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Michael Hiltzik GOLDEN STATE
Tobacco Fires Back as Ads Become Sorely Personal
By Michael Hiltzik

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The instinct for self-preservation being a familiar hallmark of all life on Earth, no one should be surprised at the tobacco industry's boundless creativity at shoring up its legal defenses.

Over the years, cigarette executives have denied knowledge of any link between smoking and bad health, concealed documentary evidence of their efforts to make cigarettes more potent, cut backroom deals with politicians to reduce their exposure to lawsuits, threatened to file for bankruptcy to evade court judgments -- the list goes on.

Lately, they've unveiled yet another novel defensive maneuver. Big Tobacco's new stratagem is to attack the anti-smoking advertising campaigns sponsored by various state and national anti-smoking agencies and often funded with money extracted from the industry itself.

The companies' beef, as laid out in a federal lawsuit that R.J. Reynolds Tobacco Holdings Co. and Lorillard Tobacco Co. filed this month against the California Department of Health Services, is that these campaigns have become uncomfortably personal. In the industry's view, they have evolved from straightforward warnings to kids about the health effects of smoking into screeds that depict "tobacco company employees and executives as loathsome persons motivated by cynicism, greed and malevolence," as the lawsuit puts it.

The plaintiffs particularly resent a series of TV commercials in which actors playing tobacco executives are shown falsely testifying that there is no connection between smoking and health, chortling over smoking-related deaths and expressing the need to expand their business by inundating children with marketing pitches.

As R.J. Reynolds executive Daniel W. Donahue grouched in an op-ed article published recently in The Times, the commercials "portray fiction as fact in an effort to sway public opinion." That is as concise a definition as I've ever heard of advertising, a service on which the tobacco industry itself spends about \$8 billion a year, according to the estimates of the anti-smoking lobby. Much of that treasure chest, of course, has employed fiction posing as fact to portray a vigorous smoking habit as the key to social success, sexual allure and just plain coolness.

The Reynolds-Lorillard lawsuit, which asks a federal judge to put a stop to the California campaign, follows other similar shots that Big Tobacco fired across the bow of industry critics. The first target was the American Legacy Foundation, the Washington group whose

"Truth" anti-smoking campaign is funded from the \$206-billion Master settlement Agreement reached between the tobacco industry and 46 states in 1998.

In 2001, Lorillard threw a conniption about a Legacy Foundation radio ad in which a teenage dog-walker called Lorillard's offices and offered the dogs' urine as a cigarette additive. (The industry had experimented with using urea, an ammonia-like chemical, to make nicotine more potent.) The company announced plans to sue Legacy, filed a complaint with the Federal Communications Commission and threatened to withhold a multimillion-dollar payment due under the settlement pact.

Last year Altria Group Inc.'s Philip Morris unit lashed out at the states of Utah and Florida for their own ad campaigns showing the industry wallowing in blood money. (Florida's best-known TV commercial has the tobacco industry winning the Devil's annual award for most lives claimed in a year, outpolling "illicit drugs" and "murder," as admiring fans such as Adolf Hitler stand by.) In both cases, the company sent letters to state officials challenging the ads' veracity, though it hasn't filed suit.

Anti-smoking advocates have watched this trend warily, in part because the demonization of tobacco companies has become the sine qua non in anti-smoking advertising.

For one thing, these ads are effective. Experts have long known that commercials warning that smoking will make you sick tend to go in one ear and out the other. Portraying tobacco executives as venal and unscrupulous, however, apparently works magic at turning smoking into a socially unacceptable habit. California officials credit their ad blitz with helping to give the state the nation's second-lowest smoking rate, after Utah.

These campaigns "basically connect the dots between the activities of real people and their health effect," says the Legacy Foundation's president and chief executive, Cheryl Heaton. What the tobacco companies want to project, she maintains, "is a fantasy world" in which cigarettes "somehow spontaneously appear and spontaneously 45 million Americans smoke them, as if there's no marketing machine or no real corporate motives that precede all of that."

The industry has mustered a raft of arguments as to why the ad campaigns are illegitimate; in California these include the assertion that the anti-industry commercials violate the 1998 ballot measure Proposition 99, which levied a 25-cent surtax per cigarette pack to finance, among other things, "community health education programs."

"The difficulty here is understanding how the vilification ads are a health education program," Donahue told me. "The ads have gradually morphed into direct attacks" on the industry.

Yet the industry's principal fear about these ad campaigns centers on their potential to poison the jury pool by shifting the blame for smoking-related illness from the smokers themselves onto the corporations sitting in the defendants' docks. Given that tobacco manufacturers face about 4,500 pending actions nationwide, this is no small concern.

If the California lawsuit looks like the tobacco industry's most comprehensive attack yet, the reason is that this state is where trial lawyers come to grasp the golden ring. Despite its low smoking rate, California still accounts for as much as one-eighth of the U.S. smoking

population. That's a lot of potential plaintiffs in a state where the generosity of jurors is world-renowned, and where the industry is already appealing \$363 million in verdicts after a string of high-profile courtroom losses.

On the other hand, the companies' contention that the California ads have destroyed their right to a fair and impartial jury falls a little flat in light of the most recent verdict here. In February, a Sacramento jury ruled in favor of Reynolds and Philip Morris and against a longtime smoker with cancer. Reynolds' Donahue, for his part, contends that the outcome of the trial makes his point: At the companies' request, the judge granted them greater latitude in weeding out jurors whose opinions of the industry may have been shaped by bad publicity.

In any event, the threat of huge California verdicts remains robust, which, it bears mentioning here, is a fairly recent development. Aficionados of California history will recall that for the decade between 1988 and 1998, this was a state in which Big Tobacco had a free ride past the courthouse.

The reason was the infamous "napkin deal" worked out at a Sacramento Chinese restaurant in the waning days of the 1987 legislative session. This unholy compact reached by the legislative leadership, insurance lobbyists and business groups barred consumer lawsuits over any product known to be "inherently unsafe," such as alcohol and tobacco. (The bill also mentioned sugar, butter, and castor oil, just for laughs.) The first business day after the bill's passage, the tobacco lobby made thousands of dollars in contributions to the campaign coffers of several important legislators, presumably by sheer coincidence.

