that work is being done properly by instituting information and communication standards, and control processes to ensure efficient and quality work.<sup>193</sup>

**1. WILLKIE FARR & GALLAGHER SUBMITS FALSE BILLS FOR REVIEW OF VINSON & ELKINS DOCUMENTS**

The City Attorney believes that Willkie Farr violated false billing statutes by charging the City of San Diego for the document review and preparation of the Vinson & Elkins report months after the report was written. In short, evidence exists to support an allegation that Willkie Farr billed the City more than \$42,000 for work that it had already done, in other words, double billed for work already completed.

Vinson & Elkins was initially hired by the City in February 2004 for legal representation in a new investigation launched by the SEC. As part of its engagement with the City, Vinson & Elkins was also tasked with investigating and issuing a “warts

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<sup>192</sup> “Report of the Audit Committee of the City of San Diego | Investigation into the San Diego City Employees’ Retirement System and the City of San Diego Sewer Rate Structure.” Kroll and Willkie Farr & Gallagher LLP. P. Q-5. (Exhibit 84)

<sup>193</sup> American Institute of Certified Public Accountants’ handbook titled “Codification of Statements on Auditing Standards. Section: “AU § 319 – Consideration of Internal Control in a Financial Statement Audit.” (Exhibit 56)

and all”<sup>194</sup> report on the City’s financial disclosure practices. The report was supposed to satisfy concerns the City’s outside auditor, KPMG, had with possible illegal acts by City officials in the competition of fraudulent financial disclosure documents.

Vinson & Elkins issued its report on 16 September 2004. The Vinson & Elkins Report was found deficient by KPMG as it failed to address potential illegal acts by City officials. The City re-hired Vinson & Elkins on 15 October 2004 and tasked the firm to issue a follow-up memorandum to address the concerns that KPMG had.

Shortly after Vinson & Elkins signed the new agreement, Michael Aguirre was elected the incoming San Diego City Attorney. Aguirre, upon taking office in December 2004, immediately declared he would conduct an investigation into potential illegal acts to address questions raised by KPMG and the SEC. Aguirre issued five “Interim Reports” regarding illegal acts over the period 14 January 2005 through 6 December 2005.<sup>195</sup>

In February 2005, the Mayor and City Council hired Kroll Inc., to analyze the reports issued by the City Attorney and Vinson & Elkins’ report and the memorandum which was under production. Kroll was tasked with analyzing the reports, reconciling the differences, and determine what happened.

Kroll’s task was expanded in March 2004 to conduct its own investigation into possible illegal acts and serve as an “audit committee” as envisioned by Sarbanes Oxley Act. Kroll then hired New York-based securities defense firm, Willkie Farr & Gallagher, to assist in the research and production of the investigative report.

At this point, the City had contracted with three different firms to conduct investigations and issue two different reports. Vinson & Elkins was working on its follow up to the 16 September 2004 report. Meanwhile, Kroll and Willkie Farr were proceeding on a separate “independent” investigation. This would necessarily mean that Kroll would and should be scrupulous in maintaining its independence from Vinson & Elkins.

Over the course of the next month, the lines between these investigation began to blur and the Vinson & Elkins, Kroll, and Willkie Farr began to work together on the research and the writing of Vinson & Elkins’ second report. This relationship began to

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<sup>194</sup> 18 February 2004 letter from Vinson & Elkins Partner Paul Maco to San Diego City Attorney Casey Gwinn. (Exhibit 3)

<sup>195</sup> San Diego City Attorney Michael Aguirre Interim Reports 1, 2, 3, 5, 6, and 7. (Exhibit 87)

flourish as April of 2005 and by May, according to invoices submitted by Vinson & Elkins to the City, members of Kroll's team were working directly with Vinson & Elkins on preparing and drafting the law firm's second report.

Over time, the relationship between Kroll, Willkie Farr and Vinson & Elkins deepened. On 16 February 2005, Lynn Turner sent an e-mail to Ewell explaining that Vinson & Elkins would, in effect, report directly to Kroll. Turner wrote, "Lamont – just to let you know I had a good call with Paul Maco yesterday and was able to communicate with Les Hand who was in NYC. Paul and I set up a reporting arrangement whereby he will report to us..."<sup>196</sup> The message was sent just days after the City Council approved the letter of engagement with Kroll in February and months before Vinson & Elkins released its second report. The message clearly illustrated that Vinson & Elkins, Kroll and Willkie Farr were working closely since the beginning of Kroll's work for the City.

In late May, Richard Sauer, a partner at Vinson & Elkins, spent 10 hours working on a "Draft report regarding securities law violations." During this time – between 24 May 2005 and 31 May 2005 – Paul Maco spent more than 30 hours meeting with Kroll representatives. Sauer then met with the Kroll team on 27 May 2005 for 5.50 hours for "team conferences" and "draft memo." Maco then met with the Kroll team on 31 May 2005 for 2.5 hours to "continue report preparation."<sup>197</sup> Despite the work indicated on the billings, the second report from Vinson & Elkins would not be released until August.

The City Council was told by the Audit Committee that they were, in fact, overseeing the evidence collection and the production of Vinson & Elkins' second report. At the 14 June 2005 meeting of the City Council, Dahlberg said:

We're on various tracks. But let's start with one of the critical tracks which is Vinson & Elkins. Right now, they have put together or are in the process of completing 19 separate analyses that represent a totality of about 125 allegations that are out there that we have overseen and reviewed and helped them structure in a way that KPMG will most likely be easy to work with and will find useful.<sup>198</sup>

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<sup>196</sup> 16 February 2005. E-mail from Lynn Turner to P. Lamont Ewell. Subject: SAn Diego [sic]. (Exhibit 88)

<sup>197</sup> 7 June 2005. Vinson & Elkins invoices to P. Lamont Ewell. (Exhibit 89)

<sup>198</sup> Transcript of the 14 June 2005 meeting of the San Diego City Council. (Exhibit 90)



Dahlberg continued:

We are right now in the process of finalizing that and going through that with them. Probably by the time we come back in four weeks, that process should be drawing near to a conclusion where we will have very substantial drafts.<sup>199</sup>

Dahlberg's comments to the City Council make clear that the Audit Committee was not only in control of the evidence and drafts that Vinson & Elkins produced, but that the Audit Committee actually assisted in writing the documents.

At the 1 August 2005 meeting of the City Council, Troy Dahlberg stated that a request from federal investigators was received for the City Council to waive all attorney-client privilege on documents compiled by Vinson & Elkins. Dahlberg told the City Council that the U.S. Attorney's Office and the SEC had both contacted Maco asking for the City's waiver. At the City Council meeting, Dahlberg stated:

Mr. Maco contacted me from Vinson & Elkins not last week, but the week before last, letting me know that he had been contacted by the U.S. Attorney...to get his notes from the interviews that he had done, which they had not yet turned over and were part of the attorney client privilege. And then also, we had gotten a request, not last week, but the week before last from the SEC to allow them to have Vinson & Elkins work papers and reports, so those two things are sitting at the table.<sup>200</sup>

Based on Dahlberg's comments, evidence in this report supports the allegation that Kroll and Willkie Farr had already been in possession of the Vinson & Elkins documents. After all, as of August 2005, the companies comprising the Audit Committee had already billed the City \$6.5 million for unspecified work that cannot be audited. Dahlberg continues at the City Council meeting:

Well, this action specifically relates to being able to reveal to just anybody, certainly if we came here and set all the binders down and started talking about them, you have waived the privilege because it would be public. The way that you would keep the privilege that you so determined that you want it to, would be that we would have to meet in closed session or something like that, with the Council and then walk through the thirty-odd binders and the two hundred pages of the Vinson &

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<sup>199</sup> Transcript of the 14 June 2005 meeting of the San Diego City Council. (Exhibit 90)

<sup>200</sup> Transcript of the 1 August 2005 meeting of the San Diego City Council. P. 2. (Exhibit 91)

Elkins report and then you can decide from that if you want to put it up on a Web site, scan it and image it. However, we would want to do that and I think we would probably want to talk to you first about how you want to do that... If you've got time, we have it upstairs.<sup>201</sup>

Dahlberg stated that all of the documents are already in the Audit Committee's possession in the City Administration building. Dahlberg further illustrated the Audit Committee's in-depth knowledge Vinson & Elkins' work plan. Dahlberg stated:

The way [Vinson & Elkins] ended up doing was they contracted to prepare summary memorandum. That was what was laid out in their engagement letter. There are issues there are many issues, hundreds more issues. And they've gone through and addressed these in these summary memos and there are probably – off the top of my head, a couple of hundred pages worth of these summary memorandums that kind of address various issues and sort of analytical basis...Everything that Vinson & Elkins has done for you in this investigation is part of this that we are talking about.<sup>202</sup>

It becomes clear with this quote that Kroll and Willkie Farr were now in possession of all of the work materials Vinson & Elkins had compiled through all of its work for the City.

Dahlberg goes so far as to list the documents. Dahlberg stated:

Let's see, there is the summary memorandum that they have, there are a group of binders that have been prepared that have an analysis in them, copies of documents, where they got documents from. Then, behind that there are a number of documents like interview memorandum, research that they have done, some on loss, some on financial accounting issues. They have done a lot of background, some of it is like public record type of things like newspaper clippings. But off the top of my head, that's probably mostly what it is.<sup>203</sup>

In his statements to the City Council, Dahlberg also stated that the Audit Committee would present the findings in Vinson & Elkins second report to the U.S. Attorney, SEC and KPMG. Dahlberg stated:

DAHLBERG: We are planning, we have the meeting set...

AGUIRRE: As the City's Audit Committee is proposing to set meetings with the SEC, U.S. Attorney's Office, and KPMG, review

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<sup>201</sup> Transcript of the 1 August 2005 meeting of the San Diego City Council. P. 4. (Exhibit 91)

<sup>202</sup> Transcript of the 1 August 2005 meeting of the San Diego City Council. P. 6-7. (Exhibit 91)

<sup>203</sup> Transcript of the 1 August 2005 meeting of the San Diego City Council. P. 14. (Exhibit 91)

and discuss Vinson & Elkins work product and results of investigations. Is that correct?

DAHLBERG: Right. I didn't believe that was something we needed voting permission on.<sup>204</sup>

Based on this testimony, the Audit Committee was not only in possession of the report and the accompanying evidence, interviews and handwritten notes, the group was knowledgeable enough about the documents and the investigation to present it to auditors and federal agencies. Dahlberg also told the Council, "We worked with Vinson & Elkins to get this thing done..."<sup>205</sup>

The second report issued by Vinson and Elkins clearly failed to meet the requirements of AU § 317, which was explicitly required by KPMG. Neither of the investigative reports by Vinson & Elkins included an analysis of the computer hard drives of City Council members and their staffs, according to Paul Maco at the 9 August 2005 meeting of the City Council.<sup>206</sup> Maco also told the City Council at this meeting that Vinson & Elkins' work for the City was completed and their engagement terminated.

