THE WALL STREET JOURNAL.
WEDNESDAY, FEBRUARY 24, 2010 - VOL. CCLV NO. 44
★★★★ $2
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Lehman's Ghost Haunts California

By John Carreyrou

SAN MATEO, Calif.—Little more than a year after the worst of the financial panic, Wall Street is bouncing back. But in this county just south of San Francisco, pain from the financial system's near-collapse is still felt every day.

San Mateo, a scenic swath of peninsula between the Pacific Ocean and San Francisco Bay, saw $155 million evaporate when Lehman Brothers went bankrupt in September 2008. On top of deep budget cuts brought on by California's fiscal crisis, the loss on Lehman securities means San Mateo's 735,000 residents are taking a hit.

Peter McCollough for The Wall Street Journal

Jean Holbrook, county school superintendent in San Mateo

Public schools here have laid off dozens of teachers and delayed or canceled renovations. Local community colleges are slashing classes and scrapping new facilities, even as enrollment surges because of the bad economy. The county trimmed its commuter rail service and shelved plans to build a new women's jail to alleviate overcrowding.

The biggest factor behind San Mateo's trouble is California's spending cuts. But its Lehman losses make a bad situation worse. The problem underscores the diverging fortunes of Wall Street and Main Street and helps explain the populist anger still simmering in many parts of the country. Last week, Barclays PLC reported that its 2009 profit more than doubled to $14.7 billion thanks in part to its acquisition of Lehman's North American operations.

Lehman Brothers' collapse is "old news for most of America," says Richard Gordon, a member

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Lehman Brothers' Collapse Haunts a County in California

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of the county's board of supervisors. But in San Mateo County, he says, "It's a continuing story that continues to unfold."

A report by Beacon Economics, commissioned by the county, estimates that the Lehman losses reduced local government spending, especially on construction projects, by $148 million over two years. The consulting firm says this resulted in 1,648 jobs lost or not created. County unemployment now hovers around 9%, double what it was 18 months ago.

Dozens of cities and counties around the country, from Sarasota, Fla., to Boulder, Colo., lost a total of $1.7 billion when Lehman went under, because they held Lehman bonds or other securities. The two worst hit states are Florida and California. Florida public agencies lost a total of more than $400 million, mostly from a state investment pool. California municipalities lost a total of $250 million across some 28 cities and counties.

San Mateo County's loss was the biggest of any municipality. Under state rules, the county government, city governments and area school districts hold their operating funds, reserves and bond proceeds together in an investment pool that lost about 6% of its value when Lehman went under.

The investment pool owned highly rated Lehman bonds and notes, which currently trade around 20 cents on the dollar. Any recovery from the bankruptcy process will take at least another year. A recovery of 20 cents on the dollar would leave the pool with a loss of roughly $125 million.

Much of the anger in San Mateo is directed at the Obama administration and, specifically, at Timothy Geithner, the Treasury secretary. Mr. Geithner has declined to use funds from the government's Troubled Asset Relief Program, or TARP, to bail out municipalities.

"There's too big to fail, and we're too small for them to care," says Mary McMillan, the county's deputy manager.

Before Wall Street's crash in late 2008, San Mateo County was on track to balance its $1.7 billion annual budget within five years. California's cutbacks and the Lehman collapse torpedoed that.

The county government lost $37 million when Lehman Brothers went under. That's on top of a $100 million deficit due in part to state cutbacks. San Mateo County has limited power to increase taxes: Boosting sales taxes requires two-thirds voter approval, and two efforts have failed in recent years.

The schools were hit hard, too. In one typical case, Lehman-related losses at the Sequoia Union High School district, one of 25 in the county, totaled $6.2 million, an amount equivalent to 7% of the district's annual budget. Meanwhile, the state cut its funding to the Sequoia district this school year by $1.9 million and is cutting it again next school year by an additional $3.4 million.