The napkin deal was repealed in 1998. The litigation floodgates opened. And now we find ourselves watching as the industry tries to hold back the tide.

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Golden State appears on Mondays and Thursdays. Michael Hiltzik can be reached at golden.state@latimes.com.

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California
Michael Hiltzik GOLDEN STATE
SBC, It's All in the Way You Look at It
By Michael Hiltzik

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For telephone customers of SBC Communications who have suffered through periodic service outages, days-long waits for repair service, abusive sales tactics and other such

peculiarities of our Texas-based local phone utility, two state public utilities commissioners last week issued a report that might come as quite a surprise.

The report praised SBC for generally "good service quality."

Written by PUC President Michael R. Peevey and Commissioner Susan P. Kennedy, this assessment was, to say the least, at odds with an earlier report by a PUC administrative law judge who cited SBC for "significant" and "numerous" service problems that in some respects amounted to a "degradation of service quality" over the last few years.

The Peevey-Kennedy appraisal also followed on the heels of a December PUC ruling to the effect that SBC had opened its local phone monopoly to so much competition that it should be allowed to enter the lucrative long-distance business, even though the company's share of the residential local phone business in its franchise area is 93%. I know of Third World dictators who don't insist on that ratio of the votes for president, even when they're running unopposed.

These are just a couple of indications that our state utility regulators may be preparing to get out of the way as SBC -- and to a lesser extent Verizon, the state's smaller incumbent local phone company -- strive to entrench themselves as dominant providers of telecommunication services in California.

Of course, the regulatory issues are seldom stated so bluntly in PUC proceedings. The topic of the latest bureaucratic cross-fire was ostensibly an oversight system the PUC implemented in the early 1990s, when it anticipated an explosion of competition in communications. The presumption was that fusty old utility principles, such as rate-of-return calculations and quality-of-service standards, would be rendered obsolete by the magic of the open market.

The PUC, therefore, created what it called the "New Regulatory Framework," to be abbreviated as NRF and pronounced "Nerf," which gives a pretty good idea of how much backbone it presents to aggressive revenue-seeking outfits such as SBC. Its main flaw, of course, is that the heaven of immaculate competition never materialized in the phone world. Only months after enactment of the federal Telecommunications Act of 1996, which was supposed to unleash the open market, SBC took over Pacific Telesis and the other "Baby Bells" likewise started gobbling each other up.

Although proponents of deregulation argue that local phone companies now face fierce challenges from wireless networks, independent long-distance companies and cable TV systems, the majority of consumers still get most of their phone service at home via the twisted pair of copper wires controlled by the offspring of Ma Bell. In California, says Denise Mann, a telecommunications expert at the commission's office of ratepayer advocate, "SBC and Verizon still have a physical stranglehold on the way into the house."

As a result, the PUC lately has been considering whether NRF may have been a tiny bit premature.

I should say here that there are plenty of people who think NRF doesn't go far enough. G. Mitchell Wilk, who implemented it during his own term as PUC president, now believes that telecommunications regulation is anachronistic: "We've got tons more competition today than

we did in 1990," he told me. "If anything, NRF should be replaced by general, broad deregulation."

That doesn't seem to be on the table just yet. Instead, we have a deep ideological split on the commission over what sort of regulation is appropriate. Kennedy, who joined the PUC in January, believes the evidence supports SBC's claim that its California phone service is among the best and cheapest in the nation. She also believes it's time the PUC faced up to the reality that its regulated phone companies are no longer protected monopolies and wards of the commission, but profit-making public corporations facing competitors on all sides.

"Every time some of my colleagues talk about the 'shareholders,' they sound like they're talking about Ken Lay," she says. "It's as though all profit is evil and they're trying to rip off the consumers. But the consumers and the shareholders are often the same people."

But that doesn't absolve the commission of holding the company to strict performance standards and preventing it from stifling newcomers to its business, says Loretta Lynch, the former PUC president who is Kennedy's ideological opposite at the agency. "We're consumer protection agency," she says, "and we've been derelict in doing our job."

The Peevey-Kennedy report represents a counterweight to one produced three months ago by Sarah Thomas, a PUC administrative law judge who cast a much more critical eye on the phone companies. In some places the reports demonstrate the phenomenon of how two parties can examine the same set of data and come to dramatically different conclusions.

Half-Full Perspective

SBC, naturally, prefers the Peevey-Kennedy version as "a more comprehensive look at our record," in the words of Lora Watts, president of SBC West. "It shows that service has steadily improved, and definitely improved since the merger. I don't believe the first discussion did that."

Thomas certainly took a different tack. She examined the company's overall behavior, not simply whether it met or exceeded a few technical benchmarks for service quality set by the PUC. She noted, for instance, that since 1995 the company's Pacific Bell unit (which has now assumed the SBC moniker) has been the subject of six formal proceedings alleging serious service problems. These include a 2001 inquiry into telephone marketing abuse that resulted in the largest fine ever levied by the commission.

She also cited several instances in which SBC provided muddled or confusing data to back up its claims of improved service. My favorite is a neat dodge through which the company concealed how many orders for new service sat around unfilled for more than 30 days, which is a figure the PUC requires the company to compile.

Instead of assembling the data as it came in -- in other words, whenever an unfilled order hit the 30-day deadline -- SBC made a bulk count once a month. To see how this could have a gratifying effect on an embarrassing statistic, consider, as Thomas did, what would happen with an order placed, say, on Dec. 29, but not filled until Feb. 14, which is 48 days later. An SBC official testified that unfilled orders were only audited on the 25th of each month. On

Jan. 25, therefore, this order wouldn't be counted because it wasn't yet 30 days overdue. At the next audit, on Feb. 25, it wouldn't be counted because it had already been filled.

By this and other questionable stratagems, SBC was able to report that it had recorded just one overdue order between January 2001 and March 2002.