Maco stated:

Our recommendation to the City at this time, this is a opportune time for us to step aside, allow you to select new SEC counsel , to move forward, to wrap up matters as expeditiously as possible. I will be happy to assist the City in identifying new counsel.<sup>207</sup>

Willkie Farr billed the City more than \$40,000 for review of documents and interviews collected by Vinson & Elkins more than four months after the submission of the firm's second report to the City Council. Willkie Farr billed the City more than \$23,000 for "Review and processing of information collected by Vinson & Elkins as part of its investigation including examinations of witness memoranda, exhibits, and related materials." These charges appeared in a series of invoices Willkie Farr submitted to the City:

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<sup>204</sup> Transcript of the 1 August 2005 meeting of the San Diego City Council. P. 17. (Exhibit 91)

<sup>205</sup> Transcript of the 1 August 2005 meeting of the San Diego City Council. P. 32. (Exhibit 91)

<sup>206</sup> Transcript of the 9 August 2005 meeting minutes of the San Diego City Council. (Exhibit 92)

<sup>207</sup> Transcript of the 9 August 2005 meeting minutes of the San Diego City Council. (Exhibit 92)

- on 16 November 2005 for a total of \$23,650;
- on 7 March 2006 for a total of \$1,530;
- on 16 March 2006 for a total \$1,867;
- and 14 April 2006 for \$15,396.<sup>208</sup>

The City Attorney believes that sufficient evidence exists to show that representatives of Willkie Farr were in possession of the Vinson & Elkins work product, documentary evidence, interview materials and report drafts long before the second Vinson & Elkins report was issued to the City of San Diego. The City Attorney believes that sufficient evidence exists to support the allegation that representatives of the Audit Committee -- including representatives of Willkie Farr -- assisted in the production of the report through its communication with the Audit Committee. The City Attorney thereby believes that ample evidence has been presented to support the allegation that Willkie Farr's billing the City \$42,419 for the review of the report, more than five months after it was released, illustrates fraudulent and excessive billings in violation of false claims statutes.

## **2. KROLL MISREPRESENTS WILLKIE FARR & GALLAGHER'S ROLE IN INVESTIGATION**

In February 2005, the Mayor and City Council hired Kroll Inc. to analyze the reports issued by the City Attorney and reports from Vinson & Elkins. Kroll was tasked to analyze the different accounts and make a final determination. Kroll's task was expanded in March 2004 to conduct a new investigation into possible illegal acts in the City and serves as an "audit committee" as contemplated by Sarbanes Oxley Act. Kroll hired New York-based securities defense firm, Willkie Farr & Gallagher, to provide "counsel and assistance" to Kroll in the investigation. A detailed analysis of invoices submitted by the firm over the final 11 months of the investigation illustrates that Willkie Farr:

- Billed the City as much as Kroll for the review of documents;

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<sup>208</sup> Willkie Farr & Gallagher invoices to the City of San Diego dated: 16 November 2005; 7 March 2006; 16 March 2006; 14 April 2006. (Exhibit 93)

- Billed a strikingly similar amount as Kroll for oversight of their separate investigative staff illustrating that Willkie Farr, a white collar defense firm, authored a defense document instead of an “independent report”;
- Billed more than five times more than Kroll for writing the report.

The City Attorney believes that Willkie Farr exceeded the scope of work as identified in the contract and charged the City without proper authorization.

The scope of duties as outlined by Willkie Farr’s letter of engagement submitted to the Audit Committee and signed for by former City Manager Lamont Ewell on 19 April 2005 stated:

The purpose of our engagement is to assist the Audit Committee in connection with financial reporting and other issues that have arisen concerning the San Diego City Employees’ Retirement System (“SDCERS”). The scope of our engagement will include counsel and assistance to the Audit Committee in connection with its independent investigation into SDCERS finances and disclosure. It will also include other matters that, in the judgment of the Audit Committee, may require inquiry or investigation.<sup>209</sup>

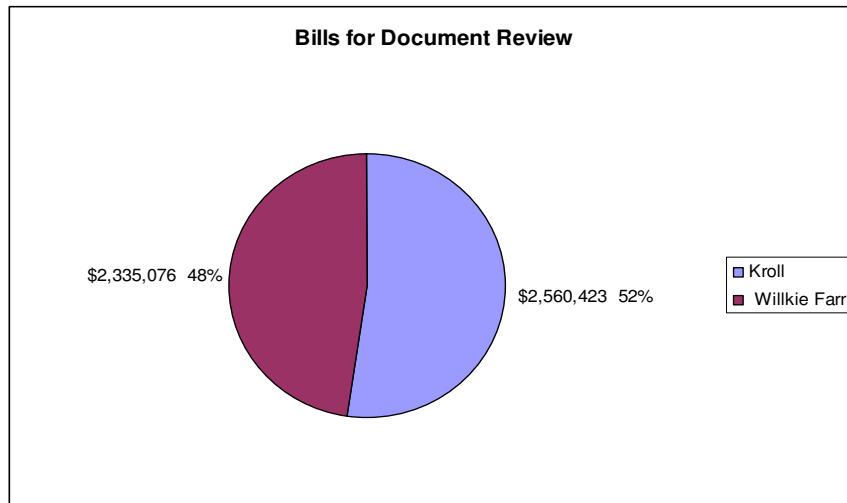
The evidence presented in this section of the report supports the claim that Willkie Farr overstepped the scope of work in its engagement letter. The firm was contracted to provide “counsel and assistance to the Audit Committee in connection with its independent investigation.” The evidence uncovered by the City Attorney, however, supports the allegation that Willkie Farr conducted an investigation, independent of Kroll, and that Willkie Farr conducted the majority of the writing of the actual report presented by the City to Kroll. However, Willkie Farr was not retained by the City or Kroll to perform these tasks. The City Attorney believes that Willkie Farr overstepped the scope of work of its engagement.

Based on the vague invoices submitted by Willkie Farr, enough evidence still exists to illustrate that Willkie Farr conducted essentially the same documents review for the report. During the last 11 months of the investigation, Kroll charged approximately \$2.5 million for document review. In comparison, Willkie Farr billed approximately \$2.3

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<sup>209</sup> 19 April 2005. Letter from Michael Young, partner at Willkie Farr & Gallagher, to Audit Committee of the City of San Diego c/o Troy Dahlberg, managing partner at Kroll Inc. (Exhibit 94)

million for document review. The graph below clearly illustrated that the firms duplicated the costs of the review.



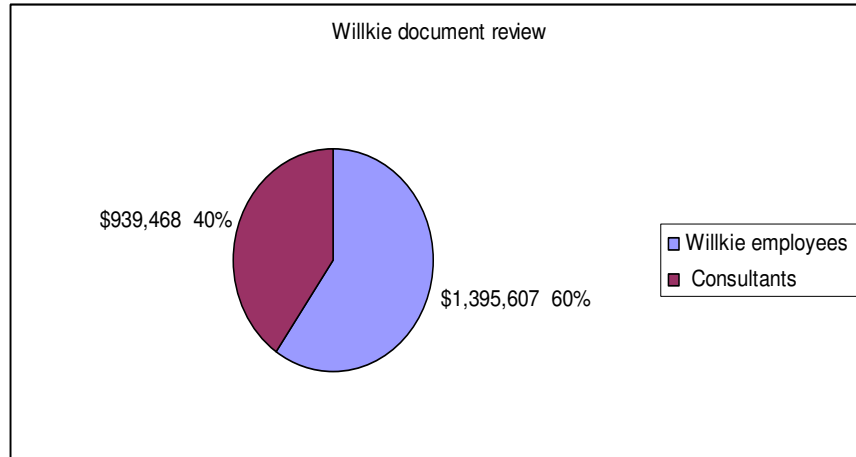
This evidence also supports the allegation that both firms were reviewing documents independent of each other. After all, if Kroll associates were looking through documents and separating only documents related to the investigation, the number of documents should have been reduced significantly and required far less than a doubling of the document review cost. Additionally, it is also worth noting that 72 associates and partners at Kroll billed the City for work on this investigation. Meanwhile, 39 associates and partners at Willkie Farr billed the City for work on this project. According to invoices, many of the attorneys at Willkie Farr billed more than associates at Kroll for the task of document review.

A more careful analysis of the Willkie Farr invoices shows that nearly half of their document review costs were for a cost associated with service by temporary attorneys and paralegals in New York-based private consulting firms.<sup>210</sup> Specifically, according to the bills, about 40 percent of Willkie Farr's document review was conducted

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<sup>210</sup> 16 March 2006 invoice from Willkie Farr & Gallagher to City of San Diego; 14 April 2006 invoice from Willkie Farr & Gallagher to City of San Diego. (Exhibit 93)

by part-time attorneys and paralegals from temporary staffing companies presumably at an hourly rate lower than in house counsel rates<sup>211</sup>:

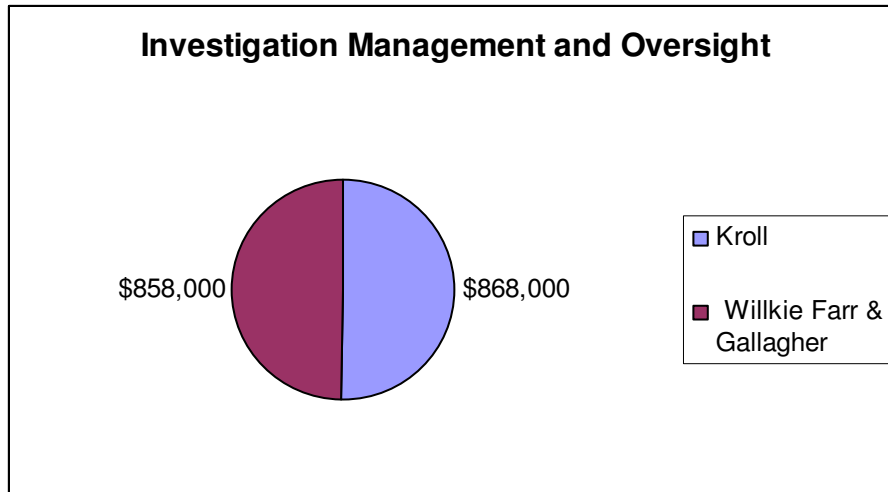


This table provides additional evidence to show that Willkie Farr was conducting a separate documents investigation distinct from the work of the Kroll firm. Again, Willkie Farr was contracted to provide “counsel and assistance to the Audit Committee in connection with its independent investigation.” The City Council never authorized Willkie Farr to conduct a separate and parallel investigation, doubling the document review effort to Kroll, who staffed its own attorneys to work on the investigation.

An analysis of the invoices submitted by both firms indicates that they charged a strikingly similar amount in their separate management and oversight of their separate investigative teams. Over the course of the last 11 months of the investigation, Willkie Farr billed more than \$858,000 for “Activities related to oversight and management of investigative team.” For the same period of time, Kroll billed the City \$868,665 for “Audit Committee oversight and management of investigation.”

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<sup>211</sup> It is important to stress that it is not currently possible for the City to audit the work of the outside consultants because Willkie Farr & Gallagher refuses to turn over detailed billing for their services. (Exhibit 95)



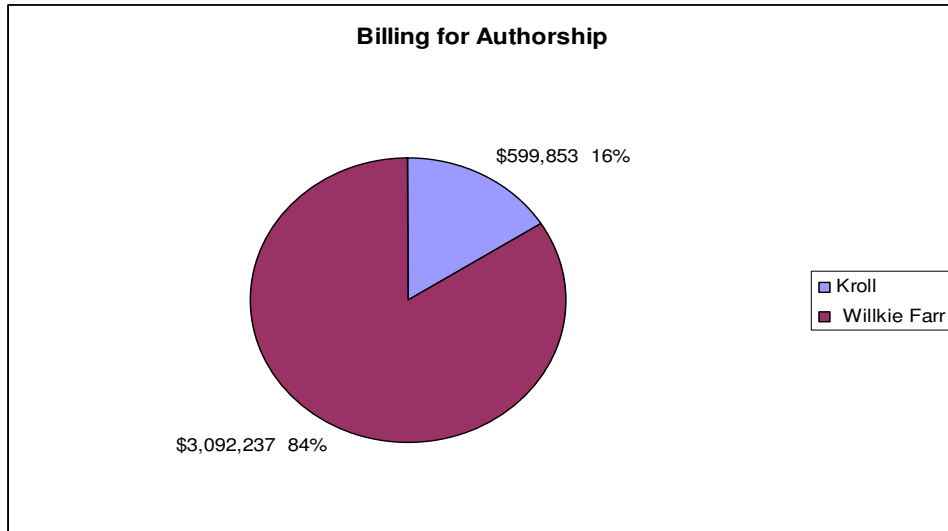
It is critical to emphasize that the City of San Diego hired Kroll to conduct an illegal acts investigation and issue an investigative report to satisfy the concerns of KPMG. Kroll hired white collar, securities defense firm Willkie Farr to provide “counsel and assistance to the Audit Committee in connection with its independent investigation....” The evidence, however, illustrates that there were two separate investigations occurring at the same time by two different companies. One investigation was being completed by the firm specializing in investigations. The other investigation conducted by a white collar criminal defense firm.

