Office of
The City Attorney
City of San Diego

MEMORANDUM

DATE: February 16, 2007

TO: Honorable Mayor and City Councilmembers

FROM: City Attorney

SUBJECT: Kroll, Willkie Farr & Gallagher and Vinson & Elkins: Consultant Conflicts of Interest

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INTRODUCTION

The City's conflict of interest codes and California law require City officials to analyze the scope of work of every consultant the City hires and determine whether the consultant meets legal definitions that require the consultant to file financial disclosure statements. In 2004 and 2005, the City retained consultants as a result of the investigation by the Securities & Exchange Commission, U.S. Attorney's Office and the FBI into the City's financial disclosure practices and related issues. In particular, the City first hired the law firm of Vinson & Elkins, and later retained Kroll, a risk assessment firm, along with the law firm of Willkie Farr & Gallagher.

It does not appear that a written determination was ever made by any City official as to whether these consultants meet the definition of a "consultant" and, therefore, are required to file financial disclosure statements. As part of an ongoing review of the City's consultants, our office has been asked to opine on whether key individuals with these firms are required to file a Statement of Economic Interest [SEI] and make appropriate financial disclosure statements.

Our analysis of whether the three entities meet the "consultant" definition follows below after an overview of the applicable law. Our conclusion is that representatives of all three firms should file SEIs based upon their direct level of involvement in making recommendations to the Mayor and City Council regarding governmental decisions affecting the City's financial policies, standards and guidelines.

DISCUSSION

A. Overview of the Law and Policy Regarding Consultant Disclosure.

1. The Political Reform Act.

The purpose of the conflict of interest provisions of the Political Reform Act [Act] is to ensure public officials, whether elected or appointed, perform their duties in an impartial manner,

free from bias caused by their financial interests or those of persons who have supported them. By disclosing relevant financial interests, public officials can determine whether a conflict of interest exists and avoid participating in a matter. The Act also makes this information available to the public to help ensure government decisions are free from undue influence or improper financial motives.

In particular, the purpose of these laws is "to promote and accomplish several state policies including: (1) assuring the independence, impartiality and honesty of public officials; (2) informing citizens regarding those economic interests of officials which might present a conflict of interest; (3) preventing improper personal gain by persons holding public office; (4) assuring that governmental decisions are properly arrived at; and (5) preventing special interests from unduly influencing governmental decisions." *County of Nevada v. MacMillen*, 11 Cal. 3d 662, 667 (1974), citing legislative findings in then-Government Code section 3601. See, Govt. Code § 81001(b).

"Public officials" include elected officers and other high-ranking public employees. In addition, certain "designated employees" are considered "public officials." The "designated employees" are the persons holding positions set forth in the City's conflict of interest code who are required to make financial disclosures. In addition, certain consultants to government agencies may be considered a "consultant" under the Act's definition and thus be required to make disclosures. In general, this occurs if the agency has delegated governmental decision-making authority to that person or the consultant is acting in a "staff capacity."

2. Definition of "Consultant."

According to Title 2, Section 18701(a)(2) of the California Code of Regulations, the regulations of the FPPC, and the California Government Code, a "consultant" is defined as follows:

> (2) "Consultant" means an individual[1] who, pursuant to a contract with a state or local government agency:
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> (A) **Makes a governmental decision** whether to:
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> 1. Approve a rate, rule or regulation;
> 2. Adopt or enforce a law;
> 3. Issue, deny, suspend, or revoke any permit, license, application, certificate, approval, order, or similar authorization or entitlement;
> 4. Authorize the agency to enter into, modify, or renew a

[1] A consultant is a natural person and not a corporation or entity; the individuals within a firm are the ones who file. Thus, if the contract is with a large corporation or entity, the work of individual employees must be reviewed to determine which individuals must file. See Widders Advice Letter, No. I-90-212.

contract provided it is the type of contract that requires agency approval;

5. Grant agency approval to a contract which requires agency approval and to which the agency is a party, or to the specifications for such a contract;
6. Grant agency approval to a plan, design, report, study, or similar item;
7. Adopt, or grant agency approval of, policies, standards, or guidelines for the agency, or for any subdivision thereof; **or**

(B) **Serves in a staff capacity** with the agency **and** in that capacity participates in making a governmental decision as defined in Regulation 18702.2, **or performs the same or substantially all the same duties** for the agency that would otherwise be performed by an individual holding a position specified in the agency's Conflict of Interest Code under Government Code Section 87302.

2 Cal. Code of Regs. § 18701(a)(2)[emphasis added].

Thus, a "consultant" will be required to disclose certain financial interests if he or she either makes a "governmental decision" or serves in a "staff capacity." These terms are placed in quotes as they have special definitions under the Act and as interpreted by the FPPC.

a. "Makes a Governmental Decision."