Thomas quite sensibly ordered the company to start producing data in compliance with the "plain meaning" of the rules. Peevey and Kennedy, while conceding that the measurement was "erroneous," seemed to find it almost amusing, calling it a "unique and strange" system. Watts says the measurement formula was "in no way an attempt to be disingenuous and was not an attempt to try to hide anything," but added that SBC will "look at" altering the process.

"We're committed to providing outstanding customer service," Watts told me. "That's the number one goal of our corporation."

But SBC's behavior sometimes undermines such assurances. In the era of the Ma Bell monopoly, which we are all supposed to abominate today, AT&T strived to meet what it called the "five nines" standard of service: The network was expected to be 99.999% reliable. (AT&T engineers sometimes talked about a goal of less than one day of outage over 40 years.)

Profit Up, Service Down

I don't know whether 99.999% plays a role in SBC's corporate goals, unless it signifies the return on investment the company hopes to achieve by laying off more employees. What we tend to hear from SBC is predictions of service cutbacks, declining reliability, fewer staff, all thanks to the idiocy of outfits like the California PUC that refuse to deregulate faster in ways the company finds acceptable.

Consider how the company carried on in announcing layoffs of 11,000 employees, including 3,000 in California, in September. Many of them were "highly trained workers," SBC announced. Watts herself was quoted as saying "we will try to maintain our customer service levels," in terms that suggested she wasn't wholly sanguine about the prospects. (Now she says the company merely laid off workers who were no longer fully occupied because of changes in the business.)

Chief Executive Ed Whitacre, meanwhile, grouched about the impact of "unrealistic and outmoded regulation on SBC's results," although a few months later the company announced it had earned a profit of \$7.5 billion in 2002, up from \$7.2 billion the year before.

SBC, moreover, is famous for aggressively defending its turf. If the California PUC is curious about how the company reacts when it doesn't cotton to the regulatory playing field, it should examine recent events in Illinois. There, unhappy at the state commerce commission's refusal to see things its way and threatening massive layoffs, the company mustered armies of lobbyists and credulous labor unionists to coerce the state legislature and governor into taking a critical category of oversight out of the regulators' hands and awarding it even more of a stranglehold on the local phone business. (The law was stayed last week by a federal judge, who condemned it as "a clear usurpation of authority.")

Can California resist such pressure? Long-term observers of the PUC say the current ideological disagreements among the five commissioners are as nasty and personal as any they've ever seen. That's odd, since all five members are Democrats appointed by Gov. Gray Davis.

When I mentioned this recently to a PUC staff member, he recalled the old adage about how when a group of Democrats are asked to form a firing squad, they assemble themselves into a circle. But companies as savvy as SBC know how to exploit such discord, which means that the people standing in the middle of the circle may well be its customers.

Golden State appears every Monday and Thursday. Michael Hiltzik can be reached at golden.state@latimes.com.

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Michael Hiltzik / GOLDEN STATE
Stock Picker, 20, a Genius? Perhaps in His Own Eyes
By Michael Hiltzik

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The more I talk to Chris Lahiji, the more I keep coming around to the following question: Is he a danger only to himself, or to other people as well?

The question comes up because Lahiji, a 20-year-old student at Santa Monica College who recently won himself some national publicity as a youthful stock market enthusiast, has begun to tout shares in a tiny, broken-down mutual fund that has offered him a job apparently on condition that he bring along some new investment money.

As Lahiji wrote on his Web site last week, anticipating his appointment as the fund's manager: "I do not know how long it will take before we become the talk of the national media."

At least he's modest.

Lahiji claims already to have attracted more than \$1.5 million in pledged investments for his prospective employer, the Frontier Equity fund, from among followers of his investment Web site, although at least \$800,000 of that appears to have been pledged by residents of

some of the 40 states from which the fund is not legally permitted to accept money at this time. He says he's ready to invest all of his own money and most of his parents' \$50,000 retirement account in the fund.

"Is that wise?" I asked him last week.

"No," he replied airily. "It's stupid. But this is about putting my money where my mouth is."

Lahiji, obviously, has a rather elevated opinion of himself, which must resonate among investors seeking answers for the dismal markets of recent years. These being credulous times, I have no doubt that this column -- which will examine Lahiji's record skeptically, as may already be clear -- will generate numerous calls and letters from prospective investors asking how they, too, can join the bandwagon.

I dropped in to see Lahiji last week largely at his own request. He had peppered the Los Angeles Times with a series of e-mails expressing irritation that his hometown newspaper had ignored his growing fame, which was rooted in brief appearances on investment talk shows on radio and CNN and PBS.

"It is disappointing to me that my own newspaper has yet to acknowledge my presence in the financial world," he wrote.

An engaging, if hyperactive, young man, Lahiji greeted me at his parents' Santa Monica home in jeans and bare feet and escorted me to an upstairs bedroom equipped with a laptop on a wireless network. Then he began telling me his life story, which started with him getting his own father into a money-losing investment in Fila at the age of 10, and includes years spent in monastic isolation poring over the arcana of company annual reports.

To him this bespeaks a quest to be recognized as an investment virtuoso by people who dismiss him merely because of his age; he seemed preoccupied with the goal of being named the "youngest mutual fund manager in history."

To me, Lahiji's modest renown is more a story of nitwits in the business press blithely buying into a publicity stunt, and of investors so demoralized by the lying and cheating of established Wall Street firms that they'll clutch at straws, as long as they come from an unconventional source, the way voters gravitate toward politicians who run for office as Washington outsiders.

There's no point denying that Lahiji has demonstrated a certain stock-picking talent. Some of his selections have racked up impressive short-term gains, occasionally by being acquired by

established companies, and he's smart enough to know that the best potential lies in stocks that aren't widely followed.

No one who knows him faults the sheer energy he devotes to the study of individual companies. "He eats this stuff for breakfast, lunch and dinner," says Mark Keeley, manager of the Keeley Small Cap Value Fund. Keeley says he generally finds Lahiji's analyses to be incisive and direct, but he's also uneasy at Lahiji's inexperience and his determination to win public acclaim while still wet behind the ears. "I've told him this is not a race," he says. "I've tried to impress upon him that this is a great business and you can have a lot of longevity, if you do things the right way."