These facts are crucially important to understanding the validity of the documents in terms of identifying potential illegal acts. Specifically, Kroll was hired by the City for its investigative skill and its ability to identify remediation steps. Kroll, specifically, was retained by the City to harness the accounting knowledge of Lynn Turner and the regulatory oversight knowledge supposedly possessed by Arthur Levitt. Willkie Farr was chosen and contracted by Kroll to assist Kroll’s investigation, not conduct an independent investigation. Willkie Farr is one of the nation’s leading white-collar criminal defense firms. The firm, in fact, represented KPMG in the largest tax fraud in the history of the United States.

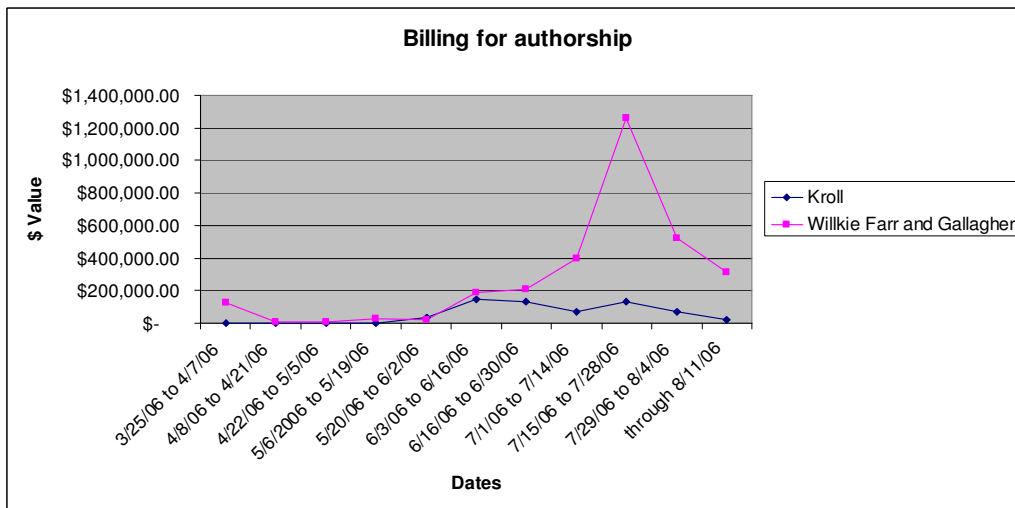
Further analysis of the bills show that Willkie Farr was responsible for writing the bulk of the report. In fact, 84 percent of the bills charged for writing the report and the factual analysis came from Willkie Farr. Kroll, who was hired to write the report and whose representative made up the entirety of the so-called Audit Committee, was



responsible for just 16 percent of the analysis and authorship of the report. The graph below provides a striking representation of which firm was, in fact, responsible for the production of the \$20 million report.



Another look at the information in a different graphical presentation illustrates how much Willkie Farr was billing the City for the preparation of the report in the final days before its release compared to Kroll’s billing.



Contrary to the City’s expectation that Kroll was authoring the report, this graph provides clear evidence that the securities defense firm, not the auditors, were the principle authors that worked on the report.

In addition, it is worth noting that Willkie Farr & Gallagher, a nationally respected criminal defense firm, charged five times more, over \$2 million more than Kroll did to write the report. This is particularly important because Kroll was the company that was hired by the City to issue the report and whose advice we have relied upon in implementing a remediation strategy. Moreover, Willkie Farr was hired by Kroll only to provide “assistance to the Audit Committee in connection with its independent investigation into SDCERS finances and disclosure,”<sup>212</sup> not to write 84 percent of the document. After all, according to the Willkie Farr’s letter of engagement, Willkie Farr and none of its employees were members of the Audit Committee.

Thus, the City Attorney believes that the “Report of the Audit Committee of the City of San Diego: Investigation into the San Diego City Employees’ Retirement System and the City of San Diego Sewer Rate Structure” is nothing more than a whitewash to serve as a defense for the Mayor and City Council who were paying the bills to Kroll and Willkie Farr & Gallagher and not the objective, warts and all, independent investigation and report the City commissioned. The City Attorney believes, based on the billings, that Kroll conducted the investigation to produce only the summary of facts section of the investigation and a small portion of the remediation. The City Attorney believes the evidence shows that Willkie Farr was responsible for conducting a separate investigation, under the leadership of defense attorneys not part of the Audit Committee, for the purpose of compiling evidence and formulating a criminal defense strategy for the individuals responsible for paying the firms bills: the Mayor, City Council and City Manager. With this as a backdrop, is it any wonder why Kroll and Willkie Farr found the Mayor, City Council, and City Manager’s only negligent in their roles in the falsification of financial documents and their subsequent approval.

### **3. KROLL AND WILLKIE FARR & GALLAGHER SUBMIT FRAUDULENT BILLS FOR JUNE 10 MEMO DOCUMENTS REVIEW**

In the later part of Kroll’s investigation, Kroll billed the City more than \$2.5 million for the review of electronic documents. This charge raises concerns over what

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<sup>212</sup> 19 April 2005. Letter from Michael Young, partner at Willkie Farr & Gallagher, to Audit Committee of the City of San Diego c/o Troy Dahlberg, managing partner at Kroll Inc. (Exhibit 94)

work the company was undertaking during the first nine months of its investigation, for which it billed \$3.8 million. Kroll was hired by the City of San Diego in February 2005 with its duties to complete an independent investigation broadened in March 2005.

At the start of Kroll's work, the City had been under investigation by the SEC and U.S. Attorney's Office for nearly a year and had responded to a number of subpoenas, which yielded a collection of more than a million paper documents.<sup>213</sup> These documents were stored at Civic Center Plaza, which also houses the San Diego City Attorney's Office. Kroll officials were given unfettered access to this information.

Despite the massive collection of documents in the City's possession, at Kroll's behest, the Mayor and City Manager issued a memo on 10 June 2005 requesting a duplicative document collection from thousands of employees across the City bureaucracy. The letter stated:

Ongoing communication with law enforcement agencies. The issue being addressed with the United States Attorney and the Securities and Exchange Commission include the completion of a comprehensive document production for the City and SDCERS. Due to issues with prior production of material subpoenaed by the law enforcement agencies, we have provided a memorandum to City employees and Council Members requesting complete production of subpoenaed materials and individual certification of completion of that task.<sup>214</sup>

The memo provided, as identified in the 10 June 2005 update discussed above, was a letter from the Mayor and City Manager to, "All City Employees, City Council, and San Diego City Retirement System" that requested documents. The letter stated:

As you know, we have received a number of subpoenas from law enforcement authorities requiring production of a broad range of documents related to matters under investigation. Additional investigative activity is now also being undertaken by the City's Audit Committee.

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<sup>213</sup> It is important to note that the information stored in the documents repository was enough for the U.S. Grand Jury to indict six former and current members of the San Diego City Employees' Retirement System on 6 January 2006; 6 January 2006. United States District Court Southern District of California January 2004 Grand Jury: United States of America, Plaintiff, v. Ronald Saathoff (1), Cathy Lexin (2), Teresa Webster (3), Lawrence Grissom (4), Lorraine Chapin (5), Defendants. Criminal Case No. 06CR0043BEN. Indictment: Title 18, U.S.C., Sec. 371 – Conspiracy to Commit Wire and Mail Fraud; Title 18, U.S.C., Secs. 1343 and 1346 – Wire Fraud; Title 18, U.S.C., Secs. 1341 and 1346 – Mail Fraud; Title 18, U.S.C., Sec. 2 – Aiding and Abetting. (Exhibit 96)

<sup>214</sup> 10 June 2005. Letter from Troy Dahlberg, Audit Committee member, to Hon. Richard Murphy, mayor of the City of San Diego. Re: "Audit Committee Update". (Exhibit 97)

We recently have discovered that documents called for by these subpoenas were not timely identified and made available to us for production to the authorities. We are therefore circulating the attached lists of documents and advising all personnel that each employee is to study the lists carefully, search their electronic and non-electronic files, and immediately identify and make available all responsive documents.<sup>215</sup>

Over the next few months, a monumental effort by City staff – many of whom were not involved in the matters under federal investigation or who were not employed by the City at the time of the events – produced more than one million paper documents.<sup>216</sup>

City officials began expressing concern about the scope of the documents requested by Kroll through the Mayor and City Manager's letter of 10 June 2005. The City's Chief Information Officer, Rey Arellano, addressed that anxiety in a letter to Lynn Turner on 23 June 2005.<sup>217</sup> Arellano wrote:

The questions generally surround the specific process to be used to conduct a search of electronic files and e-mail, whether search terms will be provided, why every City employee regardless of how far removed they may be from any of the issues needs to respond, and various questions specific to some departments' unique circumstance.<sup>218</sup>

Kroll, however, did not pare down the request and continued to collect boxes of documents – many of which had already been collected in response to subpoenas from federal investigators.

It is impossible, however, to determine whether Kroll representatives reviewed the documents already collected in response to the subpoenas because Kroll's bills failed to include detailed task listings. Therefore, it is also impossible to determine whether the

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<sup>215</sup> 10 June 2005. Letter from Mayor and City Manager to All City Employees, City Council, and San Diego City Retirement System. (Exhibit 97)

<sup>216</sup> 10 June 2005 memo from Mayor Richard Murphy and City Manager P. Lamont Ewell to all City employees, City Council, and San Diego City Employees' Retirement System. (Exhibit 97)

<sup>217</sup> 23 June 2005 letter from Rey Arellano, chief information office for the City of San Diego, to Lynn Turner. (Exhibit 98)

<sup>218</sup> 23 June 2005 letter from Rey Arellano, chief information office for the City of San Diego, to Lynn Turner. (Exhibit 98)

additional documents request to employees on 10 June 2005 was necessary in order to complete the investigation.

Later in the investigation, Kroll said that part of the reason for the delay in the completion of its investigation was that more documents were returned to Kroll than expected. In a letter to the City Council on 23 September 2005, Troy Dahlberg explained the issue:

Obtaining written confirmation of compliance with our requests from individual employees involved literally hundreds of daily contacts... Together with closely monitoring the delivery of responsive documents to the City's document repository, these daily telephone contacts consumed hundreds of hours of unanticipated Audit Committee staff time.<sup>219</sup>

Dahlberg continued in the letter:

We are currently in the process of completing our review of the hard copy documents that have been produced under our June 10<sup>th</sup> Memo. The review of these documents has been far more time intensive than we first estimated due to the unanticipated large volume of documents that were produced. We have brought on additional Audit Committee staff to review these records. We anticipate completing this review... by the end of the week.<sup>220</sup>

Kroll and Willkie Farr admitted that the June 10<sup>th</sup> memo was too broad and required additional staffing levels, all billed to the City. The review of the documents would also not be done "by the end of the week."

