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Lost City After Pension-Fund Debacle, San Diego Is Mired in Probes

Post-Scandal Regulatory Zeal Moves Beyond Companies; Clouded by Infighting Five Inquiries, Few Results

By **DEBORAH SOLOMON** Staff Reporter of **THE WALL STREET JOURNAL** *October 10, 2005; Page A1*

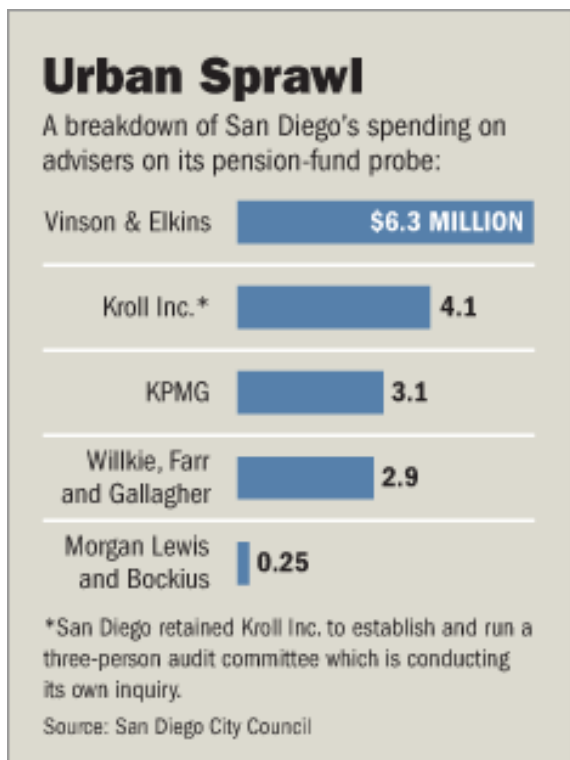
SAN DIEGO -- In January 2004, this city announced that its pension fund was facing a \$1.1 billion deficit and its accounts were riddled with errors. Following the example of companies facing similar problems, San Diego launched an investigation and hired an auditor to scrub its books.

Nearly two years later, the city is mired in a series of probes that have each taken on a life of their own. Dueling over the city's finances are the San Diego district attorney, the city attorney, three law firms, a Big Four accounting firm and a three-member audit committee led by Arthur Levitt, the former chairman of the Securities and Exchange Commission. The city attorney has taken to cross-examining audit-committee members at public hearings. Mr. Levitt says the official is making matters worse with his "sneering commentary."

San Diego has spent more than \$15 million on legal fees, audits and consultants but is only marginally closer to resolving its problems. Accounting firm KPMG LLP has refused to approve the city's 2003 financial statement and as a result, San Diego can't sell bonds to finance capital projects, such as upgrading water and sewer systems. The SEC, which is conducting its own probe along with the Justice Department, has told the city it wants the same level of cooperation it expects from corporations under investigation.

San Diego's problems show how the post-bubble regulatory zeal gripping corporate America is beginning to spill into other parts of the financial world. Cities, which have had their share of financial scandals over the years, are now finding themselves subject to the kind of scrutiny more commonly found in corporate

boardrooms. (See related article.¹)



Compared with companies, however, cities are unruly. The combination of outside investigations, local egos and urban politics can be a recipe for chaos. In San Diego, the mayor and other city officials have resigned. "A large part of the present situation has been exacerbated by political infighting," says Mr. Levitt.

San Diego's problems began with a cash crunch in 1996 caused by the cost of hosting the Republican National Convention and bidding to host the Super Bowl, among other expenses. To soften the pain, the city made a deal with its pension fund, which was sitting on a \$100 million surplus. The fund allowed San Diego to reduce annual contributions for 10 years. In return, the city pledged to make a one-time payment if the pension fund's assets fell below 82.3% of its projected liabilities.

Over the next five years, San Diego's expenses continued to grow and the stock-market returns on which the pension fund had been counting were disappointing. On Oct. 11, 2001, the

city's then-assistant auditor summed up the situation in an email titled: "EEEEK."

