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Sunny San Diego Finds Itself Being Viewed as a Kind of Enron-by-the-Sea

By JOHN M. BRODER

SAN DIEGO, Sept. 1 - In the summer of 2003, Diann Shipione, an investment adviser at UBS Financial Services in San Diego and a trustee of the city's employee retirement system, was scanning a prospectus on a proposed San Diego sewer bond issue when alarm bells began to ring in her head.

Important financial information was missing. The prospectus did not mention that the city had for years been shortchanging its public pension fund, leading to an unfunded liability of more than \$1.15 billion, or that the city owed nearly \$1 billion more in health care benefits to retirees and did not have the money. And it implied that the pension fund's actuary had approved the underfunding when Ms. Shipione knew that he had not.

In a letter to city officials, and in a commentary in the local newspaper, Ms. Shipione blew the whistle.

"I had completely lost confidence in the city's financial decision making," she said in an interview on Wednesday. "I just couldn't let this go forward."

Ms. Shipione's warning began a cascade of events that have led to a legal, financial and political crisis in San Diego, the nation's seventh-largest city, which has long enjoyed a reputation for clean and conservative governance.

The sewer bond sale was postponed. Alarmed bond-rating agencies have significantly downgraded the city's credit rating, raising borrowing costs years into the future. The city was forced to admit that it had misstated its financial condition for the last several years, and it has not yet produced a certified financial statement for 2003. Several senior city officials abruptly resigned. Retired city employees, concerned that they would lose benefits because of mismanagement of the pension fund, sued the city, demanding immediate payments into the fund. Reputable analysts have begun talking openly about the possibility that the city will have to declare bankruptcy, as Orange County did a decade ago.

And the Securities and Exchange Commission and the United States attorney's office in San Diego

opened investigations this year into possible fraud in the city's financial statements and potential political corruption. Subpoenas were served on a number of city offices and several people confirmed that they had been interviewed by the F.B.I. in connection with the inquiry.

"This is a powder keg, a major, major problem," said Mike Aguirre, a securities lawyer and former financial fraud investigator for the United States Senate and the Justice Department who is running for San Diego city attorney.

Mr. Aguirre said that the city's inability to produce a credible financial statement made it impossible to know just how severe the crisis was. He said that a corporation that behaved like the City of San Diego would be delisted from the stock exchanges. He suggested that the best solution might be reorganization under Chapter 9 of the federal bankruptcy law to allow the city to rescind pension benefits.

Mr. Aguirre blamed San Diego's laid-back civic culture in which a handful of influential businessmen, union leaders and political figures called the shots while issuing reassurances to the public that everything was on the up-and-up.

"The basic story is that San Diego has become a thoroughly corrupt community in which the power players cut the deals, you don't ask any questions, and everybody gets what they want," Mr. Aguirre said. "People don't realize that one of the largest cities in the United States is on the verge of bankruptcy, and it's on the verge because of a massive amount of local corruption that has resulted in the thorough mismanagement of city finances."

San Diego's mayor, Dick Murphy, who is up for re-election this year, declined to be interviewed for this article. His chief of staff, John Kern, acknowledged that the city's budget was under stress for a variety of reasons. But he asserted that the city was on sound fiscal footing.

"We are not on the verge of bankruptcy," Mr. Kern said in an interview in his city hall office. He said that the city's budget problems had many causes, including cutbacks in payments from the state, which is facing its own budget crisis. He also cited the poor performance of the stock market after 2000, cutting the value of the city's pension accounts. He said that last fall's devastating wildfires had cost the city millions of dollars and required substantial new investments in firefighting equipment.

He also said that hundreds of other public and private pension systems were suffering problems similar to San Diego's because of the stock market and the rising cost of benefits.

He acknowledged that the city had made a "mistake" in underfunding its pension programs, but said the practice began in 1996, under a former city administration. That year the city essentially borrowed millions from its pension plans to cover the cost of holding the Republican National Convention and has continued the practice to cover operating costs and underwrite numerous city projects.

He also acknowledged inadvertent "errors" in the city's recent financial statements.

Mr. Kern said that the city's actions were not illegal and that he understood that the federal investigations center on what he described as financial disclosure issues and not criminal behavior.

"The fundamental fact of the city and its finances is that it can meet its obligations, and we are working through the issues as carefully and methodically and expeditiously as we possibly can," Mr. Kern said.

Deborah Hartman, a spokeswoman for Carol Lam, the United States attorney for San Diego, declined to comment on her office's investigation.

Nels Mitchell, associate regional director of the Securities and Exchange Commission, said the agency did not confirm or deny the existence of any investigation.

Carl DeMaio of the San Diego Citizens' Budget Project, a nonpartisan watchdog group that has long been critical of the city's financial management, said the city's wounds were almost entirely self-inflicted and not a result of state cutbacks or the stock market. Mr. DeMaio said that officials had deceived residents about the city's fiscal condition for years but got in trouble when they issued misleading statements in recent bond offerings.

