

OFFICE OF
THE CITY ATTORNEY
CITY OF SAN DIEGO
MICHAEL J. AGUIRRE
CITY ATTORNEY

CIVIL DIVISION
1200 THIRD AVENUE, SUITE 1620
SAN DIEGO, CALIFORNIA 92101-4178
TELEPHONE (619) 236-6220
FAX (619) 236-7215

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Honorable Jerry Sanders, Mayor
City of San Diego
202 C Street, 10th Floor
San Diego, CA 92101

Dear Mayor Sanders:

I.
BACKGROUND

On 14 November 2006 the U.S. Securities & Exchange Commission (SEC) issued a cease and desist order finding that San Diego City officials violated the anti-fraud provisions of the federal securities laws.¹ The SEC determined that San Diego City officials and employees withheld information concerning hundreds of millions of dollars of pension and retiree health debt from investors in the City's bonds. The SEC made numerous findings regarding the conduct of City officials:

- The SEC found that the City of San Diego faced a "financial crisis," and in failing to disclose critical facts about its pension and retiree health care debt violated "the antifraud provisions of the federal securities laws in connection with the offer and sale of over \$260 million in municipal bonds in 2002 and 2003. At the time of these offerings, City officials knew that the City faced severe difficulty funding its future pension and health care obligations unless new revenues were obtained, pension and health care benefits were reduced, or City services were cut."² (emphasis added.)
- The SEC found the "City's looming financial crisis resulted from (1) the City's intentional under-funding of its pension plan since fiscal year 1997; (2) the City's

¹ 14 November 2006 SEC Cease and Desist Order p. 2 ("SEC Cease & Desist Order"). (Exhibit 1.)

² SEC Cease and Desist Order p. 2, attached as Exhibit 1.

granting of additional retroactive pension benefits since fiscal year 1980; (3) the City's use of the pension fund's assets to pay for the additional pension and retiree health care benefits since fiscal year 1980; and (4) the pension plan's less than anticipated earnings on its investments in fiscal years 2001 through 2003."³ (emphasis added.)

- The SEC found City officials did not disclose the "gravity of the City's financial problems" including that the "City's unfunded liability to its pension plan was expected to dramatically increase, growing from \$284 million at the beginning of fiscal year 2002 and \$720 million at the beginning of fiscal year 2003 to an estimated \$2 billion at the beginning of fiscal year 2009." Also not disclosed was the fact that the City's "projected annual pension contribution would continue to grow, from \$51 million in 2002 to \$248 million in 2009." Also not disclosed was the fact that the "estimated present value of the City's liability for retiree health benefits was \$1.1 billion."⁴
- The SEC found that the City used the improper practice of applying "surplus earnings—i.e., earnings above the actuarially projected 8% return rate -- to fund an ever-increasing amount of additional benefits for San Diego City Employees' Retirement System members."⁵
- The SEC found that in "fiscal year 1996, the City agreed to increase significantly and retroactively all employees' pension benefits. The City, however, could not afford to fund the cost of the benefit increases. The City, therefore, made the pension benefit increases contingent on CERS's agreement to the City's underfunding of its annual contribution to CERS."⁶ (emphasis added.)
- The SEC found that in "March 2000, the City again retroactively increased pension benefits. Specifically, the City and CERS settled a class action lawsuit brought by CERS members, with Corbett as the named class plaintiff. Under the Corbett settlement, the City retroactively gave increased pension benefits to both current and retired City employees, increasing CERS's liabilities."⁷

³ SEC Cease and Desist Order p. 2. (Exhibit 1.)

⁴ SEC Cease and Desist Order pp. 2-3. (Exhibit 1.)

⁵ SEC Cease and Desist Order pp. 6-7. (Exhibit 1.)

⁶ SEC Cease and Desist Order p. 7. (Exhibit 1.)

⁷ SEC Cease and Desist Order pp. 7-8. (Exhibit 1.)