Lahiji first came to public notice by claiming to have read through more than 12,000 corporate annual reports as a means of ferreting out small companies that had been overlooked by Wall Street's herd mentality.

During the spring, this claim was aired in short items in Barron's and Business Week. These were harmless enough, but then came radio and, especially, television, with its tendency to take everyone at his or her own level of self-esteem.

Geoff Colvin of the PBS show "Wall Street Week" asked Lahiji for his stock picks and let him yammer on about his desire to "become the next big name in Wall Street." Typically, radio and TV interviewers absorbed Lahiji's claims of stock-picking prowess at face value, which drove visitors to his Web site and its centerpiece, the "Lahiji Tiny Fund." Lahiji says this would-be portfolio of 150 micro-cap stocks (that is, market capitalizations generally lower than \$50 million each) has racked up a return of more than 100% since its "inception" in November. But that's manifestly misleading.

For one thing, since the "fund" hasn't actually made any purchases or sales, the stated return doesn't account for the expenses inherent in any real-world investment, such as brokerage commissions and taxes. It doesn't factor in the extent to which any sizable trade in these light-volume stocks would move the market, making it harder to buy significant shares at the lowest price. Nor does it account for the difficulty of selling at a fair price if the fund needed to dump shares quickly. But then Lahiji hasn't dropped any stocks from the fund, so its record doesn't say anything about whether he knows when to sell, along with when to buy. It's also worth noting that the fund is concentrated in one of the most volatile sectors of the stock market, and one which happens to be enjoying a huge vogue at the moment. But such vogues never last, whether they involve micro-caps or blue chips.

Had the Lahiji story ended with his imaginary fund and a few

Internet followers, there wouldn't be much more to say. But at some point earlier this year, Lahiji and the Frontier Equity Fund found each another.

Up to now, Wisconsin-based Frontier Equity has been a laughingstock of the market -- the worst-performing mutual fund in the country. Year to date it has lost 42%, and that follows losses in the previous three years of 54%, 30% and 51%. When its rather distracted founder and manager died earlier this year, the fund and its license were acquired by an investment partnership owned by Joel Blumenschein, a Milwaukee-area broker. By then it had only about \$50,000 in assets left, and \$40,000 in annual expenses. According to its prospectus, it also carries a front-end sales charge, or "load," of 8%, which is egregious for any mutual fund, let alone the worst fund in the market.

Blumenschein says he sees nothing wrong in giving the untested Lahiji a chance at managing money under professional supervision. He paints the relationship with Lahiji as a win-win. "Chris said he'd like the people following his site to have a vehicle to invest in," he told me. "I said what we need are assets."

He acknowledges that he has never met Lahiji face to face, and there are signs that he's not fully aware of the downside of employing someone with such inexperience.

When I asked Blumenschein whether Frontier Equity would be an appropriate investment for a retired couple with \$50,000, he replied that it would, as long as they didn't invest more than 10% of that sum. When I asked if he was aware that Lahiji was planning to invest almost all his parents' money, he paused pregnantly.

"I may have to talk to him about that," he said.

Meanwhile, Lahiji has been telling prospective investors that Blumenschein will waive the 8% fee, but it's unclear whether he's authorized to make that commitment, since he is not yet an employee of Frontier Equity, or whether Blumenschein has even made it in writing. (Blumenschein didn't return the call I made to nail down the issue.)

What makes Lahiji's story disquieting is not his brashness. It's the reluctance of people in and around the stock market to learn the lessons of history.

Lahiji's followers in the press and elsewhere seem oblivious to the ruthlessness of market cycles, which make demigods of stock pickers whose approach happens to coincide with prevailing conditions, and dupes of those who overstay their welcome. Joe

Granville, Elaine Garzarelli, Bob Prechter and countless others all got famous for the brief periods in which their analytical principles matched the market's own mind-set, and they all ended up reviled and ridiculed after the fundamental investing principles they claimed to have unearthed on their clients' behalf turned out not to be so fundamental after all.

Few of these people, if any, displayed more circumspection than Lahiji about their God-given analytical gifts. It took time and events to puncture their self-delusions. At the ripe old age of 20, Chris Lahiji seems to think he's immune to the same fate. But a wealth of experience still lies before him.

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California

Michael Hiltzik / GOLDEN STATE

It Doesn't Take a Genius -- or a Recall Candidate -- to See the Flaws in Prop.

13

By Michael Hiltzik

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When Certified Geniuses speak out on matters of public policy, they usually put their finger on some otherwise overlooked truth. When the subject at hand is outside their core expertise, they sometimes still hit on a truth, just not the one they thought.

So it was when billionaire Warren Buffett opined last week that there was something wrong with Proposition 13. Buffett focused on the inequity between the property tax on his home in Omaha, which is worth \$500,000, and the (much lower) tax on his home in Laguna Beach, which is worth \$4 million.

The moment I read his words, the inequity struck me too. Except I started thinking about the inequity between the tax on Buffett's California property and the tax on my California property. (I won't go into details, beyond acknowledging that my house is worth less

than his, while I pay nearly three times his \$2,264 a year.)

This is to say that one of the more troublesome flaws to emerge since the enactment of the property tax rollback in 1978 is not that Californians pay less in property levies than homeowners in other states. It's that over the last 25 years, the law has built in such a massive exemption for those who have held on to their property that the discrepancies among neighbors can be unconscionable. Buffett gets a break because he bought his home for \$150,000 in 1971. But the guy who recently spent \$5.6 million for the house down the street will pay more than \$56,000 a year in taxes, or about 2,373% more than Buffett.

Yet no cow is more sacred to our politicians than Proposition 13. Buffett's slightly misaimed criticism sent squadrons of gubernatorial candidates haring off to proclaim their lifelong devotion to the measure, the way presidential candidates pay ritual obeisance to Social Security every four years.

Arnold Schwarzenegger, Buffett's sponsor, came first, repudiating his own chief economic advisor's very first nugget of economic advice. "My position is rock solid in support of that initiative," he stated the same day.