Despite concerns by the City staff and the admission by Kroll and Willkie Farr that the additional document request had been too broad and thus, it would cost the City more money to review these unnecessary documents, the firms continued to send large bills to the City without any detail. From the time of the June 10 memo through the arrival of the Kroll invoice covering to 30 September 2005, the time of the status reports arrival, the firm billed the City approximately \$1.9 million. Willkie Farr, in comparison,

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<sup>219</sup> 23 September 2005. Letter from Lynn E. Turner and Troy Dahlberg to Honorable Mayor Toni Atkins and Members of the City Council. "Re: Audit Committee – Investigation Status Update." (Exhibit 99)

<sup>220</sup> 23 September 2005. Letter from Lynn E. Turner and Troy Dahlberg to Honorable Mayor Toni Atkins and Members of the City Council. "Re: Audit Committee – Investigation Status Update." (Exhibit 99)

submitted invoices for this period of time totaling \$2.2 million. Based on the comments from Dahlberg, a large portion of the expenses were for document review.

The firms sent another update letter to the City on 25 October 2005 making clear that the documents production was “successfully completed” and that “all responsive documents have been identified, and delivered to the City’s document repository for production to the government.”<sup>221</sup> The letter also stated that a large amount of the documents returned in response to the Audit Committee request had been reviewed. The letter stated:

Since late September we have reviewed approximately 250 boxes of documents collected according to procedures described in a June 10, 2005 memorandum to all City employees (“June 10, Memo”) for approximately 35 key individuals of interest.<sup>222</sup>

Representatives of Kroll appeared back before the City Council on 1 November 2005 and echoed this issue. Lynn Turner told the City Council:

In response to our June 10<sup>th</sup>, 2005 memo, city employees produced a volume of documents far greater than that we had identified which required more time to review.<sup>223</sup>

The firm, again, ignored Arellano’s 23 June 2005 request to pare down the search for fear too many documents would be returned. Turner also stated in his 1 November 2005 presentation to the City Council that Kroll and Willkie Farr had searched the majority of the documents collected in response to the Audit Committee production request. Turner said:

We have reviewed in excess of approximately 500 boxes of documents of individuals that we have identified as important to our investigation... This document review is made possible because we have successfully

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<sup>221</sup> 25 October 2005. Letter from Arthur Levitt, Audit Committee member; Lynn Turner, Audit Committee member; and Tory Dahlberg, Audit Committee member; to Honorable Mayor Toni Atkins. Re: Audit Committee – Investigation Status Update. (Exhibit 100)

<sup>222</sup> 25 October 2005. Letter from Arthur Levitt, Audit Committee member; Lynn Turner, Audit Committee member; and Tory Dahlberg, Audit Committee member; to Honorable Mayor Toni Atkins. Re: Audit Committee – Investigation Status Update. (Exhibit 100)

<sup>223</sup> 1 November 2005 transcript of the San Diego City Council meeting. P. 29. (Exhibit 101)

completed document collection in response to a dozen outstanding government subpoenas.<sup>224</sup>

During the time frame discussed by the Audit Committee in the update to the City – the period between “late September” and 25 October 2005 – Kroll billed the City more than \$489,000 for additional document review. The City also received another invoice without any detail from Kroll for the period covering 17 September 2005 to 30 September 2005 for \$485,862.<sup>225</sup> During this same period, Willkie Farr submitted two invoices that included \$228,914 for document review and an additional \$40,243 for outside consultants to conduct documents review. Willkie Farr also sent an invoice lacking any task listing to the City on 19 October 2005 for a total of \$980,181.

Based on evidence presented above, the City Attorney believes that Kroll and Willkie Farr billed for work that was outside of their scope of work outlined in their contractual engagement with the City. The City Attorney believes that the dissemination of the June 10 memo for the massive documents production and the Audit Committee’s blatant disregard to City staff’s concerns that volume of documents response would be too large and unnecessary. The City Attorney believes that the document review as a result of the June 10 memo is a violation of false claims statutes because Kroll and Willkie Farr fraudulently stated the necessity of the production in an effort to oversee compliance to federal subpoenas, which they never had authority to do.

#### **4. KROLL OVER BILLS ON HOTELS, AIR FARE, AND OUTSIDE CONSULTANTS**

The City Attorney believes ample evidence also exists to substantiate that Kroll submitted fraudulent bills to the City for flight transportation, hotel costs and technological support during its investigation.

During its work for the City, Kroll told the City Council that outside vendors needed to be contracted in order to build an on-line data warehouse where electronic documents could be stored. The reason, Kroll said, was to allow documents to be

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<sup>224</sup> 1 November 2005 transcript of the San Diego City Council meeting. P. 27. (Exhibit 101)

<sup>225</sup> Kroll invoices to the City of San Diego sent on 24 October 2005; 16 November 2005; and 18 November 2005. (Exhibit 102)

scanned, stored in the database, and viewed from anywhere in the United States.<sup>226</sup> This methodology, Kroll said, would lead to cost savings for the City.

This section of the 16<sup>th</sup> Interim Report will show that Kroll forced the City to pay for an electronic data warehouse, called Electronic Evidence Discovery, which evidence shows was not used. Meanwhile, Kroll continued to bill the city \$170,000 for air transportation to shuffle Kroll associates across the country. The company also billed the City another \$370,000 for hotel charges. Ironically, Kroll's initial engagement for the City was for \$250,000.<sup>227</sup>

On 12 September 2005, representatives of the City Manager's office appeared before the City Council to request an allocation of \$727,500 to hire Electronic Evidence Discovery ("EED") to create an electronic repository.<sup>228</sup> The repository would serve as a database where e-mails and scanned images of paper documents could be stored and reviewed from any computer with an internet connection. Rey Arellano, then chief information officer for the City, explained that this repository had been a request of the Audit Committee for a number of reasons. Arellano said:

An electronic depository is an essential tool for the Audit Committee to conduct its work for the following reasons: expenditure for the electronic depository reduces the cost of staff that would otherwise be required to review the extensive amount of paper documents, e-mails and electronic files... the electronic repository will allow the audit committee to complete its investigation by 2005; ...[and] the number of temporary resources required to conduct legal review would be significantly reduced and the review could be accomplished faster by using the repository search tools.<sup>229</sup>

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<sup>226</sup> 1 November 2005 transcript of the San Diego City Council meeting. (Exhibit 101)

<sup>227</sup> 10 February 2005. Kroll letter of engagement with the City of San Diego. (Exhibit 14)

<sup>228</sup> Agenda for the 12 September 2005 meeting of the San Diego City Council. (Exhibit 103)

<sup>229</sup> Comment from Rey Arellano, chief information officer for the City of San Diego, at the 12 September 2005 meeting of the San Diego City Council.



Thereby, Arellano stated that the EED database would allow Kroll to search documents at a faster rate. The City Council approved the allocation by a vote of 5-to-1, with Council member Donna Frye in opposition, and Districts 2 and the Mayor absent.<sup>230</sup>

Benito Romano told the City Council at its meeting on 26 September 2005 that Kroll had begun entering the electronic documents into the EED database:

We have begun to develop a database, a searchable database of all documents produced to the government. We are working with Electronic Evidence Discovery and American Legal Corporation to develop that database and to complete the uploading of all the documents so that the government will have ready access to a searchable database of all documents.<sup>231</sup>

In a 29 October 2005 memo, Dahlberg and Turner explained that the hard copy documents review had been completed by Kroll associates and what remained were the review of electronic documents.<sup>232</sup> Turner addressed the City Council at the 1 November 2005 and outlined specifically what the EED database would be used for. Turner said:

In today's digital age of hard drives and mail boxes, many [if] not most documents are electronic. To download and read each document in the City's computer system manually would be both very time consuming and expensive. Instead, documents that reside in relevant locations are downloaded into a database to be search electronically. Key word search terms which include terms both auditors and law enforcement agencies have provided to us and agreed upon will then be used to search for relevant documents in the database....We will review approximately 30,000 documents per week and once all documents have been reviewed, it will take four to six weeks to complete interviews and another month to complete a written report.<sup>233</sup>

Kroll submitted five invoices to the City Council before they returned to ask for more money for the expansion of the EED in December 2005. Yet, in these invoices,

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<sup>230</sup> Minutes of the 12 September 2005 meeting of the San Diego City Council. (Exhibit 104)

<sup>231</sup> Comments of Benito Romano, counsel from Willkie Farr & Gallagher, to San Diego City Council on 26 September 2005. (Exhibit 74)

<sup>232</sup> 25 October 2005. Letter from Lynn Turner and Troy Dahlberg to Honorable Mayor Toni Atkins and City Council members. "Re: Audit Committee – Investigation Status Update". (Exhibit 100)

<sup>233</sup> Transcript of 1 November 2005 meeting of the San Diego City Council. (Exhibit 101)

between 13 October 2005 and 18 November 2005, Kroll charged the City more than \$28,000 in “T&E – Air Transportation” and more than \$101,000 for “T&E Hotel Charges.” These bills contained no detailed information about the destinations of the airline tickets and no detail about the location of the hotel rooms. What is clear, however, is that City had been asked to pay more than \$700,000 for the implementation of an online document database which could be reviewed from any computer with an internet connection, yet Kroll continued to bill exorbitant amounts for travel and lodging for teams of associates, not to mention these associates hourly charges for travel itself.

Even though there is no evidence to show that the electronic database had been utilized to date, City staff came back to the City Council on 20 December 2005, on behalf of Kroll, and requested the allocation of an additional \$272,300 for the expansion of the database. According to the City Manager report, the number of documents and e-mails that needed to be scanned into the database required more memory. Howard Stapleton, a program manager for the City, told the City Council that the additional memory was required to provide,

Tools so that Kroll and others can do text searches, looking at specific custodians and all of their information from various sources, and ultimately when it comes time to produce that to some other entity, such as the SEC or the US Attorney, they can do either an on-line or a native format submission so that we can comply and submit that information to them.<sup>234</sup>

Stapleton added that about “1.8 million pieces of scanned paper is in [the EED database] right now.”<sup>235</sup> The City Council obliged and approved the funding by a vote of 6-to-1, with Council member Donna Frye in opposition and Districts 2 and 8 vacant.<sup>236</sup>

At this point, Kroll now had the enlarged electronic database to store documents which could be reviewed from any computer with internet access anywhere in the United States. Representatives of Kroll told the City Council that largely all of the hard copy documents had been reviewed and that only electronic documents and e-mails remained.

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<sup>234</sup> Comments at the 20 December 2005 meeting of the San Diego City Council. (Exhibit 105)

<sup>235</sup> Comments at the 20 December 2005 meeting of the San Diego City Council. (Exhibit 105)

<sup>236</sup> Minutes of the 20 December 2005 meeting of the San Diego City Council. (Exhibit 106)

Yet, despite these assertions, over the course of the next 10 months, Kroll continued to bill the City excessive amounts of money for air fare and hotel rooms. This was not necessary for the review of electronic documents – the lion’s share of the charges on Kroll invoices – because the documents could be reviewed from any office, in any City, at any computer with an internet connection.

According to invoices,<sup>237</sup> Kroll associates undertook an extensive electronic document review process, billing \$2.1 million from 9 February 2006 through 6 July 2006.