- The SEC found that in “April 2002, the City received a warning that the City’s pension and retiree health care liabilities would continue to grow and that the City was not adequately planning to meet those liabilities.” The warning, according to the SEC, came in the form of a report from “the City’s Blue Ribbon Committee to the City Council.”⁸
- The SEC found that in “fiscal year 2003, the City again increased its pension liability by granting additional retroactive benefits, used additional CERS assets to pay for additional pension and retiree health care benefits and an increased portion of the employees’ contribution, and obtained additional time to underfund its annual CERS contribution.”⁹
- The SEC found that the City received two reports from CER’s actuary that provided “the City with negative information regarding the present and projected status of CER’s funded ratio and the City’s unfunded liability to CERS.” According to the SEC, one report showed that the pension had “suffered an actuarial loss of \$364.8 million and that as of the end of fiscal year 2002, CER’s funded ratio was 77.3% and the City’s unfunded liability to CERS was \$720 million.”¹⁰ The second report, according to the SEC, showed that the “City’s contribution rate was projected to more than quadruple-9.83% of payroll in fiscal year 2002 (\$51 million) to 35.27% of payroll in fiscal year 2009 (\$248 million).”¹¹
- The SEC found the City’s financial adviser gave City officials “additional information regarding the projected growth of its future pension liabilities and the possible negative effect those liabilities would have on the City’s credit rating and ability to issue municipal securities.” According to the SEC, in April 2003, the financial adviser informed City officials that the “City’s unfunded liability to CERS would grow to \$1.9 billion at the end of fiscal year 2009 and to \$2.9 billion at the end of fiscal year 2021, and CERS’s funded ratio would fall to 66.5% at the end of fiscal year 2009 and would be 67% at the end of fiscal year 2021.”¹²

⁸ SEC Cease and Desist Order p. 9. (Exhibit 1.)

⁹ SEC Cease and Desist Order p. 9. (Exhibit 1.)

¹⁰ SEC Cease and Desist Order p. 10. (Exhibit 1.)

¹¹ SEC Cease and Desist Order p. 10. (Exhibit 1.)

¹² SEC Cease and Desist Order pp. 13-14. (Exhibit 1.)

- The SEC found that the “City, through certain of its officials, knew that its Disclosures were misleading. The Mayor and Council were responsible for approving the issuance of the bonds and notes, including issuance of the preliminary official statements and official statements.”¹³

On 5 September 2003, SDCERS Trustee Diann Shipione sent an e-mail to SDCERS’ Administrator Lawrence Grissom warning that bond offering documents being used by the City of San Diego to sell sewer bonds were inaccurate.¹⁴ Ms. Shipione called special attention to the statements made in the disclosure document that the SDCERS actuary had determined that the funding method being used by the City in its pension plan was “an excellent method for the City and it will be superior to the PUC method.” In fact, the funding method was being used to hide hundreds of millions of dollars of pension benefits that had been illegally created by City officials.

Ms. Shipione’s e-mail caused the City’s bond offering to be halted. On 27 January 2004 the City was required to disclose to its current bond investors hundreds of millions of dollars of debt not properly disclosed by the City previously. These disclosures prompted the SEC investigation mentioned above beginning in February 2004. Following the disclosures of the pension and retiree health care debt, the City of San Diego essentially lost its credit rating and has been unable to access the public securities markets.

With this record it is imperative that the City of San Diego restore reliable internal controls in order to ensure that investors in City bonds receive information necessary to make informed decisions relevant to San Diego City bonds. As indicated in the SEC cease and desist order the City is required to increase revenues, decrease pension and retiree health care debt, or cut city services. City officials know that revenues have not been materially increased nor have debt or service levels been materially lowered. Moreover, there are several remedial actions necessary, but not yet adopted, to place the city on a sound financial footing that would permit the City to return to the public securities markets.

II. REMEDIATION

1. Rescind MP-1 and MP-2 Benefits

As discussed in the SEC cease and desist order the City awarded retroactive benefits in exchange for funding the pension fund below the required actuarial level. These benefits were awarded for work already performed and without funding. These benefits constitute gifts of

¹³ SEC Cease and Desist Order p. 17. (Exhibit 1.)

