Sent Date: Wed, 9 Mar 2016 20:58:18 -0500 (EST)
From: "Steven Rhodes" <rhodessw@comcast.net>
To: "Nick Khouri" <KhouriN@michigan.gov>
Subject: FW: Summary Notes from Today's Calls with E&Y

Nick - I just got this alarming report from Al Koch at AlixPartners. Are you in Detroit tomorrow or Friday to discuss this?
Or, perhaps you can participate in our meeting at 9:00 am tomorrow by phone?
Thanks,
Steve

From: Koch, Al [mailto:AKoch@alixpartners.com]
Sent: Wednesday, March 9, 2016 8:06 PM
To: Steven D. Rhodes (RhodesSW@comcast.net) <RhodesSW@comcast.net>
Cc: Beckeman, Kurt <KBeckeman@alixpartners.com>; Alix, Jay <jalix@lakeviewcapitalinc.com>
Subject: Summary Notes from Today's Calls with E&Y

Steve,
Kurt and I had two calls today with Gaurav and Dan Jerneycic. They were accommodating and helpful. I've summarized below a number of observations and learnings that I hope you will find helpful.

- EY is not involved in keeping the books for the District. There is a new CFO who has been on board for about six months. He is viewed by EY as a "breath of fresh air". Having said that, however, the state of the District's accounting and other systems are largely in the same shape as was the case with the City. That means that there is no monthly close of the books, the auditors or another accounting firm needs to become very involved in helping to close the books for the year and it will be several months following the close of the year before you know what the actual deficit is for F/Y 16. (For example, in the City it was Plante & Moran that actually closed the books every year.) There is certainly not a quick fix for this problem and it means that budgets need to be prepared without actual historical information to level set the budget.
- Until last year the District always prepared a balanced budget. However, it was a fiction and was dead on arrival. Last year, EY encouraged the District to prepare a realistic budget which reflected a $97 million deficit. That budget was just re-done within the last two weeks and the revised budgeted loss is $61 million. How did they get from $97 million deficit to $61 million deficit if the books haven't been closed?
    - The changes were made by reducing the $97 million by the savings achieved from eliminating 100 central office jobs in January plus removal of still unfilled budgeted positions that were included in the $97 million.
    - A budget deficit of $60 to $70 million "feels about right" to Dan. Also, on page 4 of the material that EY shared with you last week EY did a bridge from last year's actual loss to this year's estimated loss.
    - It's certainly not perfect but in the restructuring business you learn to work with what you have and this is probably as good as you're going to

require weeks to get answered and often involve many hours and often professional fees to answer. The list prepared by Marios will only grow in length and complexity. The experience that Jay, Kurt and I had at General Motors to set up NewCo and thereafter get it up and running while continuing to deal with what was left behind was a monumental undertaking; there, of course, there were hundreds of millions in financial benefits to be derived and it was well worth it. The DPS would have no such financial benefit and, we believe, it would prove to be a frustrating and enormously costly exercise to actually set up a NewCo. It is an action that we believe should be avoided if at all possible to do so.

If you agree that this solution or one that achieves the same result is the best answer for implementing OldCo/NewCo the Finance team will work with the Legislative and NewCo Setup Team to try and make it happen.

Please let me know if you would like to schedule a call to discuss this further.

Regards,

Al

Al Koch
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    - It's certainly not perfect but in the restructuring business you learn to work with what you have and this is probably as good as you're going to

get. Unfortunately, there is always the possibility of an unpleasant surprise of some magnitude.