When I later raised the subject with Peter Ueberroth, who is trying to position himself as the thinking man's recall candidate, he bailed out too.

"The state falls off into the Pacific if you begin to mess with that issue," he said, picturesquely.

Ueberroth and Schwarzenegger are only bowing to political reality. "Proposition 13 is a political article of faith for many Californians, perhaps the majority," says Phil Isenberg, a former Democratic state assemblyman who is now a Sacramento lobbyist. "Articles of faith are not easily subjected to examination."

But has there ever been so undeserving an object of reverence?

Any local politician in California can probably cite chapter and verse about the damage Proposition 13 has done to our tax structure, decision-making process and educational system. Many homeowners contemplating the Prop. 13-driven unfairness in the tax rolls in their housing tracts and its role in the disappearance of art teachers and music programs from their schools would probably see the light.

These effects were wholly predictable. But two conditions driving the tax-cutting fervor of 1978 overwhelmed such long-term

considerations. One was that the tremendous run-up in property values across California in previous years had produced a run-up in the property tax levied on many homeowners.

"There was true fear, mostly of the elderly, that they were being driven out of their homes because of the inflation in value," says Isenberg, who was then mayor of Sacramento. Every day another horror story about people losing their homes appeared in the press. (Schwarzenegger trotted out a new one Wednesday, recalling how an old lady he once knew broke down in tears when the initiative's passage saved her from penury.)

This was compounded by rage over what was invariably described as the state's "obscene surplus." Invited to register their feelings at the polls, voters overwhelmingly chose to hack at the state's budget surplus by slashing revenues to, well, local government.

By rolling back property tax rates across California to 1% of assessed valuation, limiting routine assessment increases to 2% a year and forbidding full reassessments except upon sale of a property, Proposition 13 at one stroke cut revenues for local governments by half. That first year, Sacramento stepped in to cover the shortfalls by fronting them some of the obscene surplus. While the surplus didn't last, the so-called bailout became a budgetary fixture.

Thus the biggest irony of Prop. 13 -- which nobody noticed at the time because it didn't fit into Howard Jarvis' crusty sound bites -- was that its backers had exploited one of the supposed glories of California's progressive era, the voter initiative, to undo another progressive milestone, the wresting of local government finances from centralized state control.

This has had several lasting drawbacks. It has transferred virtually all major decision-making on schools to the state, which now controls two-thirds of total education funding (up from one-third before Prop. 13). Anyone who has watched a school board wrestle with state educational mandates or with state funding cutbacks knows what that means.

Perhaps most damaging, it has placed the state's overall budget at the mercy of the sales tax, which hits poor people disproportionately hard, and income tax, which is the most unpredictable and volatile revenue source. Here is the very root of the current budget disaster: It's impossible to exercise fiscal restraint when you're hooked on a revenue source that, as my colleague Jim Flanigan has pointed out, rises and ebbs unpredictably.

For all these reasons, Prop. 13 exemplifies the flaws in the

participant democracy of which we are so proud. Every few years, Californians decide to get mad as hell and enact an initiative or constitutional amendment that addresses an immediate social concern with an absurdly overwrought and lobotomized solution. Then we spend decades dealing with the unintended consequences.

Thus the 1990 term-limits initiative, largely aimed at then-Assembly Speaker Willie Brown, bequeathed us a state legislature full of junior Willie Browns who are just as venal and arrogant as the original, but not as smart, and who would be overmatched by the task of designating a state bird, much less unraveling energy deregulation or passing a budget. The three-strikes initiative of November 1994, which has filled our prisons with pizza thieves on life sentences, arose from an anti-crime hysteria stoked by "tough-on-crime" hacks such as then-Gov. Pete Wilson. (He who has risen from the dead as co-chairman of the Schwarzenegger campaign.)

There are solutions to the Prop. 13 gallows, awaiting only a "leader" to place them on the table. One hardy perennial is the "split roll," through which commercial property such as office buildings and shopping malls would be periodically reassessed so that they shoulder a proportionately larger share of total taxes. Proponents such as Lt. Gov. Cruz Bustamante consider this politically feasible because there are fewer office building owners than homeowners, and they can't move their buildings out of state as a tax protest.

Others note that rebalancing Prop. 13 doesn't necessitate raising overall taxes, and that you can protect the elderly or poor by allowing them to defer paying higher taxes until they sell their homes, at which point the arrears would be paid out of the proceeds.

But Californians aren't ready to give up on Prop. 13. People think their high property values are partially the fruit of their low taxes, and if they hamstring state government to preserve their paper net worth, that's a mortgage they can live with.

"It may be," says Isenberg, "that only a true fiscal disaster will make voters understand." But how far are we from that?

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Safeway's Merger Loss Eclipses Labor Woes
By Michael Hiltzik

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Type of Material: Column

No one could accuse Steven A. Burd, the chairman and chief executive of Safeway Inc., of shrinking from his role of chief spear carrier for the supermarket companies in their battle with unionized workers in Southern California.

Burd has been a most articulate spokesman for the notion that rising labor costs represent a mortal threat to the industry's profitability. He has backed up that position with hardball negotiations at Vons and other Safeway chains in the U.S. and Canada, sometimes even following through on a threat to shut stores if their unions don't fall into line.

During a recent conference call with a clique of Wall Street analysts, he characterized the employers' attempt to hold down labor costs as "an investment in our future" and predicted that lost sales during the present work stoppage would prove to be "infinitesimal, compared to the cost of not doing this." Capitulating on this contract, he said, could cost Safeway as much as \$130 million over its three-year term.

Burd's math inspired me to do some arithmetic of my own. Assuming his figure is right (and I have no reason to doubt it), I calculated that by these terms it would take the company's local unionized workforce the better part of three decades to do as much damage to Safeway's bottom line as Burd did with a single merger deal in 1998.

I am speaking of Safeway's notorious acquisition of the 113-store Dominick's supermarket chain in Chicago. Dominick's was a modestly upscale grocery when Safeway bought it from Yucaipa Cos., a Los Angeles company run by grocery magnate Ron Burkle, for \$1.8 billion in cash and assumed debt.