"If the U.S. attorney finds the city knowingly misled investors with Enron-like accounting, we could see both a large civil liability and criminal indictments," Mr. DeMaio said. "I believe that people for political and personal gain built this Ponzi scheme, and it's coming home to roost this year."

Among the chief causes of the long-term instability of the city's employee retirement fund was a pair of decisions in 2002 to add benefits for future retirees while reducing the city's annual contribution to the funds. Among the most costly was a program called a deferred retirement option plan, or DROP, which allows a worker to defer retirement and build up a special account earning 8 percent interest and a 2 percent annual cost-of-living adjustment. Such programs have touched off investigations in Philadelphia, Houston and Milwaukee.

That action prompted an impassioned warning from Ms. Shipione, who was one of only 2 of 13 members of the San Diego City Employees' Retirement System board to vote against the plan. She said that DROP would entitle a worker earning an average of \$50,000 to collect a lump sum of more than \$300,000 at retirement, along with all his or her other benefits. A higher-paid employee could walk away with close to \$1 million.

At the same time, the city approved a reduction in payments into the retirement fund.

Ms. Shipione went before the City Council in November 2002 and said the changes were a recipe for disaster.

"It made no sense fiscally, no sense," she said. "The city has never been able to afford this kind of

retirement program. I told them, 'This is corrupt.' "

City officials ignored her warnings and approved the benefit increases and the underpayments to the account, then glossed over them in bond issues last year. They are reaping the whirlwind today.

"I saw this happen in Orange County and I realized I had to speak up," Ms. Shipione said. "I let the retirement board know, I let the mayor and the council know, and no one appeared interested. The city basically did it to itself."

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UNION-TRIBUNE EDITORIAL

Tawdry display

City pension board changes would snag critic

July 21, 2004

Long before the mismanagement of the municipal pension fund erupted into a full-scale crisis threatening to destroy San Diego's financial standing, a lone voice warned repeatedly about the emerging folly. But Mayor Dick Murphy and the City Council spurned the prescient pleas of Diann Shipione, a La Jolla investment adviser who serves on the city's retirement board.

Now that her dire admonitions have materialized – amid a federal criminal probe of the city's pension dealings and a costly downgrading of its credit rating – the City Council has moved to silence Shipione. In what smacks of political vengeance, Murphy and a council majority voted this week to ban investment advisers from the pension board. Shipione, whose tenacious whistle-blowing has made her persona non grata at City Hall, is an investment adviser.

The author of the provision to ban investment advisers was Councilman Michael Zucchet. He denies his action was directed against Shipione, who is widely known as the investment expert who challenged the City Council's reckless policy of deliberately underfunding the pension system while simultaneously expanding benefits to lavish levels. "I had no idea, until I read it in the paper this morning, what Diann Shipione does for a living," declares Zucchet.

Maybe so. The truth is that the City Council remains in denial that the pension debacle is a very grave matter, and that fundamental reform is imperative to avert a meltdown of the general fund.

That the council still doesn't get it is clear from the way it shunned the Pension Reform Committee's call for an independent retirement board free of the glaring conflicts of interest that have contributed to the crisis at hand. Under the current arrangement, nine of the board's 13 trustees are vested members of the very pension fund they administer. Their votes to enhance their own personal retirement checks compromise the integrity of the board.

Yet instead of endorsing a panel composed of seven professionally qualified trustees who have no personal stake in their own actions, as the

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Pension Reform Committee urged, the council voted to retain a 13-member board, with seven independent members and six representatives of the city's powerful public employee unions and vested retirees. And, of course, the expertise of investment advisers would be barred.

Some have suggested the council's shameless assault on Shipione was part of a cynical bid to derail a measure headed for the November ballot to overhaul the retirement board. Zucchet's provision ousting Shipione was included at the last minute of the council's debate over putting the proposition before voters. If in fact voters reject the watered-down reform measure, it would preserve the status quo – thereby perpetuating the glaring conflicts that leave the public employee unions in full control of the pension board.

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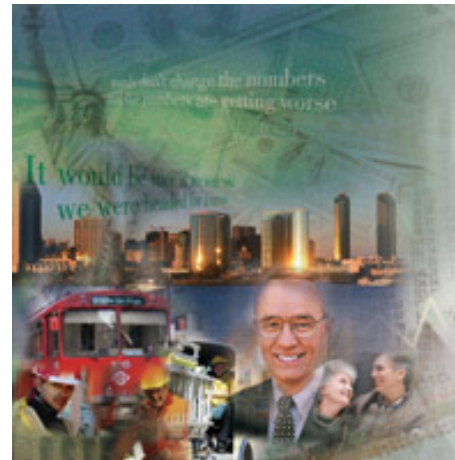
The City Hall Shell Game

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Chronic underfunding and phoned-up financial statements have brought a projected \$2.6 billion deficit in the city of San Diego's pension and health benefits. What will it take to bail it out?