¹⁴ 5 September 2003 e-mail from Diann Shipione, SDCERS Board Trustee, to Lawrence Grissom, administrator with SDCERS. Subject: “Incorrect Pension Materials in Bond Solicitation Circular.” (Exhibit 2.)

public funds', prohibited payments for work already performed, and were given in violation of the liability limit laws. Under the State Constitution and City Charter the benefits are illegal and must be rescinded.

2. Actual Value of Purchase Service Credits

City employees were permitted to buy purchase service credits but they were allowed to do so at below the full value. Granting purchase service credits at prices below the value received by the City employees constitutes a gift of public funds and violates the liability limit law both of which are prohibited by the City Charter and State Constitution. The 17,000 years of purchase services credits must be reduced to actual value.

3. Actual Value of DROP

City employees were permitted to enter into a deferred retirement option plan that allowed them to receive a retirement distribution while still working and receiving their salary. DROP was also supposed to be cost neutral but in fact the program has been administered at a cost to the City of several hundred million dollars. Granting DROP on its current terms is a gift of public funds and a violation of the liability limit law. The DROP program must be reduced to a cost neutral level.

4. Purchase Service Credits 10 and 20 year Vesting

The City Charter requires employees work for 10 years to vest in the City's pension plan and 20 years to retiree with additional benefits. The City Council adopted a provision that allows city employees to purchase 5 years of purchase service credits to satisfy the 10 year vesting, after only working for 5 years. A practice has been adopted by the City pension system allowing employees to buy years of purchase service credits to satisfy the 20 year vesting provision that allows for additional benefits. These programs violate the Charter and should be discontinued.

5. City Attorney Counsel for Pension System

The San Diego City Charter and Municipal Code §24.0910 provide that the City Attorney appoints the attorney for the City's pension system. The City Attorney has not been permitted to name the pension system's attorney. The City Attorney under the Charter and Municipal Code should be reinstated as the attorney for the pension system.

6. Reform Management of Pension System

The management of the pension system must be reformed in order to restore the internal controls of the City's financial system. Recently, the City Attorney's office discovered that the Internal Revenue Service in March 2007 determined that the City must immediately pay \$100 million into the pension fund liability to replace funds used to pay for health benefits. This information has not been disclosed in the City's financial statements. Moreover, the trustees

who were appointed are not dedicated to establishing reliable internal controls within the pension system. Responsible trustees must be appointed before the City can represent to investors that it has put in place proper internal controls.

7. Remove Surplus Earnings

The pension system uses a discredited and improper method known as "surplus earnings" to distribute pension assets to pay for "contingent" benefits. Despite repeated efforts to repeal the surplus earnings provisions from the Municipal Code a majority of the City Council, under direction from the pension board administration, has failed to act. Again, this provision must be removed from the Municipal Code and the practice stopped.

8. Misrepresentation in IRS 5300 Determination Letter

The pension system has applied for an IRS Determination Letter under the voluntary compliance program that allows pension systems to correct prior misconduct and receive a determination letter from the IRS that the system is operating within IRS rules. The City Attorney has reviewed two letters from the pension system to the IRS dated 14 March and 20 March 2007. These letters fail to disclose pertinent information to the IRS. For example, in regards to the former trustee who received an unfunded increase in his retirement benefit no mention is made of the relationship between his increased benefit and his role in securing approval of the City's continued underfunding of the pension plan. Also no mention is made of the fact that funds were not withheld for a portion of his benefit to cover the costs of his increased benefits. Again, the City, as plan sponsor must review the representations made by the pension system representatives to ensure that there are no material misrepresentations.

9. Confirm DROP Purchase Service Credit Ended 2005

Two legal opinions have been sent to the pension system administrators confirming the fact that DROP and Purchase Service Credit benefits were ended as of July 2005. The system administrator has informed the City that the pension system does not recognize the end date for these benefits as July 2005. The pension system is refusing to follow the clear language of the Municipal Code. This issue must be resolved so that accurate information about the City's pension liabilities can be provided in our financial statements.