For Yucaipa, which had purchased the chain three years earlier for \$693 million, this deal was a windfall. Under its management, sales had grown steadily, although they were flattening out a bit in 1997-98, just before Safeway took over. From that point on, as Safeway later disclosed, business at Dominick's headed straight down.

By the time it placed the chain up for sale last November, Safeway was valuing Dominick's on its own books at about \$315 million. That suggests the company squandered more than \$1 billion of its

shareholders' money on this deal. Compared with that sum, the \$130 million that Burd is trying to shave from the local union contract may not exactly be "infinitesimal." But it is, well, way smaller.

I don't wish to suggest by this that the supermarkets give the union everything it wants to settle the current conflict. As I have written before, both sides will probably have to give in on some cherished principles to reach a fair result.

Nor is Safeway the only employer involved. Albertsons Inc. and Kroger Co.'s Ralphs chain are also participating, and both have taken a hard line against their unions here and elsewhere. All three complain that their markets have been invaded by warehouse stores, nonunion groceries and the penny pincher Wal-Mart, and there's no point in denying that these competitors represent a genuine threat.

But there's always more than one way to address a business challenge, and some managements handle them better than others.

That brings us back to Dominick's. Some analysts believe that Burd's first mistake was overpaying. Safeway maintains that it paid a fair market multiple. But by the reckoning of Andrew Wolf, an industry analyst at BB&T Capital Markets in Richmond, Va., who has been a Safeway skeptic, the price came to more than \$16 million per store -- compared with the \$11.3 million per store Safeway paid for Vons in 1997.

That price, Wolf surmises, may have pushed Burd to recover costs quickly by cutting staff and replacing familiar local brands with Safeway house brands. "They took labor out of the stores and put their private-label products in because they get a few more cents' margin from those," Wolf says. "Do that too fast, and it's not going to work."

While shoppers abandoned Dominick's, Safeway's financial reports, which don't normally break out individual chain results, spoke of sunny companywide sales gains, same-store improvements, rising overall profit. But in May 2002, an accounting change forced Safeway to disclose that it had reduced its estimate of Dominick's book value by \$589 million since the acquisition.

Six months later, Safeway dropped the other shoe, disclosing that same-store sales and operating profit at Dominick's had been falling steadily for almost as long as Safeway had been in charge. Burd said he would sell the chain unless its workers accepted a pay cut to match the scale at the chain's biggest local competitor.

Safeway wrote down the chain by an additional \$788 million, reducing its value to \$315 million, and solicited purchase offers.

One of these came from Ron Burkle, whose Yucaipa Cos. offered about \$350 million to take the limping business off Burd's hands.

(Safeway rejected Yucaipa's bid as inadequate, leading to a lawsuit in which Yucaipa contends that Safeway never intended to take its bid seriously because it would be too embarrassed to return the chain to the original owner at a huge loss.)

Throughout most of this period, by the way, the same Wall Street analysts who now clamor for a lid on Safeway's labor costs gave Burd the benefit of the doubt. With the exception of a few analysts like Wolf, who downgraded Safeway in 2001, most have continued to rate it a buy. This may be a holdover from 1999-2000, when the company's stock doubled to a peak of \$62.50. But from there they have ridden the stock down to the current price of about \$22.

It's curious how few of these analysts treat the Dominick's debacle as a blot on Burd's management, especially because at least two other Safeway acquisitions -- Texas-based Randall's Food Markets and Genuardi's Family Markets in the Philadelphia area -- have similarly failed to thrive under its ownership. To be fair, Safeway notes that two other major acquisitions have been quite successful (Vons and Carrs, an Alaska chain) and says the strategic missteps at Randall's and Genuardi's are being worked out.

Still, while Safeway pleads that the poor economy and changes in the supermarket business are the culprits for the profit crunch, Burd is starting to look like the guy who's been through a few ugly divorces: The point comes when you have to wonder whether maybe he's the problem. At a recent round table sponsored by a trade journal, the moderator asked whether it was time for Burd to "step aside." (The consensus was that he still deserves a chance to turn things around in an upbeat economic environment.)

One possible trouble spot is Burd's scorched-earth approach to labor relations, which often boils down to his threatening store closures if he doesn't win. On occasion, this negotiating ploy has worked, although its obvious limitation is that Safeway might eventually run out of stores to close.

But there are signs that it is hampering Safeway's attempt to unload Dominick's. A pending deal with an unidentified buyer reputed to be a Minneapolis grocery chain depends on the union's cooperation, but talks have broken down. Rumors are circulating that Safeway may be planning to keep Dominick's after all, although that would mean dealing again with a highly suspicious union.

If that happens, what would Safeway have gained by treating labor so truculently? Dominick's enjoyed labor peace for years before its

acquisition by Safeway; just before the merger, it even stated publicly that it had "never experienced a work stoppage and considers its relations with its employees to be good."

After five years of Safeway management, that idyllic world was a distant memory. Is this really the only way to get costs under control?

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Michael Hiltzik GOLDEN STATE
City Putting a Pound in the Way of Progress
By Michael Hiltzik

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Type of Material: Column

The question raised by Francisco Pinedo's plans to turn a few square blocks of South-Central L.A. into the leading furniture design mart on the West Coast is this: Can the city of Los Angeles get out of its own way?

Pinedo, 40, is already responsible for one of the more striking real estate transformations the downtrodden community has ever seen. This is the conversion of four derelict brick warehouses and factories on South Western Avenue into the L.A. Design Center, an architectural landmark he opened last December to provide 80,000 square feet of showroom space for his company, Cisco Bros. Corp., and a few other custom furniture makers.

The \$3-million project, the financing for which Pinedo arranged himself, has been such a success in attracting tenants, buyers and attention that he soon began drafting a grander plan -- to nearly triple its size, in part by acquiring an adjoining 80,000-square-foot parcel to the south. The idea was to bring more of the hundreds of small furniture shops in the community together into a critical mass, one-stop shopping for decorators looking for original wares, and to allow South-Central to escape its stereotype as a hub of nothing but despair.