San Mateo ranks among California's most diverse counties. Home to software giant Oracle Corp. and biotechnology pioneer Genentech, it encompasses both wealthy enclaves and working-class, immigrant cities such as Daly City and East Palo Alto that depend heavily on county services. In East Palo Alto, unemployment is 20%.

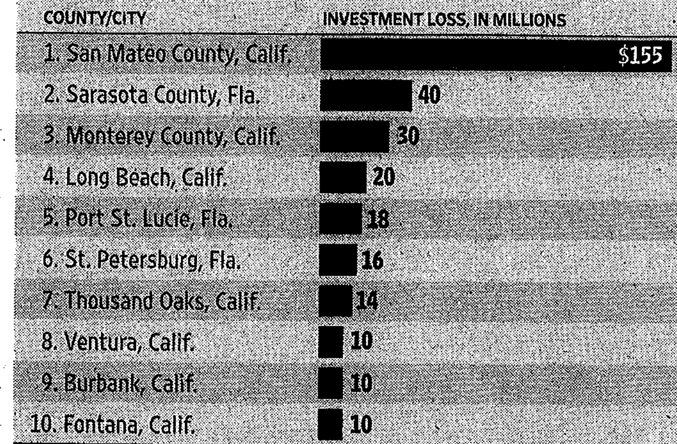
When Lehman Brothers filed for bankruptcy-court protection on Sept. 15, 2008, the news was met with a mix of panic and disbelief by local officials. The county's schools took the worst hit, losing $38 million overnight. Two county school districts, the Sequoia district and the Menlo Park City Elementary School District, had just sold more than $90 million worth of bonds to fund renovations and expansions and deposited the proceeds in the county investment fund. The lost bond proceeds totaled nearly $8 million, a debt local taxpayers will be paying off for the next 30 years.

Jean Holbrook, the county's superintendent of schools, says the Lehman losses came on the heels of deep funding cuts from the state that had already cost the jobs of 91 of the school's 681 employees, including 21 teachers. In the ensuing year, 60 more school employees would have to be let go, resulting in larger class sizes and fewer elective courses.

San Mateo's board of supervisors ordered an independent review of the way the county investment fund was run, but found no wrongdoing. In keeping with rules California passed in the mid-1990s (following Orange County's disastrous experiment with derivatives), San Mateo's treasurer had invested in highly rated securities and put no more than 10% of the fund in any single issuer.

Collateral Damage

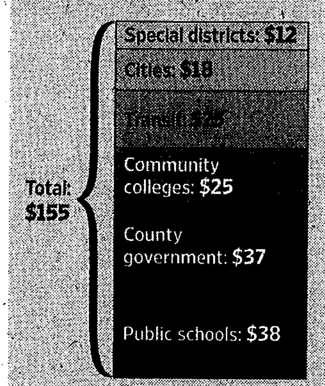
The municipalities the worst hit by Lehman Brothers' collapse, by size of investment loss:



Source: San Mateo County research

Money Breakdown

San Mateo County's losses on Lehman securities, in millions



Source: San Mateo County Treasurer's Office

With Lehman bonds trading at pennies on the dollar, county officials held little hope of recovering their investment through bankruptcy proceedings. So they opted for a two-pronged strategy: They sued former Lehman Brothers executives for fraud, and they lobbied their state congressional representatives to insert language in TARP legislation that would let municipalities tap the federal rescue program.

Though such language was included in the final bill, bailing out municipalities was low on the list of the federal government's priorities in late 2008 as the financial system flirted with collapse.

To rally support and keep the issue alive in Washington, Ms. McMillan, the deputy county manager, began reaching out to other counties and cities ensnared in the Lehman bankruptcy.

In May 2009, as financial institutions began to stabilize and the specter of a depression subsided, the House Committee on Financial Services agreed to hold a hearing on the matter.