During this same period of time -- 9 February 2006 through 6 July 2006 -- Kroll billed the City for more than \$141,000 in “T&E Hotel Charges” for 440 nights in hotels in New York, San Diego, and Los Angeles. These rooms included 309 nights stay in New York, 37 nights in San Diego, and 94 nights in Los Angeles. The following table provides a comprehensive look at the charges:

<b>Date of Kroll Invoice</b>	<b>Nights total</b>	<b>New York</b>	<b>San Diego</b>	<b>Los Angeles</b>
10-Jan-06	2	0	2	0
19-Jan-06	1	0	1	0
23-Jan-06	0	0	0	0
30-Jan-06	0	0	0	0
3-Feb-06	2	0	2	0
9-Feb-06	9	8	1	0
21-Feb-06	28	16	4	8
8-Mar-06	63	52	1	10
16-Mar-06	51	41	0	10
4-Apr-06	79	54	15	10
19-Apr-06	90	73	4	13
27-Apr-06	58	45	0	13
18-May-06	28	7	4	17
26-May-06	21	9	3	9
20-Jun-06	6	2	0	4
6-Jul-06	2	2	0	0
<b>TOTALS</b>	<b>440</b>	<b>309</b>	<b>37</b>	<b>94</b>

It is important to stress that the City had, by this point, spent nearly \$1 million for the creation and expansion of an online document repository to allow the documents to be

<sup>237</sup> Kroll invoices to the City of San Diego dated: 9 February 2006; 21 February 2006; 8 March 2006; 16 March 2006; 4 April 2006; 19 April 2006; 27 April 2006; 18 May 2006; 26 May 2006; 20 June 2006; 6 July 2006. (Exhibit 107)

viewed from any computer with access to the internet and that all review of paper documents was completed.

Indeed, Kroll told City officials that contracting with EED “reduces the cost of staff,” according to Rey Arellano’s comments at the 12 September 2005 meeting of the City Council. The City, however, was charged more than \$2.5 million for documents review from 11 November 2005 through 6 July 2006.

In fact, a great deal of Arellano’s comments that day proved to be erroneous. Arellano told the City Council:

And more importantly, the electronic repository will allow the audit committee to complete its investigation by 2005.<sup>238</sup>

Kroll and Willkie Farr did not issue the final investigation and report to the San Diego City Council until 8 August 2006 – 11 months after Arellano made these comments.

Perhaps, more disconcerting about the City’s \$1 million expenditure to EED at the behest of Kroll, is that the company never used the database. According to a series of e-mails between the City Attorney’s Office and representatives of EED, Kroll never used a key function in the EED database to flag documents. Geoff Bogie, client service manager at EED, wrote:

EED does capture reviewer annotations that a reviewer makes...[W]e can provide...when a reviewer makes an annotation and can provide that as first annotation date/time, last annotation date/time for any time period.

In this case, the only reviewer that is assigned to the sandiego1-review Discovery Partner site is Jeff Klein and he has not saved any annotations to the site (meaning that he may have searched the data set, but since he did not make any annotative calls and save them there is no record of such activity).<sup>239</sup>

In other words, Bogie explained that when a document review takes place, an associate will mark, or “flag”, a document that is important to the investigation. Once the documents are “flagged,” it is then reviewed by a higher level investigator or reviewed,

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<sup>238</sup> Comments from Rey Arellano at the San Diego City Council meeting of 12 September 2005.

<sup>239</sup> 24 May 2006. E-mail from Geoff Bogie, client services manager at Electronic Evidence Discovery, to Karen DeCrescenzo, principal paralegal at the Office of the San Diego City Attorney. Subject: “Re: San Diego (894091) Signed Contracts.” (Exhibit 108)

analyzed, and perhaps selected as important evidence for inclusion in the final analysis of the report.

However, in a follow up interview on 5 December 2006 with Jayne Cantrell, client services manager for EED, Cantrell said, “I don’t think [Jeffery Klein]’s been on the site at all.”

The fact that the electronic database was not used is supported by the billing records themselves. Specifically, it appears from the invoices that Kroll and Willkie Farr simply flew teams of associates to collect documents. Indeed, Kroll billed the City a total \$338,844 for transportation and Willkie Farr charged \$101,009 for the same. Once the documents had been collected, evidence shows that the documents were mailed across the country. Specifically, over the course of the investigation, Kroll billed the City more than \$16,000 for postage and courier services and Willkie Farr billed more than \$41,000 for postage and courier services. The City Attorney believes that if Kroll and Willkie Farr had been reviewing documents via an electronic database, little, if any, cost for airfare, ground transportation, couriers or postage would have been warranted.

<b>Firm</b>	<b>Air Transportation</b>	<b>Ground Transportation</b>	<b>Meals</b>	<b>Postage &amp; Courier</b>	<b>Total</b>
<b>Kroll</b>	\$174,864	\$62,989	\$100,991	\$16,000	\$354,884
<b>Willkie Farr &amp; Gallagher</b>	\$44,473	\$1,447	\$55,089	\$41,000	\$142,009

**5. KROLL AND WILLKIE FARR & GALLAGHER SUBMIT FALSE CLAIMS TO THE CITY IN CONNECTION WITH DISCUSSIONS WITH THE UNION-TRIBUNE**

Kroll and Willkie Farr stepped outside of their contractual obligations to the City by meeting on multiple occasions and engaging in lobbying activities with the editorial board of the Union-Tribune. Evidence is presented in this section of the report that supports the allegation that Kroll and Willkie Farr submitted false bills in charging the City of San Diego for the discussions with the newspaper. The charges were not properly reflected on invoices Kroll and Willkie Farr submitted to the City, nor is it likely the expenses would be covered by the City’s contract.

Early in Kroll's work for the City, City Manager Phillip Lamont Ewell, or P. Lamont Ewell, sent an e-mail on 3 March 2005 to Lynn Turner asking, "How do you feel about arranging a meeting with you and the Editor of the [Union] Tribune for Monday since you are here? It may help with the next days editorial, which will surely follow given the request of Council to sign the agreement."<sup>240</sup> The agreement Ewell mentioned is a letter that Turner asked City Council members to sign to "refrain from the personal criticism and accusation...whether it be in this Chamber, the press conferences...or elsewhere."<sup>241</sup> Councilmember Donna Frye and the City Attorney refused to sign the agreement.

This period was marked by a contentious atmosphere following the City Attorney's release of a series of Interim Reports. The City Attorney believes this was an effort by Ewell to use Kroll and Willkie Farr to lobby the Union Tribune editorial board, a task that neither firm was contractually authorized nor permitted to engage in. An additional Ewell e-mail illustrates that Kroll and Willkie Farr over a period of months lobbied the Union-Tribune editorial board and representatives of the San Diego Regional Chamber of Commerce, a local pro-business group, to support the payment of Kroll and Willkie Farr invoices.

More than one month later, Ewell received an e-mail from Turner outlining an update to Union Tribune editors stating,

I did have a call today with Bill Osbourn [sic] updating him on our progress – I did tell him this was not going to be done quickly as he was asking for timing. I said we were committed to the thorough and comprehensive investigation that KPMG would require prior to signing off. Bill Kettle [Bob Kettle, director of the Union –Tribune editorial page] was on the other line and Bill was going to have him call me when I return from DC.<sup>242</sup>

Ewell continued to receive updates from Turner after conversations with the Union-Tribune editorial board. Turner sent an e-mail on 22 April 2005 stating, "Just got

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<sup>240</sup> 3 March 2005. E-mail from P. Lamont Ewell to Lynn Turner. Subject: "Re: Resolution/Letter for Council" (Exhibit 109)

<sup>241</sup> Minutes from the 7 March 2005 meeting of the San Diego City Council.[sic] San Diego City Council resolution R-300203. (Exhibit 110)

<sup>242</sup> 12 April 2005. E-mail from Lynn Turner to P. Lamont Ewell. Subject: "Re: Update" (Exhibit 111)

off the line with Kittle he seemed to understand what was going [on].”<sup>243</sup> As evidenced by e-mails found from Ewell, Turner was also updating other members of the community. In a 24 April 2005 e-mail to Ewell, Turner wrote, “In addition to talking to the press, I have also alerted the Chamber as to current events as well as the two council members who are our contacts.”<sup>244</sup>

At this time, a series of articles touting the City’s need for Kroll appeared in the Union-Tribune editorial pages. The first article was a question-and-answer session between representatives of Kroll, Willkie Farr, and the Union-Tribune editorial board. According to the article, printed on May 15, 2005,<sup>245</sup> Levitt commented on the timing for the conclusion of the investigation and stated:

I think this project calls for a resolution by the end of the year. I don’t know very much about whether it’s a million or two million or exactly what the number is.<sup>246</sup>

Turner, who was also present at the meeting, echoed Levitt’s timing estimates. Turner said, “We’ve got to be there by the end of the year.”<sup>247</sup> The next Union-Tribune editorial appeared on 11 August 2005 and provided a more forceful endorsement for Kroll. The Union-Tribune editorial board wrote:

The indispensable key to getting the city back on its feet financially is the three-member audit committee chaired by former Securities and Exchange Commission chairman Arthur Levitt. Operating with total independence, the panel is assisting KPMG, the city’s outside auditor, in completing the stalled financial statements that have locked San Diego out of capital markets for over a year... This probe is instrumental to both the SEC’s anticipated enforcement action against the city and U.S. Attorney Carol Lam’s criminal investigation... Without the independent oversight

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<sup>243</sup> 22 April 2005. E-mail from Lynn Turner to P. Lamont Ewell. Subject: “Re: Just got off the line with Kittle.” (Exhibit 112)

<sup>244</sup> 24 April 2005. E-mail from Lynn Turner to P. Lamont Ewell. Subject: “Re: Horribly Misquoted.” (Exhibit 113)

<sup>245</sup> 15 May 2005. “Q&A: Lynn Turner, Arthur Levitt, Benito Romano.” *San Diego Union-Tribune*. (Exhibit 114)

<sup>246</sup> 15 May 2005. “Q&A: Lynn Turner, Arthur Levitt, Benito Romano.” *San Diego Union-Tribune*. (Exhibit 114)

<sup>247</sup> 15 May 2005. “Q&A: Lynn Turner, Arthur Levitt, Benito Romano.” *San Diego Union-Tribune*. (Exhibit 114)

provided by the audit committee, all of San Diego's efforts to regain its financial strength would collapse in one catastrophic stroke...If Aguirre is incapable of becoming part of the solution, he at least must stop obstructing those who are committed to moving San Diego forward responsibly.<sup>248</sup>

Arthur Levitt also submitted an article for publication in the San Diego Union-Tribune which was printed on 11 August 2005.<sup>249</sup> It is unclear, in light of any details in the billings, if the City was billed for the preparation of an article that advocated the necessity of retaining Kroll. It is also unclear if the City was billed for the placement of the article.

The City at this point had contracted with Kroll to conduct an investigation and issue a report to the City. Kroll had been working for more than six months and issued nothing to the City.

Representatives of Kroll and Willkie Farr appeared before the City Council on 1 November 2005. When questioned by the City Attorney, Troy Dahlberg admitted to meeting with the editors of the San Diego Union Tribune and billing the City for that time.<sup>250</sup> Representatives of Kroll and Willkie Farr have also billed the City for meeting with the San Diego Regional Chamber of Commerce and The Wall Street Journal, according to Dahlberg's comments at the City Council meeting:<sup>251</sup>

AGUIRRE: Are you charging for your meetings with the Editorial Board?

ROMANO: You do not know?...

AGUIRRE: Are you charging for your meetings with the Editorial Board with the Union Tribune? Are you charging the City for that?

DAHLBERG: Yes.

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<sup>248</sup> 11 August 2005. "Aguirre's Gambit." *San Diego Union-Tribune*. (Exhibit 115)

<sup>249</sup> Levitt, Arthur. "Reviving San Diego: Looking at the numbers at City Hall." *San Diego Union-Tribune*. 11 August 2005. (Exhibit 116)

<sup>250</sup> Transcript of the 1 November 2005 meeting of the San Diego City Council. (Exhibit 117)

<sup>251</sup> Transcript of the 1 November 2005 meeting of the San Diego City Council. P. 73-4. (Exhibit 117)



This conversation perfectly illustrates that Kroll and Willkie Farr were billing the City for activities that had no relationship to their investigation. The conversation also illustrates that Kroll and Willkie Farr were billing for activities that were not detailed in their invoice statements.