Under section 18701(a)(2)(A), an individual "makes a governmental decision" when he or she, acting within the authority of his or her position: (i) votes on a matter; (ii) appoints a person; (iii) obligates or commits the agency to any course of action; (iv) enters into any contractual agreement on behalf of the agency; (v) determines not to act on the actions above. 2 Cal. Code of Regs. § 18702.1. A person likely would be considered a "consultant" if such decision making authority is delegated to that person.

b. Serves in a "Staff Capacity."

Under section 18701(a)(2)(B), a "consultant" will be required to disclose financial interests if he or she serves in a "staff capacity" *and* participates in making a governmental decision as defined in Regulation 18702.2. This includes an official who, when acting within the authority of his or her position,

> (a) Negotiates, *without significant substantive review*, with a governmental entity or private person regarding a governmental decision . . . **or**
>
> (b) Advises or makes recommendations to the decision maker either directly or *without significant intervening substantive review*, by:

> (1) Conducting research or making any investigation which requires the exercise of judgment on the part of the official and the purpose of which is to influence a governmental decision referenced in Title 2, California Code of Regulations, section 18701(a)(2)(A); **or**
>
> (2) Preparing or presenting any report, analysis, or opinion, orally, or in writing, which requires the exercise of judgment on the part of the official and the purpose of which is to influence a governmental decision referenced in Title 2, California Code of Regulations, section 18701(a)(2)(A).

2 Cal. Code of Regs. § 18702.2; Cal. Govt. Code § 83112.

According to the FPPC, an individual "serves in a staff capacity" if he or she performs substantially all the same tasks that normally would be performed by a staff member of a government entity. The length of a contractor's services to an agency and whether services are rendered on a regular and continuous basis are other factors to consider in making this determination. Similarly, an individual will be considered a "consultant" if he or she performs the same or substantially all the same duties for the City that would otherwise be performed by an individual holding a position specified in the agency's Conflict of Interest Code under Government Code section 87302.

In most cases, individuals who work on only one project or a limited range of projects for an agency are not considered to be working in a "staff capacity." However, if the scope of duties changes and an individual provides ongoing advice on a wide range of matters, he or she may be deemed to be acting in a "staff capacity." This is especially so if the tasks are substantially the same as those performed by a person in a position that is or should be specified in the City's conflict of interest code. Accordingly, individuals who serve in a staff capacity and "participate in" government decisions on general matters on an ongoing basis would be "consultants" under the above regulations.

B. Specific Determinations.

1. Kroll.

Background: In February 2005 the City hired Kroll Inc. to review and evaluate the findings of the investigations by the City Attorney and Vinson & Elkins related to the City's financial disclosure practices. Kroll also was asked to assist in assessing the City's internal control deficiencies related to the investigations. On March 8, 2005, Kroll's role was expanded when the City Council designated three Kroll principals as the City's "Audit Committee" as contemplated by the Sarbanes-Oxley Act.[2]

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[2] The Audit Committee consisted of Arthur Levitt, Jr., Lynn E. Turner and Troy A. Dahlberg. (See Resolution No. R-300203.)

The first phase of Kroll's retention was to serve as an Independent Investigator for matters relating to the unfunded liability of the San Diego City Employees' Retirement System [SDCERS] and for errors discovered in the footnotes of the City's audited financial statements. Kroll was to work with the City's outside auditor, KPMG, to understand their concerns and identify a satisfactory work program to assist them in obtaining the necessary evidence and documentation required by applicable accounting, auditing and professional services. This phase also included the review and evaluation of investigative reports issued by Vinson & Elkins and the City Attorney.

The second phase included consultation with City personnel to establish internal controls that, if implemented and properly operated by the City, could provide reasonable assurance that the transactions identified in the reports in the first phase are properly reported and disclosed in the City's financial statements. The work was to be coordinated with the City Auditor and Comptroller, the internal audit department manager, and the City's outside independent auditors as to the scope and nature of internal controls that the City would need to assess, document, implement, and test.

In a May 6, 2005, status report to the City Manager, Kroll described the activities of the Audit Committee in more detail. These activities included: meeting and holding discussions with independent auditors to coordinate its work; ongoing communications with law enforcement agencies; and meeting with SDCERS and their advisors regarding various issues involved with the investigation. The report also confirmed that the Audit Committee would be making recommendations on necessary remediation issues that may arise.

On August 8, 2006, Kroll presented its "Report of the Audit Committee of the City of San Diego." The lengthy report described the results of its investigation and provided more than 50 recommended proposed remediation measures. The recommendations included: reorganization of financial reporting; the creation of new positions; methods of ensuring the independence of the auditors; improvements to information technology and risk management; and other suggestions regarding the City's financial reporting and internal controls. This report was presented directly to the Mayor and City Council at a City Council meeting. The cost of the investigation and recommendations presented in the Audit Committee's Report was more than $20 million.