Eager to avoid the one-time payment -- which would have totaled \$500 million -- San Diego negotiated another deal in 2002: In lieu of handing over a lump sum, it agreed to increase employment benefits to city employees and raise annual contributions to the pension fund.

Between 1996 and 2003, San Diego sold \$1.2 billion of bonds in 16 offerings, but it didn't disclose either the pension fund's deterioration or the city's liability. Any entity selling stocks or bonds on the open market is obliged to divulge all significant financial data.

As the city prepared to market a further \$500 million bond offering in September 2003, Diann Shipione, then a pension-board trustee, emailed an outside San Diego attorney about the omissions. Ms. Shipione says she started paying closer attention to the city's finances after it avoided making the one-time payment in 2002. The bond offering was shelved and on Jan. 27, 2004, San Diego publicly disclosed its financial woes.

The city's first move was to hire Vinson & Elkins LLP, a big Houston law firm, to review its disclosure practices. When the SEC started to investigate, San Diego asked Vinson to also represent it before the federal agency. Rounding out the professional help, the city hired KPMG in April.

Immediately, these hires created problems. KPMG said it wouldn't issue the audit until Vinson's investigation was complete, and reserved the right to withdraw from the audit if it thought the review was "insufficient," according to a copy of KPMG's letter accepting the assignment.

When Vinson issued its report in September last year, it said the city's past disclosure was inadequate but unintentional. KPMG blasted the probe in a letter to the assistant city attorney, saying Vinson's review was

too narrow. KPMG itself had reasons to be vigilant: It had been fined by the SEC in connection with work on some corporate audits and was being investigated by the Justice Department over sales of tax shelters.

Two weeks later, KPMG wrote another letter questioning whether Vinson could complete its investigation "in an objective and independent manner." The auditor was concerned that Vinson couldn't properly investigate the conduct of a city it was also defending before the SEC. The firm said San Diego needed an independent entity -- similar to a corporate audit committee -- to oversee the investigation. It recommended firing Vinson, although the city didn't adopt the suggestion, and refused to approve the audit.

Paul Maco, the lead Vinson attorney on this case, says the firm's twin duties didn't affect its independence. "Both the city and the SEC were aware from the outset of what we were doing, and our agreement with the city also clearly states that the reports are not to be advocacy documents, but are to be objective, warts-and-all reports," says Mr. Maco.

George Ledwith, a KPMG spokesman, says the firm "has communicated with the city and its audit committee concerning the status of our audit, and our concerns about the matters being investigated."

To overcome KPMG's objections, Vinson agreed to perform a second, more comprehensive investigation, which included a review of more than one million electronic documents, including emails, written by city employees. It also allowed KPMG to attend interviews and approve search terms used to mine computer hard drives.

A 'Separate' Investigation

Just as the storm appeared to be receding, Michael Aguirre, (pronounced Ah-GERE-ee) won election in November to the post of city attorney on a pledge to tackle corruption in City Hall. Three days after taking office, Mr. Aguirre, a Democrat, announced his own "separate and independent" investigation of the pension fund.

A stocky 56-year-old with slicked-back hair, Mr. Aguirre says he likes to "fight it out." As a 15-year-old high-school student, he opted to stay in Phoenix so he could continue playing football, instead of moving to Albuquerque, N.M., with his parents. While a securities lawyer, Mr. Aguirre sued Christopher Cox, then a California congressman and now the chairman of the SEC, because of Mr. Cox's role as outside attorney to a company accused of fraud. Mr. Aguirre dropped the suit and Mr. Cox has repeatedly denied its allegations.

"Mike has no off button," says Steven Erie, a professor of political science at the University of California San Diego, who is writing a book on the city's fiscal woes.

Mr. Aguirre says the SEC's investigation has caused San Diego to spend millions in fees on lawyers and consultants. "Everyone is chowing down on a city that's in desperate straits," he says.

In January 2005, he began issuing reports brimming with accusations, including that the mayor and city council had violated federal securities law (no one has been charged with such a crime). He blasted Vinson's first review as a "whitewash," proposed putting San Diego's pension system in receivership and said he, rather than the law firm, should be communicating with the SEC.