The Union-Tribune editorial board provided another glowing recommendation of Kroll and Willkie Farr just days after new Mayor Jerry Sanders took office. The article, released on 13 December 2005, challenged the Mayor to pay Kroll additional monies and, again, touted Kroll and Willkie Farr's job qualifications. The Union-Tribune editorial board wrote:

The keystone of San Diego's financial recovery is its independent audit committee. The city's ability to borrow money, issue certified financial statements and conduct a range of other essential business – not to mention get out from under the cloud of multiple federal probes – all hinges on the completion of the audit committee's investigation... Yet, astonishingly, the panel is on the brink of shutting down because of an interruption in its funding from the city.<sup>252</sup>

The editorial article points out that new Mayor Jerry Sanders was apprehensive about paying the company another \$14 million without a guarantee that the work would be completed or that a timeline for completion be provided. The Union-Tribune editorial board took aim and fired at Sanders' request in the article stating:

Mayor Jerry Sanders and the City Council must move quickly to avert this looming calamity.... The urgent solution here is for Mayor Sanders to reach an ironclad funding agreement with the audit committee that is satisfactory to KPMG in terms of the scope and duration of the investigation. Then Sanders must present the matter to the City Council as soon as possible... San Diego's fiscal upheaval demands strong, determined direction from the top. This all-important issue poses the first critical test of Jerry Sanders' leadership.<sup>253</sup>

An even more forceful article in support of Kroll and Willkie Farr was issued by the Union-Tribune editorial board on 17 January 2006, titled "Pay the bills." The article, the strongest at that point, was a blatant threat to the City Council members. The editorial

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<sup>252</sup> 13 December 2005. "Sanders' first test: Audit committee's probe must continue." *San Diego Union-Tribune* (Exhibit 118)

<sup>253</sup> 13 December 2005. "Sanders' first test: Audit committee's probe must continue." *San Diego Union-Tribune* (Exhibit 118)

stated that without the Audit Committee, the City would end up in certain financial ruin.

The article stated:

If the City Council balks at funding for the audit committee, its investigation will collapse promptly. This, in turn, almost certainly would prompt KPMG to walk away from the 2003 audit, triggering a calamitous downward spiral in San Diego's already precarious financial situation...If San Diego now reneges on this fundamental commitment, the SEC won't be forgiving about it. Nor will the U.S. Attorney's Office. Nor will the city's creditors.<sup>254</sup>

The editorial continued:

Our strong hope for today is that Aguirre will conduct himself in a professional manner and that Council President Scott Peters and council members Toni Atkins, Jim Madaffer, Brian Maienschein and Tony Young will step up to their obligation to restore San Diego's financial viability.<sup>255</sup>

This passage is perhaps the most egregious misrepresentation of Kroll and Willkie Farr's investigatory role. The Union-Tribune essentially promised that all the City's problems would disappear if the Audit Committee was paid more City funds.

While the City Council agreed on 17 January 2006 to provide Kroll with an additional \$10 million of funding, Kroll and Willkie Farr would not agree to any commitment to complete its investigations. Indeed, without detailed billing, the City had no way to judge what stage of the process they were in. Regardless of the company's refusal to provide some indication of when the report would be finished and at what additional cost to taxpayers, the UT editorial board applauded the decisions:

In the end, the indispensable work of the audit committee was saved by the council's decisions to pay all of the \$10 million out of the general fund...We urge the panel to do everything it can to both stay within the allotted \$10 million and also try to wrap up its investigation by the end of May. The panel's long anticipated report is the essential next step in San Diego's financial recovery.<sup>256</sup>

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<sup>254</sup> 17 January 2006. "Pay the bills". *San Diego Union-Tribune*. (Exhibit 119)

<sup>255</sup> 17 January 2006. "Pay the bills". *San Diego Union-Tribune*. (Exhibit 119)

<sup>256</sup> 19 January 2006. "A sorry spectacle | Audit payment question stumped the city". *The San Diego Union-Tribune*. (Exhibit 120)

Unsurprisingly, Kroll and Willkie Farr did not finish their report in May as the Union-Tribune editorial board had hoped. Rather, the two firms said the report would not be completed on time.<sup>257</sup>

Mayor Sanders appeared at the 11 July 2006 meeting of the San Diego City Council and accused the firm of taking advantage of the City and “holding our city hostage” in an attempt to pressure the firms to expeditiously finish the costly project. At the meeting, Mayor Sanders also addressed concerns that Kroll had provided draft copies of the report to federal investigators and auditors prior to providing it to the City of San Diego.<sup>258</sup>

Rather than question the Audit Committee’s consistent delays, the Union Tribune editorial board’s defense of Kroll and Willkie Farr became more steadfast. Astoundingly, the Union-Tribune editorial board attacked Sanders’ comments and efforts to hold the firm to a timeline and fixed cost for the remainder of the work. The editorial board issued another article on 12 July 2006, titled “Ill-advised move | Mayor’s attack on audit panel harms city” which stated:

We share with Mayor Jerry Sanders and the City Council the frustration over how long it has taken San Diego’s independent audit committee to complete its \$20 million probe of illegal acts...All the same, Mayor Sanders’ wholesale attack on the audit committee yesterday services only to undermine the city’s once-laudatory commitment to a thorough and independent investigation...Yet Mayor Sanders bluntly assailed the panel for ‘holding our city hostage’ and called the City Council’s decision to establish it ‘ill-conceived.’... Without it, San Diego is doomed to financial purgatory. So, let’s get on with completing the report.<sup>259</sup>

In the article, the editorial board made its position clear: it will now defend the audit committee against any attempt that any City official made to pressure Kroll or Willkie Farr to finish its \$20 million study. The Union-Tribune editorial board article also wrote a

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<sup>257</sup> Vigil, Jennifer. “S.D. to summon Kroll for answers | Officials upset report on finances isn’t done.” *San Diego Union-Tribune*. 12 July 2006. (Exhibit 121)

<sup>258</sup> Vigil, Jennifer, “Kroll unsure when report on finances will be done.” *San Diego Union-Tribune*. 13 July 2006. (Exhibit 122)

<sup>259</sup> 12 July 2005. “Ill-advised move | Mayor’s attack on audit panel harms city.” *San Diego Union-Tribune*. (Exhibit 123)

statement that provided evidence that representatives of Kroll and Willkie Farr were in communication with the newspapers editorial writers:

Whether the mayor likes it or not, the audit committee's report – which is certain to be highly critical of city officials – is the only way for San Diego to begin its financial recovery.<sup>260</sup>

The quote raised suspicions that Kroll and Willkie Farr had potentially provided the editorial board with a copy of the report.

Still, the invoices submitted by Kroll and Willkie Farr to the City of San Diego submitted included no details about conversations with newspaper editors. However, Dahlberg had stated to the City Council that Kroll was, in fact, billing for the firm's conversation with the newspaper editors and business groups. At that point in time, Kroll and Willke Farr had not provided a copy of the report to the City and taxpayers.

An appearance by Bob Kittle, editor of the Union-Tribune editorial page, on a radio show on 14 July 2006 provided further evidence that he was either briefed on the contents of the report or given a copy of the report by Kroll and Willkie Farr prior to the its release to the City of San Diego. Kittle's statements on the show illustrate that he had detailed knowledge of the contents of the report. Kittle stated on the show:

Let me explain what is really happening with this report. The draft, and it's over 300-pages, has gone to KPMG for its review," Kittle said. "The reason for that is, if it doesn't satisfy KPMG that all of the investigation is thorough, then it's useless. But, a draft will be given, it has not yet been given, to the SEC for its review before it's released as well...[Kroll's] report, unlike [City Attorney] Mike Aguirre's reports, unlike any other report that has been done, is going to be much more detailed. It is going to name names. It is going to name, I believe, city officials including elected city officials – council members, potentially current, past, including a previous mayor as having committed violations.<sup>261</sup>

Kittle's comment came just days after a spokesperson for Mayor Jerry Sanders indicated that no one knew who the report was given to. Kittle also said, with surprising certainty, what kind of conclusions that report will include.

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<sup>260</sup> 12 July 2005. "Ill-advised move | Mayor's attack on audit panel harms city." *San Diego Union-Tribune*. (Exhibit 123)

<sup>261</sup> 14 July 2006 broadcast of *KPBS Editors' Roundtable*. "City Finances, Guantanamo, and the National Debt."

When Kroll and Willkie Farr finally announced the date for the release of the report, the Union Tribune editorial board instantly sang praise for the work despite the two years of delay and the price tag that exceeded the original \$250,000 cost estimate 80 times over. The editorial board's 6 August 2006 article provided additional evidence that representatives of Kroll and Willkie Farr both discussed the topic with Union-Tribune, at a cost to the taxpayers, as well as provided the newspaper with a copy of the report prior to its release. The article stated:

This week will mark a crucial turn in San Diego's financial upheaval when the findings of the long-awaited audit committee investigation will be delivered to the City Council. The 370-page report is likely to document wide-scale misconduct...the first 320 pages of the panel's report are expected to be a forensic look at what went wrong at City Hall during the past decade. The last 50 pages are said to comprise a detailed remediation plan...<sup>262</sup>

The article also cast a series of aspersion on the City Attorney for his attempts to receive detailed invoices from Kroll and Willkie Farr to ensure that the obscenely expensive report was conducted without any false billings.

Regrettably, however, City Attorney Mike Aguirre has attempted to interject into the City Council discussion another topic altogether – his unsustainable claims that Kroll Inc. has engaged in fraudulent billing practices in carrying out its \$20 million investigation. In a bombastic letter last week, Aguirre demanded that Kroll bring to the council session “all contemporaneous daily, weekly, monthly and periodic timecards and other internal time keeping reports for each individual who recorded time worked on this project...’ Never mind that such a volume of material would require a tractor-trailer to haul it into the council chambers.”<sup>263</sup>

It is clear from this passage that the editorial board had become more interested in enriching Kroll and Willkie Farr than ensuring that the \$20 million of taxpayers funds was spent properly, accurately, and in compliance with fair billing regulations.

The evidence provided in this section of the report – including e-mails, testimony and articles supports the allegation that representatives of Kroll and Willkie Farr engaged in lobbying activities to apply political pressure on City Hall to continue to pay bills.

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<sup>262</sup> 6 August 2006. “Hour of decision | Report on City Hall wrongdoing finally at hand.” *San Diego Union-Tribune*. (Exhibit 124)

<sup>263</sup> 6 August 2006. “Hour of decision | Report on City Hall wrongdoing finally at hand.” *San Diego Union-Tribune*. (Exhibit 124)

More importantly, representatives of Kroll stated that it had billed for discussions with newspaper editors. Most importantly, however, is the fact that these charges never appeared on the invoices that Kroll and Willkie Farr submitted to the City of San Diego. The City Attorney believes that this evidence supports the allegation that Kroll submitted false bills to the City of San Diego.

**6. INVOICES SHOW KROLL ASSOCIATES OVER BILLING CITY OF SAN DIEGO**

The only true detailed invoice submitted by Kroll to the City on 13 July 2005 provides evidence that the company was charging more than their normal billing rates. In other words, Kroll was padding their employee billing rates for work for the City of San Diego.