Analysis. As noted above, a "consultant" is an individual that "makes a governmental decision" or serves in a "staff capacity." Generally, an outside independent auditor retained to perform a specific one-time audit to verify receipts, assets, expenditures, without having the authority to recommend a course of action is not the type to be covered by the Act. (See Maze Advice Letter, No. I-95-296). However, if the individuals attend meetings of the agency, provide services beyond the limited scope, or perform other activities such that they serve in a quasi-staff capacity, the individuals may be deemed "consultants" and required to disclose financial interests.

In this case, the individuals serving on the Audit Committee served in a "staff capacity" by participating in ongoing communications with law enforcement agencies, coordinating with the City's independent outside auditors, and making recommendations to correct financial reporting deficiencies. These activities are substantially the same as those that would have been performed by City employees subject to disclosure requirements.

Further, a "consultant" acts in a "staff capacity" when the consultant: "advises or makes recommendations to the decision maker either directly or without significant intervening substantive review, by: (1) conducting research or making any investigation which requires the exercise of judgment on the part of the official and the purpose of which is to influence a governmental decision; or (2) preparing or presenting any report, analysis, or opinion, orally, or in writing, which requires the exercise of judgment on the part of the official and the purpose of which is to influence a governmental decision. 2 Cal. Code of Regs. § 18702.2.

The Audit Committee conducted an investigation and prepared a lengthy report that required the exercise of judgment, and made recommendations directly to the City Council and Mayor to influence governmental decisions to adopt new policies and procedures. The recommendations were reviewed by the Mayor's Office after the report was received, however, it does not appear that this review meets the definition of a "significant intervening substantive review." A consultant participates in a decision, even if it is reviewed by several of his superiors, if those superiors rely on the data or analysis prepared by the consultant without checking it independently, if they rely on the professional judgment of the consultant, or if the consultant in some other way actually may influence the final decision.[3] In this case, it appears that the Mayor's Office heavily relied on the professional judgment of the Audit Committee and fully adopted each of the recommendations in the Mayor's August 24, 2006, response to the report.

In addition to the Mayor's review, the Independent Budget Analyst conducted a separate review of the Audit Committee's Report. In her August 30, 2006 report, the IBA indicated that there should be a "critical examination" of the remediation measures prior to adoption. In particular, the IBA report urged a public participation process to discuss the measures and possible alternatives. On the other hand, the report also states the IBA "has not found any of the remediations to be inappropriate or unnecessary; rather we encourage the adoption of all remediations proposed as part of a total strategy to achieve financial accountability and operational success." There is ongoing review by the City as it moves to implement the Audit Committee's recommendations. Nonetheless, it appears that the City has, for the most part, relied on judgment of the Audit Committee and is not conducting a separate substantive review of the analysis or conclusions.

For the above reasons, we conclude that the individuals serving on the Audit Committee would be considered "consultants" under the FPPC regulations. These individuals were acting in a "staff capacity" by making recommendations directly to the Council to influence government decisions regarding significant financial policies, standards, and guidelines. They also participated in discussions with the SEC and other governmental agencies. Because the Audit

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[3] See Corn Advice Letter, No. I-90-434.

Committee's duties were broad and unlimited, disclosure of their financial interests is warranted. Accordingly, we recommend that the Audit Committee members file disclosures to the broadest disclosure level for a staff member under the Mayor's code.

2. Willkie, Farr & Gallagher LLP.

Willkie Farr's retention was considered integral to performance of the Audit Committee's duties. In its May 6, 2005 status report, Kroll advised the City that: "the completion of the Audit Committee's work is contingent upon our ability to retain outside independent legal counsel." Willkie Farr's contract had a potentially broad scope, stating that it would provide assistance to the Audit Committee in connection with its investigation into SDCERS finances and disclosures, and other matters that, in the Audit Committee's judgment, may require inquiry or investigation. Although the contract with Willkie Farr was not directly with the City, the former City Manager signed the contract acknowledging the City's obligation to pay the fees and agreeing to indemnify Willkie Farr, if necessary.

It is clear that the firm played an ongoing and substantial role in the Audit Committee's work. The firm's name appears on the cover of the Audit Committee's Report. To the extent that individuals prepared the Kroll report and participated in making recommendations related to the City's policies, procedures, and guidelines, they would be considered to have acted in a "staff capacity." As noted in the Kroll section above, a consultant participates in a decision, even if it is reviewed by several of his superiors, if those superiors rely on the data or analysis prepared by the consultant without checking it independently, if they rely on the professional judgment of the consultant, or if the consultant in some other way actually may influence the final decision. Further, a subconsultant may be a "consultant" if their work is not subject to significant intervening substantive review.[4] We assume that the Audit Committee relied on the analysis and professional judgment of Willkie Farr in preparing the Kroll report.