By Larry Edwards | Photo-Illustrations by Joe Griffin

The city's retirement system is broken, and only drastic steps, not Band-Aid solutions, will solve a crisis that threatens to bankrupt San Diego—or require a taxpayer bailout. With a projected \$1.5 billion deficit in its pension plan for the coming fiscal year, and an additional \$1.1 billion deficit in promised retiree healthcare benefits, the city has dug itself into a deep financial hole. The only way out may be extreme measures, its harshest critics say.



The “B” word—which raises the specter of Orange County a decade ago—is not something you’ll hear anyone at City Hall utter publicly, but it certainly is being whispered. If not bankruptcy, how about a tax hike in the form of a pension levy that needs, by one interpretation of the city charter, only city council approval, avoiding that pesky little hiccup known as voter approval.

Through a sophisticated shell game that leaves even veteran financial analysts’ heads spinning, the city has, in the most charitable terms, obfuscated how pension and healthcare benefits are booked. And it has flat out lied about it in financial disclosure statements. Hence, the inquiry by the Securities & Exchange Commission and the criminal investigation by the U.S. Attorney’s office.

How did this happen? Faced with revenue shortfalls and budget deficits, the city robbed Peter to pay Paul, and the retirement system took the hit. It was exacerbated by a falling stock market, or so the city says.

San Diego is not alone in this. The debacle mirrors what’s happening throughout the

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country, in both the public and private sectors. San Diego County has a similar problem, as do other municipalities throughout the state. At the county, supervisors last month decided to issue \$400 million in bonds to cover part of its own \$1.4 billion pension fund deficit. It's the third time in 10 years the county has borrowed to meet unfunded pension liabilities. And that \$1.4 billion deficit doesn't count nearly \$700 million in investment losses, which may or may not be offset by investment gains in the next few years.

Meanwhile, within the private sector, large corporations are faced with multibillion-dollar retirement system deficits. Most companies no longer offer the expensive, defined-benefit plans the city has, instead opting for defined-contribution plans, such as a 401(k), where the sponsor's liability is reduced substantially.

There often is more wiggle room in the private sector, so companies are dumping retiree healthcare benefits to prop up their bottom lines. The city of San Diego may not have that option.

In early March, Mayor Dick Murphy touted a program he says will get the city back on its feet, stemming the flow of red ink from its pension fund—red ink that was intentionally hidden not only from taxpayers but the city's bondholders. But that program—secured by \$500 million of city property—was put in place only after a figurative gun was pointed at the city's head, a gun in the shape of a retiree class-action lawsuit and a downgrade in the city's credit rating.

San Diego is now embarking on a five-step recovery program that ends the chronic underfunding that began in 1996 (and was reauthorized in 2002) and wipes out the \$137 million shortfall created by the underfunding. The city claims the shortfall is only \$98.1 million, but that figure is a year old and doesn't include the \$38.8 million that wasn't paid into the system this year. The cumulative shortfall, combined with a shortsighted investment strategy and double-entry bookkeeping, has resulted in the projected \$2.6 billion-dollar deficit.

The settlement did avert bankruptcy, at least for now, says attorney Michael Conger, who litigated the retiree lawsuit. "Without the city starting to deal with this underfunding problem, it would have been in bankruptcy in this decade," he says. Conger also represents two retired probation officers who are suing the county for underfunding its pension plan. "For [county supervisor and mayoral candidate] Ron Roberts to criticize Dick Murphy over the pension problems is the pot calling the kettle black," he says.

Meanwhile, the city's settlement agreement only defers the problem until 2009; it is not a long-term solution, says Diann Shipione, a member of the San Diego City Employees Retirement System board of directors. By then, the current administration at City Hall will be gone, passing the buck—or lack thereof—to its successor, which is why Shipione cast the lone “no” vote when the settlement was presented to the retirement board for approval.

“It’s moving deck chairs on the Titanic from the right side to the left. The thing has already hit the iceberg,” she says.

It was Shipione, the only member of the board with a financial services background, who last September blew the whistle on the city’s phoned-up financial disclosure statements to bond rating agencies. While acknowledging the agreement to stop the underfunding is a positive step, she says it doesn’t address the \$1.2 billion deficit, which she predicts will grow to \$1.5 billion when the figures are recalculated on June 30, the end of the current fiscal year. The settlement only buys a few years before an even larger crisis surfaces, she says.

Critics like Conger and Shipione believe the city purposely let the problem get out of hand so it would have no choice but to take extreme measures—a tax increase or bankruptcy—rather than make the politically difficult decision to cut services, lay off employees and curtail the spiraling increase in employee retirement benefits. That’s why the notion of a tax hike is not farfetched, Shipione says.