A detailed bill sent to the Mayor’s office illustrates that representatives of Kroll had an hourly rate and a separate, and more expensive, hourly rate for invoices submitted to the City of San Diego. The invoice, which includes detailed information kept by the employee, included the employee’s name, hours spent on the task and a description of the work done. For example, an entry for Kenneth W. Matte was:

Date	Initials	Name/Invoice Number	Hours	Amount	Description
03/02/2005	000203	Kenneth W. Mate	4.00	1,260.00	Assign research; divide subjects; start
04/05/2005		Invoice+13107 21	4.00	1,260.00	research regarding subjects

It is clear that the sentence that described the task continued into the box directly below it. The date that the work was completed, 03/02/2005, is kept in a separate line than the date the time was actually put into an invoice, 04/05/2005, and sent to the City of San Diego. It is clear from the entry that Kenneth W. Mate’s billing rate for Kroll and for the project with the City of San Diego was \$315.00 per hour.<sup>264</sup>

<sup>264</sup> This \$315 per hour figure was calculated by dividing the number of hours worked into the billing charge. The figure is verified by Mate’s billing rate as listed in page 2 of the 5 April 2002 invoice Kroll sent to the City of San Diego. The 5 April 2005 invoice is included in this report under Exhibit 79.

The invoice, however, list different billing rates for certain employees. Specifically, the invoices list a billing rate and directly beneath, an invoice number submitted to the City with a much higher rate. For example:

Date	Initials	Name/Invoice Number	Hours	Amount	Description
3/01/2005	243397	David Callaghan	11.00	3,190.00	Meetings with KPMG, city officials, attorneys
4/05/2005		Invoice=1310722	11.00	4,400	

The invoice shows that David Callaghan’s normal billing rate was \$290 per hour. His billing rate, however, for the invoice submitted to the City was \$400 per hour.

What is so unusual about this practice for billing different amount is that only certain employees were engaging in this over billing. For example:

Date	Initials	Name/Invoice Number	Hours	Amount	Description
3/02/2005	025365	Jennifer Arnini	9.00	1,710.00	
4/05/2005		Invoice=1310722	9.00	2,700.00 <sup>265</sup>	

The mark up for Jennifer Arnini is more severe. Arnini’s normal billing rate is \$190 per hour. When Arnini’s hourly rate was calculated for the City’s invoice, the billing rate jumped to \$300 per hour. Kroll employee David Cogan also had inflated rates when the Kroll invoice to the City was calculated.

Date	Initials	Name/Invoice Number	Hours	Amount	Description
3/15/2005	001753	David Cogan	2.00	530.00	Research
4/05/2005		Invoice=1310722	2.00	700.00	

It is clear in this invoice entry that David Cogan’s normal billing rate was \$265 per hour, which jumped to \$350 per hour for the invoice sent to the City of San Diego.

Consequently, the City Attorney believes that Kroll was intentionally inflating the billing rate for specific Kroll employees to over bill the City. Kroll provided no information about any specialized education or certifications for these individuals which

<sup>265</sup> 13 July 2005 e-mail from Troy Dahlberg, managing partner at Kroll Inc., to Ravila Ruderman, staff for form Mayor Dick Murphy. Subject: “Invoice Detail.” Carbon copied: Tom Story, former chief of staff to Mayor Dick Murphy. (Exhibit 79)

would warrant a higher billing rate for the City. Thus, the City Attorney believes this is another example of Kroll submitting false bills to the City of San Diego.

## **VI. KROLL AND KPMG BUSINESS IN CITY OF SAN DIEGO**

### **1. KPMG MANIPULATED ITS STANDARDS TO BENEFIT KROLL AND WILLKIE FARR & GALLAGHER**

The City of San Diego hired accounting firm KPMG to reanalyze and complete the City's 2003 Certified Annual Financial Statement. Shortly after the firm was hired, separate investigations into the City were launched by the SEC and U.S. Attorney's office to look into alleged falsification of financial documents and other fraudulent activities.

As outlined in earlier sections of this report, KPMG issued a series of letters urging the City of San Diego to complete an investigation to determine whether any illegal acts took place and to determine which city officials were involved. The first letter sent by KPMG to the City, provided a series of questions that needed to be answered. The letter, as specified in earlier sections, also contained the rules that the accounting profession follows in completing investigations of this nature.

In an effort to comply with the directives issued by KPMG, the City hired Houston-based law firm Vinson & Elkins to conduct the investigation. Vinson & Elkins issued its final report on 16 September 2004 and found that disclosure violations had occurred but found it "difficult to attribute the City's failure to fully and accurately ascribe [this] matter to intentional misconduct on the part of individual employees."<sup>266</sup>

KPMG immediately discounted the Vinson & Elkins report as "inadequate" in a 11 October 2004 letter. The letter stated:

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<sup>266</sup> 16 September 2004. Vinson & Elkins: Report on Investigation: The City of San Diego, California's Disclosure Obligations to Find the San Diego City Employees' Retirement System and Related Disclosure Practices 1996-2004 with Recommended Procedures and Changes to the Municipal Code." P. 161. (Exhibit 125)



[W]e do not believe that the City of San Diego (“City”) has conducted an adequate investigation in order to conclude that likely illegal acts have not occurred, or that appropriate remedial action has been taken. Such an investigation is necessary in order for an auditor to complete an audit in accordance with generally accepted auditing standards and *Government Auditing Standards*.<sup>267</sup>

KPMG specifically stated that the Vinson & Elkins investigation failed to answer the question of whether the City Council took “actions that resulted in the underfunding or misuse of pension funds that is a violation of State, City or other laws.”<sup>268</sup>

KPMG sent a follow-up letter to the City on 29 October 2004 to press the importance of undertaking a full investigation:

In our correspondence, we not only discussed relevant auditing literature, but also explicated for the City some of the applicable principles that require the City in its financial statement to make disclosures of any violations of finance-related laws and regulations.<sup>269</sup>

The City again contracted with Vinson & Elkins to conduct the second investigation to meet the standards as set forth by KPMG and the AICPA.

Shortly thereafter, the voters of San Diego elected a new City Attorney, Michael Aguirre, who took office in December 2004. Aguirre immediately announced his office would conduct an illegal acts investigation into allegations that the City of San Diego had not accurately disclosed information regarding the under funding of the pension in its financial disclosure documents. Aguirre released a series of Interim Reports detailing the illegal acts by city officials and named individuals culpable of securities laws violations.<sup>270</sup>

The City now had a series of reports issued by the City Attorney and the Vinson & Elkins report, which was discounted by KPMG. As discussed above, the City of San

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<sup>267</sup> 11 October 2004. Letter from Steven G. DeVetter to Leslie J. Girard. Re: “City of San Diego Fiscal Year 2003 Audit.” (Exhibit 8)

<sup>268</sup> 11 October 2004. Letter from Steven G. DeVetter to Leslie J. Girard. Re: “City of San Diego Fiscal Year 2003 Audit.” (Exhibit 8)

<sup>269</sup> 29 October 2004. Letter from Steven G. DeVetter to Mayor Dick Murphy and Lamont Ewell, city manager of the City of San Diego. (Exhibit 10)

<sup>270</sup> San Diego City Attorney Interim Reports 1, 2, 3, 5, 6, 7. (Exhibit 87)

Diego hired Kroll in February 2005 to compare the Vinson & Elkins report to the City Attorney reports and draw conclusions on which was correct. In March 2005, the scope of Kroll's duties was expanded to include a full investigation to satisfy questions raised by KPMG. Kroll, in turn, hired Willkie Farr to provide legal services to Kroll. The duo issued their report to the City of San Diego on 8 August 2006.

Representatives of KPMG attended the San Diego City Council meeting on 8 August 2006 and outlined what the investigation needed to include. Steve DeVetter, a partner for KPMG, stated that an evaluation of the securities laws was necessary.

AGUIRRE: [N]ow, Mr. DeVetter, can you please go to your October 11, 2004 letter, if you wouldn't mind. This is another letter that you sent to the City of San Diego, correct?

DE VETTER: Correct.

AGUIRRE: And in this letter, you further elaborated in what had to be found by the law firm or group that was going to do the illegal acts investigation, correct?

DE VETTER: Correct.

AGUIRRE: And in that letter on page 8 you said, quote, "The City need to determine whether the City's public disclosures including its financial statements likely violate the anti-fraud provisions of the securities laws," correct? That's on page 8?

DE VETTER: Correct.<sup>271</sup>

DeVetter's comment echoed what had been said in the letter: that the Mayor and City Council's role in approving the fraudulent financial disclosures leading to the sale of hundreds of millions of dollars of municipal bonds needed to be analyzed for potential violations of securities laws.

As stated in earlier sections of this report, representatives from Kroll and Willkie Farr told the City Council that an analysis of potential illegal acts committed by the Mayor and the San Diego City Council was not conducted. Romano told the City Council

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<sup>271</sup> Transcript of the 8 August 2006 meeting of the San Diego City Council. (Exhibit 52)

that neither Kroll nor Willkie Farr analyzed whether the Mayor and City Council violated federal securities laws. In fact, in the face of DeVetter's assertion, Romano maintained the position that the analysis of the securities laws was unnecessary to KPMG.

AGUIRRE: Okay, so Mr. Romano, does your report determine whether the City's public disclosures including the financial statements likely violated the anti-fraud provisions of the securities laws?

ROMANO: We did with respect, yes we did.

AGUIRRE: What did you determine?

ROMANO: We determined that the disclosures were deficient and...

AGUIRRE: No, no. I'm asking you, it says here [in KPMG's 11 October 2004 letter] "likely violated the securities laws". Did you make a determination that the [City] Council likely violated the securities laws?

ROMANO: The Council?

AGUIRRE: Yes.

ROMANO: No we didn't. We did not make that determination. We focused on the element that we felt was most important to KPMG.

AGUIRRE: And who gave you that understanding?

ROMANO: Um, I don't know if anyone gave me that I understanding. That was the premise that we proceeded on.<sup>272</sup>

Romano specifically admitted that the illegal acts analysis was not completed despite the numerous letters and direction provided by KPMG.

It is clear from the record established in this report that Vinson & Elkins failed to complete the illegal acts analysis of the Federal security laws requested by KPMG and, as a result, KPMG discounted the investigation and required the City to conduct a more in-depth investigation.

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<sup>272</sup> Transcript of the 8 August 2005 meeting of the San Diego City Council. (Exhibit 52)

It is also clear from Romano's comments at the 8 August 2006 meeting of the San Diego City Council that the illegal acts investigation requested by KPMG was not completed to the standards set forth by AICPA. The report issued by Kroll and Willkie Farr was not analyzed using the same standards as the work of Vinson & Elkins.

At the City Council meeting on 8 August 2006 KPMG drastically changed the standards that the investigation must meet:

AGUIRRE: [I]s that satisfactory to you, is that finding [in the Kroll and Willkie Farr report] satisfactory to you for purposes of your audit.

DeVETTER: Just a second, to clarify the process. I think Mr. Morris characterized a general reaction to the court. The important thing in this letter is to lay out the responsibilities of the City. So our goal here was to push the city to do the right thing, so the City has to assess the report of the investigators and we will tell you if your assessment is now complete or not, we are not judging, we did not hire the audit committee.

AGUIRRE: So you don't know if that's sufficient for your purposes then.