That's when he discovered that municipal officials had a different plan for the property: They want to use the site for a dog pound.

Now, Pinedo has nothing against animal shelters per se. The proposed South-Central facility, a \$10.5-million project that would include 270 kennels, would help combat the community's genuine problem with stray dogs.

But Pinedo argues, sensibly, that if the pound goes in, the prospects for the most ambitious commercial-industrial project in South-Central go out. There would be no room for the expansion he envisions, and no chance to mark the district as a source of creative excitement.

"My argument is that you can put an animal shelter anywhere else in this community," Pinedo says. "But what are the chances to build a concentration of industry -- to grow an industry -- in this community?"

To Pinedo this is far from an abstract question. After emigrating from Mexico with his family at the age of 13, he grew up in South-Central, a few blocks east of the Design Center. When an accident left his father unable to continue working as a laborer, Pinedo quit school and found a job in an upholstery shop, eventually parlaying his experience into the local management of a national furniture company, and then into his own firm, seeded with \$10,000 of savings in 1990.

To dodge competition from mass-produced furniture built overseas, Cisco Bros. serves an elite market of decorators and custom retailers. In the seven years since Pinedo moved his factory from Vernon to downtown L.A., around the corner from the Design Center, annual revenue has grown to nearly \$20 million and the workforce has expanded from 50 to more than 200. Most of these skilled workers earn \$12 to \$15 an hour.

Pinedo estimates that Los Angeles firms account for 30% of the country's custom furniture business. Except for the Pacific Design Center in West Hollywood -- a showroom for more traditional manufacturers -- these makers lacked a place in Southern California to display their handiwork.

The L.A. Design Center was conceived as the kernel that would start changing that. With its loft-like showrooms, a modern art gallery and a sunny courtyard that serves as a parking lot by day and a venue for community events by night, it began to attract visitors from all over the country, while hinting at a bigger rehabilitation to come.

"This is what I'd call a catalytic development," says Renata Simril, who worked with Pinedo as an official of the nonprofit group Genesis L.A. before landing an appointment as deputy mayor for economic development last month. "South L.A. deserves this kind of high-quality design that brings in a different quality of clientele. Cisco is really changing the idea of what's possible."

The city says it wasn't aware of Pinedo's intentions for expansion until he actually sought to buy the adjoining parcel. By that time, officials point out, planning for the pound was well underway, and the property was already subject to an eminent domain proceeding.

This is a fair enough defense, as far as it goes. But is it unreasonable to think that the city, whose search for a suitable location for the animal shelter consumed more than a year, might have considered the pound's

effect on the neighbors? Did anyone notice an architecturally sophisticated \$3-million renovation project going up next door to the chosen site?

The City Council voted to start the condemnation process in September 2002, when construction work on the Design Center had been going on for more than seven months. The decision "may not have been as thoughtful as it should have been," concedes Councilman Bernard Parks, who represents the neighborhood.

Alternatively, once Pinedo's design center started generating community buzz, why didn't anyone from City Hall stop by and say something along the lines of: "Cisco, this is a spectacular and courageous development you've undertaken in the heart of South-Central. Is there anything we can do for you?"

It is on this latter point that Pinedo really faults the city. "It's hard for them to believe someone's doing this with no agenda in mind," he told me last week. "They expected me to ask them for tax incentives. You can tell they're very suspicious."

Indeed, the city's policy for economic development in South-Central sounds like something deprived of oxygen at a very young age. Parks, who only assumed his council seat this spring, writes on his Web site of persuading the fast-food chains inundating the neighborhood to build warehouses and the like along with their cheesy restaurants. I suppose no community can ever have enough warehouses, but that's not much of a master plan.

People who have dealt with economic issues in South-Central say such pedestrian thinking is widespread. Part of the problem may be

redevelopment fatigue: City leaders have heard so many grandiose ideas for the community from developers who failed to get them off the ground that they instinctively tune out most new pitches that come along.

The very uniqueness of Pinedo's plan initially fed their mistrust. "People had a hard time getting their heads around it," says Simril. "They found it hard to take at face value that here was a business owner, facing all the problems of workers' compensation and everything else, who wasn't picking up and moving to Arizona, but trying to build something in South L.A."

In the months since Pinedo's plans first collided with the animal shelter project, some progress has been made at City Hall. "Everyone's finally come to grips with the idea" that an expansion of the design center should be favored over a dog pound at that location, Parks told me. Most of the agencies with a hand in the issue -- from the community redevelopment agency to City Atty. Rocky Delgado's office, which is managing the condemnation process -- say they're searching for ways to turn the situation into a "win-win," say by finding an alternate site for the shelter.

Yet they also talk about how the dog pound project is continuing as planned "at this stage," as though they're trying to corral a runaway train. Because the city is set to acquire the site as of Dec. 31, and it's illegal to condemn property for one purpose and subsequently devote it to another, the City Council must take some direct action before the end of the year to forestall the process.

"The city is very far along in the proceedings for the animal shelter," warns Assistant City Atty. Cecilia Estolano, who has presented officials with an analysis of their legal options and is awaiting the council's instructions.

If all this sounds as though finding a way to assist an innovative project in South-Central has paralyzed the municipal government, that's not surprising. One source of Pinedo's frustration is the disrespect he believes his community receives from City Hall. Certainly, one imagines that if the same problem arose on the Westside or in parts of the Valley, there wouldn't be so much dithering over the legal issues because powerful interests would send out the order, in Winston Churchill's words, for "action this day."

South-Central is out of that loop. "Business only happens among people who know the system," Pinedo says. "There's a whole network of people out there, but no one's reaching out to the guy making furniture on 60th Street."

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Michael Hiltzik / GOLDEN STATE
Lockyer Not Above a Little Legal Aid
By Michael Hiltzik

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California Atty. Gen. Bill Lockyer's warning to Gray Davis this summer to avoid what he labeled "puke politics" struck a memorable blow on behalf of integrity in public discourse. One can only wonder if Lockyer has as sensitive an eye for what might be termed "puke businesses."

