

COMPASS

SPECIAL REPORT

Learning from the Mistakes of Others: The San Diego Crisis

By David Brodsky, Managing Director

In every decade, a new crisis rocks public finance and shapes the future of our practice. Over the course of my municipal finance consciousness, I have witnessed New York City's note default in the 1970's, the Washington Public Power Supply System's bond default in the 1980's, and the Orange County bankruptcy in the 1990's. The hallmark of this decade appears to be the crisis in the City of San Diego, where underfunding of the City's pension system has sent the ratings of this once-AAA-city tumbling. Perhaps even more disruptive than the financial strain has been the intense focus on the City's prior bond disclosure, resulting in censure by the Securities and Exchange Commission; costing the City millions in legal and accounting exercises; and blocking it from market access. And San Diego has not defaulted on a single debt obligation!

As a service to our clients, KNN Public Finance offers this overview of the San Diego legal and fiscal crisis and some suggestions for avoiding similar entanglements in your agency.

What Went Wrong: An Overview of the Crisis

The City of San Diego's finances began to unravel a decade ago, when the City increased pension benefits while instituting unusual actuarial practices that resulted in the underfunding of its retirement system.

Such practices were continued as late as 2002, when increased benefits were approved without any apparent cost. The combination of benefit increases, along with the pattern of underfunding, stock-market losses, and settlements with retirees, have added up to a pension system shortfall estimated to be well in excess of \$1 billion. But until recently, the City's unusual practices and its eroding funding ratios were invisible; they were not clearly disclosed in either its annual financial report or its municipal bond disclosure.

When the City itself chose to voluntarily disclose its past practice to the bond market in early 2004, it set off an avalanche of events that continue to consume them. Two dozen city officials and several City Council members have been accused of wrongdoing ranging from simple negligence to breaking securities laws in the disclosure relating to more than \$2 billion in bonds.

Consultants from Kroll Inc., led by former SEC Chairman Arthur Levitt, released a 266 page report on August 8, 2006, that detailed San Diego's fiscal failings. The report accuses the City of making a long list of fraudulent misrepresentations to investors: "The City's derelictions... resulted in numerous violations of the federal securities laws as the City repeatedly obtained money from public investors through financial statements and related disclosures that were false....Under the pressure of short-term needs, City officials gave expedience a higher priority than fiscal responsibility and came to view the law as an impediment to be circumvented through artful manipulation."

On November 14, 2006, the City settled with the Securities Exchange Commission. The SEC found that the City of San Diego committed securities fraud and “knew or was reckless in not knowing that its disclosures were materially misleading.” The U.S. Attorney’s Office and the Securities Exchange Commission are both continuing their investigations of the roles played by individuals in this case.

This course of events has had detrimental affects on the City, its employees, and its citizens. With all attention turned to the growing crisis, little progress can be made on any other initiative in the State’s second largest city. Access to the capital markets has evaporated and major capital programs are stopped in their tracks. Millions of dollars have been spent on consultants.

Perhaps most disconcerting to someone who works with municipal officials for a living, a number of experienced and hardworking professionals saw their own careers turned upside down. Others were forced to leave, or chose to interrupt their career tracks and work elsewhere. Beyond the headlines are dozens, if not hundreds, of personal tragedies. San Diego serves as a sobering reminder of the potential consequences of mistakes in the issuance of public securities. It is also a reminder that both the public institution and the civil servant are better served by attention to full disclosure than by a positive spin.

Risky Business: Guidelines for Avoiding Inadequate Disclosure

The roots of San Diego’s crisis lie not in its financial position, but its disclosure of its financial position. The crisis began with a disclosure finding, and the investigations by outside attorneys Vincent and Elkins, the SEC, Kroll, and others have all focused primarily on the disclosure of financial practices rather than on the practices themselves. Even now, the City struggles to release its audited financial reports dating back to the 2003 fiscal year, as it is practically paralyzed by the burden of simply describing itself.

For anyone working in the area of finance who has responsibility for preparing financial reports and bond offering documents, San Diego is a like horror show. A municipal

official or financial professional cannot help but feel a chill in the spine when they contemplate the risks inherent in their jobs. Following San Diego, the act of reporting and disclosure should never feel or be the same.

But the public’s business must continue, which includes publishing information and accessing the public markets. There are a number of steps an issuer can take to defend itself from the risks of inadequate disclosure. You can hire accountants and bond professionals with the experience and integrity to help guide you in reviewing your financials and drafting official statements. But municipal officials must also take seriously their own roles in investigating themselves and ensuring that they have disclosed all material information.

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There is no simple checklist for good disclosure. But with common sense and an open and inquisitive attitude, most public officials can be assured that they do not leave themselves exposed to second-guessing. Here are a few things to keep in mind when preparing an official statement for one of your own bond deals:

- Pay attention to things that don’t sit quite right with you: statements you don’t understand, or information that doesn’t seem quite accurate. If you as the issuer don’t understand something, don’t assume that the investor will. Listen to your gut, and don’t stop asking questions until you are satisfied. As the issuer, all your questions are legitimate.
- Be willing to share information that might make your institution look bad: that is just the kind of information that can be considered material under securities law. Think of the official statement less as a sales document and more as your defense if you are ever challenged.

- Read the boilerplate. Often nobody does, and it can be wrong.
- Look for inconsistencies between the official statement and other public documents. For example, does the official statement agree with your CAFR? Often pursuing such inconsistencies not only corrects errors, it leads to a deeper understanding of the facts.
- Review any materials that you have provided to the rating agencies or your own decision makers. If you thought it was material for them, it probably would be material to investors. Listen to the questions that the rating and bond insurance analysts ask; should those answers also be added to your official statement?
- Consider using the official statement to supplement your audit where not clear. In the wake of San Diego, many issuers have added an expanded discussion of their retirement systems to their official statements.
- Spread internal responsibility for the document. Have several people read the official statement. Set up a "due diligence" meeting with finance and other officials to review what information is included in the document, and what is not.

There is little written guidance on municipal disclosure, nor is there a one-size-fits-all approach. But you can minimize the risks to both your agency and yourself if you: exercise good judgment, are disciplined and diligent in your review, and continue to ask yourself, "What would I think was important in understanding our credit quality?"

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Mr. Brodsky has over 20 years experience in municipal finance. Mr. Brodsky joined KNN early in 1998 to head up KNN's city and special district consulting practice, and he serves as financial advisor to a number of cities throughout the State. His transaction work has included lease revenue and enterprise revenue debt, redevelopment, special tax and pension obligations.

For nearly six years, Mr. Brodsky was a Vice President and Senior Credit Officer with Moody's Investors Service. He served as a senior member of the analytic and management team responsible for all types of local government bond and note ratings on the Pacific Coast, and was a member of Moody's national rating committee.

Prior to joining Moody's, Mr. Brodsky spent over twelve years with the City of Los Angeles, where he was responsible for financial planning, debt issuance and bond administration for general government departments of the City of Los Angeles. His experience included \$1 billion in lease revenue obligations, seven voter authorizations, establishment of enterprise revenue systems, and Mello-Roos, assessments, and the creation of several innovative security-types, including selling bonds to finance judgments.

Mr. Brodsky is a graduate of the University of California, Santa Cruz, earning a B.A. with highest honors in Modern Society and Social Thought. He is the author of a well-received study of Los Angeles, "L.A. Freeway: An Appreciative Essay", published by the University of California Press.

Mr. Brodsky is a frequent speaker on public finance issues, and has spoken at conferences sponsored by the California Redevelopment Agency, the California Debt and Investment Advisory Commission, the Bond Buyer, and the Association of Government Leasing and Finance.



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