The city attorney's accusations sparked anxiety at KPMG, which started worrying about whom in San Diego it could trust. In February, to allay these fears, the city acceded to one of KPMG's demands and set up an independent audit committee consisting of Mr. Levitt, a former SEC chief accountant and an accountant with security firm Kroll Inc. Its role was to answer KPMG's questions on the city's behalf by conducting its own investigation while also trying to reconcile the existing reports. The committee, in turn, hired the law firm Willkie Farr & Gallagher LLP to assist.

The SEC was also growing concerned and started pressuring San Diego to conduct its investigation in a more orderly fashion. At a March meeting, an SEC official distributed a document to city officials outlining the steps companies are expected to take in such circumstances, according to several people who attended the meeting. They included: firing culpable individuals, waiving attorney-client privileges and fixing the problem.

As the document was passed around, an SEC attorney told the group: I can't tell you what to do, but here's an example of what others have done, according to two officials present. The SEC declined to comment.

Both KPMG and the new audit committee became more aggressive in demanding to see various documents in the city's possession. KPMG was well aware that the SEC had sanctioned accounting firms for overlooking information during other audits. Specifically, it wanted documents relating to an out-of-court settlement between the pension fund and retirees who had sued it. KPMG thought the documents might shed light on the original deal between the city and the pension fund.

"What KPMG doesn't want is to sign an unqualified opinion only to have the SEC or FBI come out with something new that would throw egg in their face," says City Councilman Jim Madaffer, a Republican.

In April, the 13-member pension board -- which included new, independent members who had just joined the board -- refused to hand over the documents, citing attorney-client privilege. KPMG said that as a result it would continue to refuse to approve the audit.

One month later, four city officials under investigation resigned or were put on leave. Mayor Dick Murphy, a Republican who had narrowly won re-election a few months earlier, said he'd step down, in part because of the pension-fund probe. He declined to comment. Elections to replace him are scheduled for next month.

By June, the pension board was close to approving a waiver that would allow it to hand over the documents sought by KPMG, according to several people involved.

Then Mr. Aguirre stepped in again. Unconvinced that progress was being made, he filed a lawsuit seeking damages against the pension board's trustees personally. He also asked a court to appoint him as the fund's legal counsel. Four of the new trustees, including several who supported granting the waiver, resigned, citing a fear of further lawsuits.

August Meeting

At a meeting in early August, the SEC told city officials that even Vinson's second report didn't qualify as an independent review, according to several people who attended. Among other things, the SEC was concerned that Vinson had provided some information to employees in advance of their interviews. Vinson's Mr. Maco

says that's a standard practice in investigations.

On Aug. 8, all of San Diego's various lawyers, auditors and consultants assembled before the city council to give a progress report and request funding. At the meeting, Vinson resigned as the city's counsel, saying it had completed the work it was hired to perform.

Mr. Aguirre pushed -- unsuccessfully -- for the city to fire KPMG and the audit committee. He grilled the city's consultants about their charges, saying he had unsuccessfully "tried to get Mr. Levitt's time sheets to verify that he has done the work he says he's done." He also made a stink about the audit committee's expenses, including \$20,000 in transport costs.

Mr. Levitt, raising his voice, told the council: "If you think we're in this for limos or dinners or expenses you should fire us right now." He added: "Never in eight years in Washington have I experienced the kind of petty, personal, sneering commentary made by this elected official."

In late August, a federal judge ordered the pension board to turn over the documents requested by KPMG, based on a request from the U.S. Attorney for the Southern District of California. The process of handing over the documents was again complicated by Mr. Aguirre who also subpoenaed them. He informed the city council that he planned to take over negotiations with the SEC. The council ignored him and instead retained Morgan Lewis & Bockius LLP, a Philadelphia law firm specializing in white-collar fraud.

Asked whether he might be making the situation worse, Mr. Aguirre says: "I sometimes wonder that myself."

Thus far, the investigations haven't turned up evidence of widespread wrongdoing. The San Diego District Attorney has charged six former and current pension-fund trustees on conflict-of-interest charges. The trustees were city employees who saw their benefits increase from between \$386 a month to \$2,530 a month as a result of the city's deal with the pension fund, according to the complaint. Five separate investigations are continuing.

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