The thought arises because of Lockyer's relationship with an outfit called Pre-Paid Legal Services Inc. As its name implies, this Oklahoma company markets insurance-like plans that supposedly grant subscribers access, for a monthly fee as low as \$16, to first-class legal representation on a wide range of civil and criminal matters. In the words of an animated come-on posted on the company Web site: "You'll be able to say, 'I'm going to talk to my lawyer about this' -- and mean it!"

Lockyer made a public appearance at a huge rally the company staged Nov. 8 at the Long Beach Convention Center, where -- depending on whom you ask -- he either extolled its goal of bringing reasonably priced legal services to the masses and hung around for a couple of hours (according to Pre-Paid officials) or delivered a routine "stump speech" and quickly departed (according to his staff).

What isn't disputable is that in the week following this appearance, Lockyer's campaign chest was fattened by a total of \$20,000 from several Pre-Paid executives, including founder and Chief Executive Harland Stonecipher. Ex-football star Fran Tarkenton, who was formerly a Pre-Paid board member and still maintains business ties with the company, chipped in an additional \$5,000.

Lockyer's spokesman says the attorney general was invited to the Long Beach event by former Oklahoma Atty. Gen. Mike Turpin, an old friend who is now a lawyer on Pre-Paid's roster. The spokesman also observed that Lockyer already had raised \$10 million for the 2006 election, as though to suggest that the \$25,000 from the folks at

Pre-Paid is a mere bagatelle. (Lockyer is expected to run for governor.)

Yet clearly, the A.G. should be asking himself if Turpin has hooked him up with the kind of company that, as California's chief consumer protection officer, he might more wisely keep at arm's length. For a clue, I would suggest that he check out the "legal proceedings" section of Pre-Paid's most recent annual report.

There, the company discloses that as of the end of last year, it was facing 28 customer lawsuits involving 298 plaintiffs in Alabama alleging fraud and other offenses; 14 lawsuits involving 428 plaintiffs in Mississippi; and a lawsuit by former sales representatives seeking class-action certification in Oklahoma. These suits seek hundreds of millions of dollars in damages.

Earlier this year, Pre-Paid received a subpoena from federal prosecutors in Manhattan, seeking information about New York Stock Exchange trading in its stock, apparently by one of its top officers, just before its announcement of disappointing results for the fourth quarter of 2002. The Securities and Exchange Commission said it was opening an inquiry on the same subject.

It's never a good sign for a company when the "legal proceedings" section of its annual report makes for such absorbing reading. When I asked Lockyer's office whether he was aware of this information before attending the company's rally and accepting its cash, I was thanked and told: "He is now." But they didn't say if he'll return the money.

For its part, Pre-Paid says that Stonecipher was traveling and unavailable, and thus couldn't reply to my questions about its business or relationship with Lockyer. In its annual report, the company says it will "vigorously defend its interests" in the lawsuits.

Perhaps the most interesting thing about Pre-Paid is that the company doesn't merely sell legal plans; it also peddles "business opportunities." Pre-Paid is a multilevel marketing enterprise: After you sign on as a company sales agent, or "associate" (by paying a fee), you're supposed to earn commissions not only on the legal plans you sell to customers, but on the plans sold by other salesmen that you recruit into your own network. The company's latest annual report discloses that commissions on new policies get divvied up among an average of 18 salespersons.

The Oklahoma lawsuit brought by former associates alleges that Pre-Paid has systematically overstated the popularity of its legal plans -- and, in turn, the sales force's potential commissions. The

complaint further suggests that the company's promotional efforts are aimed more at recruiting salespersons (who usually must buy a legal plan to receive commissions on those sold to others) than acquiring customers.

Among other things, the company encourages recruits to enroll in its company's "Fast Start to Success" program, a sort of motivational training session, by paying graduates of the program an enhanced commission rate. Signing up for "Fast Start" costs as much as an additional \$149, from which CEO Stonecipher was paid a \$10 bonus per enrollee from 1999 through 2001, to the tune of \$2.8 million.

The core question about Pre-Paid is whether what it sells is worth buying. The company compares its products to health insurance policies, but only about one-third of its monthly membership fees go to actually providing services. By comparison, even bad HMOs typically spend more than 85% of their revenue on medical care.

One way Pre-Paid keeps its expenses down is by excluding services on which the average person might expect coverage. Among legal issues not covered within the basic plan are divorces, separations, bankruptcies, DUIs and drug-related matters.

Members are eligible for a 25% discount from their plan's lawyer's fees for representation in any such cases. But because there's no contractual ceiling on what the standard fee might be, the discount's value is dubious. The basic plan provides for up to 60 hours of a lawyer's time for the defense of a civil suit, but I'd wish good luck to any defendant who enters a courtroom after only 2.5 hours of pre-trial preparation, which is all the plan provides for members the first year.

These factors may explain why Pre-Paid has recently run into difficulties expanding its business. Over the last 12 months, sales of new plans have declined by as much as 14% compared with year-earlier periods; the recruiting of new salesmen has declined by 40%. These are particularly worrisome figures because only about half of all new customers renew their policies for a second year.

Pre-Paid Legal does have plenty of fans, including many politicians who have been plied with its campaign contributions. Last year, for example, Oklahoma Atty. Gen. Drew Edmondson personally lobbied the SEC to investigate whether short sellers had been driving down the price of Pre-Paid's stock by circulating negative stories. "I have recently been made aware of a market practice known as 'short selling' and am amazed that it is legal," he wrote the agency.

Leaving aside whether the people of Oklahoma are well served by an attorney general for whom the commonplace practice of short selling

comes as a big surprise, Edmondson's letter demonstrates that in the marketplace for politicians, Pre-Paid knows how to get value for money.

That's what's so disquieting about Lockyer's apparent nonchalance about the company's campaign contributions. Pre-Paid hasn't been accused of doing anything illegal in California, as Lockyer's spokesman points out. But the former governor hadn't done anything illegal when the A.G. lit out after him for his negative campaigning. Now that Lockyer has taken Pre-Paid's money, can we be sure that he'll be watching the company as sternly as he watched Gray Davis?

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