DeVETTER: That is part of our general reaction, and we are anxious to see the City's response to the report.<sup>273</sup>

In response to questions about whether or not the Kroll and Willkie Farr report satisfies guidelines established by the AICPA, DeVetter told the City Council that "we are not judging, we did not hire audit committee."<sup>274</sup> DeVetter's comments were in direct contradiction to KPMG's comments about the Vinson & Elkins report and KPMG's requirement that the City hire another investigative firm to conduct an "adequate"<sup>275</sup> investigation. More specifically, KPMG's 11 October 2004 letter to the City, which requested a new investigation, stated:

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<sup>273</sup> Transcript of the 8 August 2006 meeting of the San Diego City Council. (Exhibit 52)

<sup>274</sup> Transcript of the 8 August 2006 meeting of the San Diego City Council. (Exhibit 52)

<sup>275</sup> 11 October 2004. Letter from Steven G. DeVetter to Leslie J. Girard. Re: "City of San Diego Fiscal Year 2003 Audit." (Exhibit 8)

[W]e do not believe that the City of San Diego (“City”) has conducted an adequate investigation in order to conclude that likely illegal acts have not occurred, or that appropriate remedial action has been taken. Such an investigation is necessary in order for an auditor to complete an audit in accordance with generally accepted auditing standards and *Government Standards*.<sup>276</sup>

The letter goes on to state:

[Government Accounting Standards Board] standards require governments to disclose certain violations of compliance requirements. [National Council on Government Accounting] states that the notes to the financial statements should disclose material violations of finance-related legal and contractual provisions. In addition, material violations, or potential violations, of finance-related and contractual provisions should be considered for recording a loss contingency...<sup>277</sup>

KPMG also stated in a subsequent letter that a full illegal acts investigation must be completed and the conclusions included in the footnotes of the financial statements to be viewed by the ratings agencies and potential investors. A letter sent by KPMG to the City on 29 October 2004 stated:

In our correspondence, we not only discussed relevant auditing literature, but also explicated for the City some of the applicable principles that require the City in its financial statements to make disclosures of any violations of finance –related laws and regulations.<sup>278</sup>

It is important to re-emphasize that the “relevant auditing literature” and the “applicable principles” include the AU § 317. The standard specifically states:

When the auditor becomes aware of information concerning a possible illegal act, the auditor should obtain an understanding of the nature of the act, the circumstance in which it occurred, and sufficient other information to evaluate the effect on the financial statements. In doing so, the auditor

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<sup>276</sup> 11 October 2004. Letter from Steven G. DeVetter to Leslie J. Girard. Re: “City of San Diego Fiscal Year 2003 Audit.” (Exhibit 8)

<sup>277</sup> 11 October 2004. Letter from Steven G. DeVetter to Leslie J. Girard. Re: “City of San Diego Fiscal Year 2003 Audit.” (Exhibit 8)

<sup>278</sup> 29 October 2004. Letter from Steven G. DeVetter to Mayor Dick Murphy and Lamont Ewell, city manager of the City of San Diego. (Exhibit 10)

should inquire of management at a level above those involved, if possible.<sup>279</sup>

The standard specifically states that the investigation should “inquire of management at a level above those involved.”

Kroll and Willkie Farr, in their report, specifically state that:

[W]e believe that the evidence supports the determination that the following City representatives acted with wrongful intent, i.e., scienter as defined pursuant to Section 10(b)) of the Securities Exchange Act of 1934:

Deputy City Manager Patricia Frazier  
City Treasurer Mary Vattimo  
Auditor and Comptroller Ed Ryan  
Deputy Auditor and Comptroller Terri Webster  
SDCERS Administrator Larry Grissom  
Utilities Finance Administrator Dennis Kahlie  
Deputy Director, MWW William Hanley  
Deputy City Attorney Kelley Salt<sup>280</sup>

These individuals represent the very highest management levels of the City bureaucracy and many of these individuals handled projects and answered directly to the Mayor, City Council, and City Council committees. Yet, Kroll and Willkie Farr did not perform the illegal acts analysis to establish culpability or establish what was known by the Mayor or by any member of the City Council despite the fact that at the 8 August 2006 meeting of the San Diego City Council, DeVetter states that the auditing standards require an investigation reaching to the highest levels of the organization:

AGUIRRE: Okay, and in that section you said that “when the auditor becomes aware of information concerning a possible illegal act, the auditor should obtain an understanding that the nature of the act, the circumstances in which it occurred, and sufficient other information to evaluate the effect on the financial statements.” And that’s what you did here, right?

DeVETTER: Correct.

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<sup>279</sup> 9 August 2004 letter Steven G. DeVetter, partner at KPMG, to Leslie Girard, assistant city attorney for the City of San Diego. Subject: “Re: Investigation”. (Exhibit 5)

<sup>280</sup> 8 August 2006. “Report of the Audit Committee of the City of San Diego: Investigation into the San Diego City Employees’ Retirement System and the City of San Diego Sewer Rate Structure.” P. 238. (Exhibit 41)

AGUIRRE: So, what we are trying to determine... sorry, let me continue “in doing so the auditor should inquire of management at a level above those involved if possible”, okay so in this case, the people that might have been involved were the council members themselves, right?

DeVETTER: Correct.<sup>281</sup>

Thus, the analysis of whether the Mayor and the City Council violated federal securities laws, however, was never completed by Kroll, as was expected by the City and KPMG.

Rather, the standards that KPMG used to analyze the Vinson & Elkins investigation was not applied to the work of Kroll and Willkie Farr. Instead, a completely different standards was applied to test the validity and sufficiency of the report issued by Kroll and Willkie Farr. Specifically, KPMG discounted the work of Vinson & Elkins. KPMG wrote in its 11 October 2004 letter to the City:

[W]e do not believe that the City of San Diego...has conducted an adequate investigation in order to conclude that likely illegal acts have not occurred...”

In the letter, KPMG specifically states that in order for an investigation to be considered sufficient, the investigation must meet the investigative standards as set forth by the AICPA. It is clear that KPMG discounted the work of Vinson & Elkins for not performing an investigation to meet the AICPA standards. It is also clear that Kroll and Willkie Farr did not investigate to meet the AICPA standards, yet KPMG did not discount the report. This clearly indicates that KPMG analyzed the work of Vinson & Elkins using a different standard than the analysis of the Kroll and Willkie Farr report.

DeVetter went on to state at the 8 August 2006 meeting of the City Council that KPMG will not evaluate whether or not the Kroll and Willkie Farr report was adequate. Rather, DeVetter said it is the City’s responsibility to decide how to use the report:

DeVETTER: We can evaluate your reactions to the report and what the City is going to do.

AGUIRRE: Okay, but what I’m saying to you is that in terms of satisfying your needs, what we can do is put in detail in a

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<sup>281</sup> Transcript of the 8 August 2005 meeting of the San Diego City Council. (Exhibit 52)

disclosure to make sure that the user of the financial statement has all of the relevant information they need with regard to this issue and that should be sufficient, correct??

DeVETTER: I'm not sure I understood the question, but if there is disclosure you feel is important to be in the financial statement, I would encourage you to put it in the financial statements.<sup>282</sup>

In other words, DeVetter, essentially stated that whether the investigation is in compliance with the applicable audit standards is not an issue. Rather, DeVetter stated the only important issue is for the City to ensure that "disclosure you feel is important" appear in the future financial statements. William Morris, western regional director for KPMG, also spoke at the meeting and stated that the thoroughness of investigation was not the issue. Morris echoed DeVetter's statements and said that the important issue is what the City puts in its disclosures.

AGUIRRE: Okay, so, so where we are right now though is that we now have had one party determine that there was violations, one party determine that there weren't violations, so is one way that we can solve this problem is simply describe that in the footnote and then let the reader judge from that whatever that they want to take from it.

MORRIS: Speaking out of singular judgment, amongst many judgments that we are going to have to make with respect to the closing process. Em, and I don't think that we are prepared to give you that simple yes or no that you like with respect to this particular answer. We are going to sit there and look at both of these information, we have yet to read the final copy of this report and we will form a judgment based on advising council that we will also receive with respect to this matter. You correctly point out that disclosure is very very critical here and I have every reason to believe the city will do that.<sup>283</sup>

Morris reemphasized DeVetter's comments that the scope of the investigation is not as serious of an issue as the facts that are disclosed in the financial statements. Morris and DeVetter's statements clearly contradict their previous requirements that the investigation

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<sup>282</sup> Transcript of the 8 August 2005 meeting of the San Diego City Council. (Exhibit 52)

<sup>283</sup> Transcript of the 8 August 2005 meeting of the San Diego City Council. (Exhibit 52)



comply with their letters and applicable accounting standards. This is crucially important because it also provides clear evidence that KPMG set an extremely different standard for Vinson & Elkins than the standard set for Kroll and Willkie Farr.

KPMG originally discounted the work of Vinson & Elkin's report issued to the City on 16 September 2004 because:

[W]e do not believe that the City of San Diego ("City") has conducted an adequate investigation in order to conclude that likely illegal acts have not occurred, or that appropriate remedial action has been taken. Such an investigation is necessary in order for an auditor to complete an audit in accordance with generally accepted auditing standards and *Government Auditing Standards*.<sup>284</sup>

The important message to stress from KPMG's letter to the City in this comment: "[W]e do not believe that the City of San Diego ("City") has conducted an adequate investigation in order to conclude that likely illegal acts have not occurred..." It is clear from the record that Kroll and Willkie Farr did not conduct an adequate investigation to meet the criteria as set forth in KPMG's discounting of the Vinson & Elkins report. KPMG specifically included the language from the AICPA's auditing standard AU § 317 in its correspondences to the City regarding Vinson & Elkins' deficient investigation. KPMG also specifically stated in its letters to the City:

[Government Accounting Standards Board] standards require governments to disclose certain violations of compliance requirement. [National Council on Government Accounting]...states that the notes to the financial statements should disclose material violations of finance-related legal and contractual provisions. In addition, material violations, or potential violations, of finance-related and contractual provisions should be considered for recording a loss contingency...<sup>285</sup>

It is clear from the transcript of the 8 August 2006 meeting of the City Council that these issues, as set forth by KPMG, were not addressed in the Kroll and Willkie Farr report. It is also clear that KPMG did not analyze the Kroll and Willkie Farr under the same level of scrutiny and to the same standards that the Vinson & Elkins report was held to. Specifically, KPMG requested an analysis of all potentially illegal acts by city

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<sup>284</sup> 11 October 2004. Letter from Steven G. DeVetter to Leslie J. Girard. Re: City of San Diego Fiscal Year 2003 Audit. (Exhibit 8)

<sup>285</sup> 11 October 2004. Letter from Steven G. DeVetter to Leslie J. Girard. Re: City of San Diego Fiscal Year 2003 Audit. (Exhibit 8)

officials, which representatives of Willkie Farr admitted was not completed. As a result, the City paid an extra \$20 million for the Kroll and Willkie Farr report which did not surpass the level of analysis as the Vinson & Elkins report.

The City Attorney believes that the City's expenditure of the \$20 million to Kroll and Willkie Farr at the behest of KPMG was unnecessary and constitutes a fraud against the taxpayers of San Diego.

## **VII. CONCLUSION**

The purpose of this 16<sup>th</sup> Interim Report is to further promote the importance of transparency in government. It is imperative in the case of government contracts that the municipality receives a clear understanding of what work, if any, is being done to most efficiently expend public funds.

It is clear based on the evidence presented in this 16<sup>th</sup> Interim Report that any semblance of transparency into the work conducted by Kroll and Willkie Farr & Gallagher was stymied. The evidence presented in this 16<sup>th</sup> Interim Report supports the allegation that both companies -- Kroll and Willkie Farr & Gallagher -- took advantage of the lack of transparency in invoices to continually extend the deadline of the investigation, bill rates higher than rates to other clients, misrepresent their role in the authorship of the report, bill for activities that had nothing to do with the report, and, in general, take advantage of a City in the most dire of financial conditions.

Based on the facts and conditions detailed in this report, it is the opinion of the City Attorney that the City should seek the recovery of monies from Kroll and Willkie Farr & Gallagher using any legal means available.

By



Michael J. Aguirre  
San Diego City Attorney