Even though Willkie Farr was a subconsultant to the Audit Committee, the firm prepared memos to City employees, worked directly with the City Attorney's Office on subpoena compliance procedures, and took part in discussions with other government agencies on behalf of the City. These activities are the type that would usually be performed by City attorneys or officials that are subject to the disclosure requirements. Under the totality of these facts and circumstances, Willkie Farr would be considered a "consultant" of the City. Accordingly, the Willkie Farr principals who worked on the Audit Committee Report should file to the highest disclosure level under the Mayor's code.

3. Vinson & Elkins LLP.

V&E's contract with the City, dated February 18, 2004, states that the firm was retained to "provide legal advice and representation to the City in the SEC and U.S. Attorney inquiry" and, as part of that representation, to "conduct an internal review of City disclosure relating to

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[4] See Gilbert Advice Letter, No. I-88-441.

pension matters" with the scope to be agreed upon separately. Shortly thereafter, the scope was expanded to review the City's disclosure practices from January 1996 through February 2004 and to investigate whether the City failed to meet disclosure obligations concerning its funding of SDCERS.

As stated in V&E's September 16, 2004, report, the firm conducted a six-month investigation in which it did the following:

> [We] conducted interviews with current and former City officials and employees, including the Mayor and many members of the City Council, outside counsel for the City, the City's former outside auditors, SDCERS Trustees and administrators, the SDCERS actuary and a third party actuary with knowledge of SDCERS. We reviewed City disclosure documents, reports and memoranda, and paper and electronic files of present and former City employees, including many thousands of e-mail messages. We also reviewed audio tapes and video tapes of City Council and committee meetings, as well as minutes of SDCERS Board meetings, and other documents SDCERS, its Trustees and staff made available to us. In addition, we have reviewed historical media coverage of the City's relationship to its pension system. **In fashioning proposed enhancements to the City's disclosure and financial reporting controls**, we used as guides, among other things, provisions of the Sarbanes-Oxley Act of 2002 and relevant SEC regulations and pronouncements, while acknowledging that in most instances there exists no legal requirement that these standards be adopted for municipalities. Our findings and recommendations set out below rest on this foundation. [Emphasis added.]

V&E also proposed a draft ordinance amending the Municipal Code, and made other recommendations relating to the City's financial reporting and disclosures. These recommendations were reviewed by the City Manager who wholeheartedly supported the adoption in his report to the City Council dated September 23, 2004. Even though the recommendations were reviewed by the City Manager, the exception for consultants whose opinions are made "without significant intervening substantive review," is narrowly construed. As noted above, a consultant participates in a decision, even if it is reviewed by several of his superiors, if those superiors rely on the data or analysis prepared by the consultant without checking it independently, if they rely on the professional judgment of the consultant, or if the consultant in some other way actually may influence the final decision.

In this case, it appears that V&E's conclusions, recommendations, and professional judgment were relied upon and adopted by the City without significant independent review of their analysis. These factors weigh in favor of key members of the law firm filing SEIs for the years in which they were working on this contract.[5] Accordingly, we recommend that the V&E

[5] The authors of the report are listed as Paul S. Maco and Richard C. Sauer, Vinson & Elkins L.L.P.

principals who conducted the work referenced above file SEI forms and disclose financial interests under the broadest category under the Mayor's code.

CONCLUSION

The intent of the Political Reform Act is to prevent conflicts of interest and ensure transparency in government. In general, such policies require local agencies to designate officials, employees and consultants who participate in making government decisions and require those individuals to file statements of economic interests. Under FPPC regulations, an individual will meet the criteria of a "consultant" required to make certain financial disclosures if the individual "makes a governmental decision" or serves in a "staff capacity." Our office concludes that the principals of Kroll, Willkie Farr & Gallagher and Vinson & Elkins who conducted work for the City fall into the definition of "consultant" under California law and the City's conflict of interest codes and thus must file disclosures. Each of the three firms made reports directly to the decision maker – here, the Mayor and City Council – without significant intervening substantive review.

Key employees of Kroll and Willkie Farr & Gallagher who investigated the City's financial disclosure practices and issued a report recommending remedial measures made their recommendations directly to the City Council without "significant intervening substantive review." The firms prepared and presented a report that required their exercise of judgment and that was designed to influence a governmental decision. The law firm of Vinson & Elkins conducted a smaller scale investigation and also made recommendations related to the City's financial disclosure practices that were adopted without "significant intervening review." Accordingly, we conclude that key individuals of these firms meet the definition of a "consultant" under applicable law and the principals responsible for that work should file statements of economic interest for the years in which they worked for the City. Finally, we conclude that these individuals should report to the broadest level of disclosure under the "consultant" designation in the Mayor's Office conflict of interest code.

Respectfully submitted,

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MJA:jb
cc: Elizabeth Maland, City Clerk
MS-2007-3