10. Reduce and fund pension deficit of \$1 billion within 15 year amortization

The City must take all reasonable steps to reduce the \$1 billion pension deficit by removing the benefits that were granted unlawfully. Court rulings have shown that the City must act affirmatively to delete retroactive benefits, DROP benefits given at levels above actual costs, and purchase of service credits granted above actual value. Removing these benefits will reduce the pension deficit by hundreds of millions of dollars. As for the remaining debt it must be amortized under our Charter within 15 years as directed by voters in 2004. The Mayor has adopted the position of the pension board while ignoring the written advice letter provided by the

City Attorney's office. These steps must be taken if the City is to avoid a massive tax increase to pay for these illegal benefits.

11. Reduce and Fund Retiree Health Care Deficit

In a series of agreements made without providing same year funding City officials have created a \$1.4 billion health care benefit deficit for retirees. This deficit must be reduced by deleting the benefits conferred without proper funding e.g. indexing retiree health benefits to federal actuarial increases. The deficit based upon legitimate health care benefits for retirees must be paid and not simply pushed off to future generations.

12. Retain City Actuary

The City must retain an actuary in order to have an independent source of information to make informed decisions about the pension debt crisis the City faces.

13. Continue Litigation to Remove Illegal Pension Benefits

City officials have a fiduciary duty to remove the illegal pension benefits and to take all necessary and appropriate legal action related to avoiding the illegal portion of the pension debt. Recent emails from City union leaders make it clear that a campaign has been and is underway to pressure the City Attorney from dropping the pension cases aimed at removing illegal pension debt from the City's books. Certain council members have appeared to join in that campaign. The Mayor and City Council must take all steps necessary to remove the illegal debt including pursuing pension related litigation.

14. False or Misleading Statements About City Financial Condition

The Mayor¹⁵ and certain City Council members have made statements that could be interpreted as false and misleading concerning the City's financial condition. These statements suggest that the City has resolved its financial problems. Unfortunately, based, in part, on last

¹⁵ In August the Mayor told San Diego Magazine in a published interview that the City was "in much better shape." The Mayor stated: "We've got payment schedules worked out with this five-year plan and the budget we just adopted for fixing most of the major financial issues." The Mayor also stated that "we're actually paying in more than we're required to." He then went on to say with regard to the retiree health care that "no body even anticipated." (Exhibit 3.) These statements were false and misleading. There are no payment schedules "worked out." The five year plan assumes wage increases at rates below those given. The payments to the pension plan are back-loaded for years after the Mayor's term would expire. The City is required under law to pay within a 15 year amortization schedule the Mayor is using a 20-year amortization which means the City is paying less than required not more as he has represented. Finally, the retiree health care deficit has been known for several years and, like the Mayor's plan, pushed off to future generations.

year's salary increases and also on the failure to take needed corrective action of decreasing pension and retiree health debt the City is still in critical financial condition.

III.
CONCLUSION

City officials destroyed the City's credit rating by increasing pension and retiree health care benefits without proper funding and in violation of local and state laws. The SEC issued a cease and desist order finding these City officials engaged in securities fraud. The SEC identified the massive debt facing the City and noted that the only way to solve the problem created was by decreasing the debt, increasing the revenues, or cutting services.

Rather than do the work needed to get rid of the illegal debt and fund the remaining obligations, the Mayor and certain members of the City Council have opted to continue the past practices of relying on the pension system's phony numbers and pushing the debt off to future generations. The City must reverse course and make the hard choices needed to return the City to financial health before it can re-enter the public financial markets.

All of the points listed above must be dealt with by swift and decisive council action or our great City will find itself even more at peril than it presently is.

Very truly yours,



MICHAEL J. AGUIRRE, City Attorney

MJA:meb

cc: Honorary Councilmembers
Congressman Barney Frank, Chairman, House Financial Services Committee
Linda Chatman Thomsen, Securities and Exchange Commission
Kelly Bowers, Securities and Exchange Commission