City Attorney Casey Gwinn, who declined to be interviewed for this article, has been asked to investigate whether Section 76 of the city charter allows the city council to levy a pension tax “in the event of any great necessity or emergency” without voter approval. Conger believes that is the case, acknowledging the bankruptcy option could also resurface.

Another question under investigation by the city attorney’s office is whether city employees are vested in the healthcare program. Either way, it’s a Hobson’s choice, Shipione says. If employees are vested, the city will likely be sued by bondholders for not disclosing the \$1.1 billion liability. If they are not vested, the city could be sued by the employees, many of whom value the lifetime healthcare benefit more than the pension itself.

“It would be nice if we were told [by the city manager] we were headed toward a crisis

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before it happened,” says District 6 representative Donna Frye, who in November 2002 was the lone councilmember opposed to increasing employee benefits and continuing the underfunding. (City manager Michael Uberuaga announced his resignation on March 16.) One thing the city must stop immediately, she says, is using closed sessions and secret memoranda of understanding and start discussing the pension system woes publicly. “Bottom line, we’re just going to have to be more honest. That’s probably the thing that’s in the shortest supply,” says Frye, noting the city is facing a \$50 million budget shortfall for fiscal year 2005.

In April 2003, Frye asked for an audit of the retirement program, but she says the mayor refused to docket that subject for council discussion, effectively sweeping it under the carpet for another six months. Murphy declined to be interviewed, but said, following the lawsuit settlement, that the city pension plan “is secure and continues to be secure.”

Not so, says Shipione. The city has yet to address the \$1.1 billion healthcare deficit, and that house of cards could tumble. Nor did the settlement roll back the increase in retirement benefits engineered by current employees, some of whom will retire in the next few years.

Ron Saathoff, for example, will not only be getting a pension for serving as a firefighter, he will get a pension for being president of the Fire Fighters Union, Local 415. Combined, he will get more than \$100,000 a year when he retires, according to Conger, even though his salary as a firefighter is about \$80,000 a year.

For most retirees, there is a retirement benefit cap of 90 percent of one’s highest salary, and a city worker retiring this year will receive, on average, a pension of \$53,000 a year.

How did Saathoff get such a sweetheart deal? As a member of the retirement board, he was able to ensure that benefit. Although it was approved by the city council, it was contingent upon the retirement board voting to continue underfunding the pension plan, and he was in the majority that voted to do so.

Saathoff says the increased benefits were simply to bring the pensions of the city’s safety employees up to par with their counterparts in other cities. He also says that he personally pays the full contribution for the union portion of his pension plan.

A fundamental flaw in the retirement system, critics say, is an inherent conflict of



interest of the majority of the retirement board's 13 members. And for any meaningful change to occur, the board must become fully independent. Today's problem was created, in part, by having employee representatives negotiating increased retirement benefits, then voting to continue underfunding the pension plan as members of the board. "Other than Diann Shipione, every single one of them ought to resign," Conger says.

Saathoff insists there is no conflict of interest and that Shipione and Conger have blown things way out of proportion. "It's disconcerting to me and other members of the board that we have a member out there literally decrying this whole process, [saying] that the sky is falling," says Saathoff, who blames the three-year slump in the stock market for the pension fund deficit. "The system is well-managed; it's certainly well-invested."

Conger disagrees. He contends blaming the stock market is "another complete falsehood by the city." Over the past 10 years, he says, the pension board has announced a 9.11 percent annual return on its investments. Because the actuarial assumption calls for an 8 percent rate of return, the fund should actually have a surplus. How did it fall so far behind? Intentional self-deception. That rate of return also assumes reinvestment of capital gains.

But the city declares a surplus any year the rate of return exceeds 8 percent and siphons off that surplus to pay contingent retiree benefits and health coverage, rather than leaving it in the fund to make up the slack during lean years. Under this policy, the city actually needs a 12 percent return on its investments to keep from accruing a deficit, according to Conger.

"This year, they are going to siphon about \$120 million right off the top if they [have a surplus], and they project they will," he says.

Long term, the city is looking to the Pension Reform Committee to come up with alternatives. The committee's report, due later this month, will examine the unfunded liability, the structure of the retirement board, the type of benefits the city offers and what the city can afford, as well as the possibility of future employees joining the state's CalPERS retirement system.

Will anyone be listening? "If history repeats itself, then the committee's recommendations will fall on equally deaf ears," Shipione says.

"The Blue Ribbon Committee gave loud warnings about pension-plan problems in

February 2002, and those warnings were completely disregarded by the mayor and council in November 2002,” she adds. “What you’re faced with here is that words don’t change the numbers, and the numbers are very bad and getting worse.”

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