In their testimony before the committee, Democratic Reps. Anna Eshoo and Jackie Speier, whose districts span parts of San Mateo County, argued that the $1.7 billion municipalities were asking for amounted to just one-quarter of 1% of TARP funds and paled in comparison with the hundreds of billions of dollars the Treasury Department had provided to banks.

Ron Galatolo, chancellor of San Mateo's community colleges, told the assembled congressmen that he felt it was "highly inequitable to use TARP funding to shore up banks and to bail out failing corporations but fail to protect agencies' taxpayer dollars, such as ours."

After the hearing, Rep. Eshoo sought a meeting with Mr. Geithner, but says the Treasury secretary didn't respond to her letters and phone calls for months.

Rep. Eshoo finally met with him on Oct. 28, followed by a second meeting on Dec. 2. She says Mr. Geithner told her that TARP was intended only for financial institutions and that rescuing municipalities would open a Pandora's box of claims from other investors.

Rep. Eshoo invoked the passage inserted a year earlier in the TARP bill, which refers to "the need to ensure stability for U.S. public instrumentalities, such as counties and cities, that may have suffered significant increased costs or losses in the current market turmoil."

She says Mr. Geithner said the passage fell short of mandating use of TARP funds to bail out municipalities.

While declining to comment on the meetings, a Treasury spokeswoman says: "There are countless well-intentioned ideas for deploying TARP funds, but we determined that making Lehman Brothers' creditors whole is not consistent with what Congress intended for TARP funding."

In San Mateo, reverberations from the Lehman losses were on display on the campus of Cañada College, one of the county's three community colleges, earlier this month. Students held a two-day teach-in to protest faculty layoffs, course cancellations and fees that jumped 30% this year.

Lilliam Castellanos, a 35-year-old student majoring in Latin America studies to become an interpreter, said she could no longer afford textbooks because the funding for a program that handed out book vouchers to Hispanic students had been cut sharply. Other students complained about long wait lists to get into courses and a reduction in the number of counselors.

Mr. Galatolo, the chancellor, says the colleges' $25 million Lehman loss compounded funding cuts made by the state, forcing him to slash the colleges' annual budget by one-fifth, to $100 million from $125 million.

Of the $25 million loss, $20 million had been earmarked for new buildings and classrooms that he says now won't be built. The remaining $5 million came directly out of the colleges' operating fund.

Mr. Galatolo says he's angered by the return of multimillion-dollar bonuses on Wall Street "while we can't make ends meet for our students." As for Mr. Geithner, he says, "He had the ability to help us, and he chose not to."

On the other side of the peninsula, in the wind-swept, rural community of Half Moon Bay, Robert Gaskill, superintendent of the Cabrillo Unified School District, says his district's share of the Lehman loss was $1.4 million, out of an annual budget of $28 million.

Mr. Gaskill says he had to lay off five teachers and projects that 20 more will be let go in the 2010-11 school year, out of 177, because of state funding cuts. The district is also paring back summer school.

Michael Bachicha, former director of the schools' special programs, sat through the school-board meeting at which his job was eliminated in April 2009. Because he had tenure, Mr. Bachicha was able to land another job teaching at the district's "continuation" high school for students who are falling behind. But his salary dropped from $105,000 to $72,000.

'There's too big to fail, and we're too small for them to care,' says the county's deputy manager.

Around the same time, his wife lost her job as a kindergarten teacher at a local private school.

Mr. Gaskill, the district superintendent, says the teaching job that Mr. Bachicha took bumped someone else less senior off the payroll, resulting in one of the five teacher layoffs.

Ms. McMillan, the deputy county manager, hasn't given up on getting the Lehman money back. She holds conference calls every two weeks with officials from other affected counties and cities to plot strategy. On last week's call, 35 people dialed in from across the country.

In the meantime, the county is gearing up to dismiss hundreds of employees this spring, the first time it has had to resort to mass layoffs, according to Mr. Gordon, the member of the board of supervisors.