- The NewCo estimate for FY17 assuming adoption of the State proposed restructuring plan is a deficit of $29 million. Considering the District's inability to keep its books currently and the apparent tendency of employees to incur expenditures without budgetary authority (see next comment) I think that you need to think about the NewCo probable deficit as being more in a range for FY 17. Based on Dan's $60 to $70 estimate for FY 16 my suggestion is that you think about a range more like $30 to $50 million deficit for FY 17 unless and until it gets nailed down a lot tighter and there are some controls in place to hit budget.
    - Gaurav said that the $29 million projected deficit is not a "lay-up", which I interpreted to mean that work needs to be done to assure that it doesn't get worse and perhaps can be improved.
    - Approximately 70% of District spending is on payroll and benefits. Other expenses such as utilities, building maintenance and repairs, etc. really cannot be avoided.
    - The District's income will be fixed by the amount of Foundation Grant. Other income isn't all that significant.
    - I was on the Bloomfield Hills School Board for 8 years and always believed that the school district was largely a fixed income and fixed cost operation. There really wasn't much that could be done to reduce expenses other than to reduce payroll. The remaining expenses that are truly variable are not very consequential.
    - What all of this means to me is that the opportunities to balance revenue and expenses with the Governor's restructuring plan as it is currently proposed will be extremely difficult. It raises the point that beginning in year 1 the District will be spending more than it is taking in and will need to resort to incurring new debt in order to operate.
    - Unless altered, it is a long-term recipe for failure.
- The slide on page 9 of the presentation that you had with EY showed payables over 90 days of $60 million. I asked why there was $15 of unentered liabilities. Dan said that employees cannot incur expenses without budget authority so a practice is to incur the liabilities and effectively "hide" the cost, which probably gets swept up in the year-end deficit when the books are finally closed many months after year end. A risk to any year's budget is the extent to which this practice occurs.
    - Dan mentioned that there are many vendor relationships that have been in place for many years. FYI, some years ago when Roy Roberts was the Emergency Manager for DPS he told me of shocking contracts; he also said that he had dealt with all of them by canceling them and putting everything out to bid. Perhaps so but they may have returned. You might want to ask Dan his view of whether there are cozy vendor arrangements that need to be re-bid by a relentless purchasing office.
    - You are aware of the Sodexo judgement for about $25 million. However, only $13 million has been recorded in the DPS records. If the judgment is upheld there will need to be another $12 million added to the $60 million vendors over 90 days.
- Gaurav mentioned that, like Detroit, all of the processes at the Schools are broken. This means that you should anticipate a high degree of inefficiency at all levels of the organization. Hopefully, you will find that this isn't the case but you might want to ask Gaurav and Dan their opinion of the functions such as HR, Purchasing, Finance, etc. I asked if DPS was roughly parallel to the City in this respect and Gaurav said that it was in many respects, which is not good news for what you will be working with.

- I asked Gaurav for the size of the EY team. He said that there are four full time and a total of about 10 people who touch the District, which he felt averaged about 6 FTEs.
  - The team is divided about 50/50 in headcount between the financial team and education specialists from their consulting acquisition (The Parthenon Group).
  - The Parthenon team is working on things like education strategy and how to get the DPS to deliver better education. Gaurav can give you a much better summary of what they are doing.
  - In a distressed situation it wouldn't be uncommon for the restructuring leader to put nonessential consulting services on hold. You might want to ask whether it would make sense for EY to temporarily remove the Parthenon strategy team until you are able to hire a new Superintendent and he/she is able to get acclimated. If so, it might be an opportunity to reduce the monthly EY cost in the short-term, which could help the cash position. The new Superintendent can then decide the extent to which he/she needs/wants Parthenon people to continue.
  - For what it's worth, my sense of an engagement with 4 working full time and 6 others spending part time on the engagement is that the 6 part timers may not be contributing significant value to the engagement. If the 6 are spending substantial time (say 25 hours per week) that would be a different story. But, if they are hitting the billing code for 5 or 10 hours per week I would be very skeptical. You might want to ask Gaurav to present a monthly summary of employees, hours worked and their principal task(s) and make an assessment of whether the engagement is being managed in a sensible way.
  - BTW if you ask Gaurav about temporarily shutting down the Parthenon portion of his team it won't be a surprise. I said that it is possible you might mention it. I knew that I would suggest it to you for consideration and didn't want him to be surprised if you choose to raise the question.
- On the question of cash v. accrual I think that I have a better understanding of what may have occurred. I think that it is appropriate that EY do their cash forecasting on the cash basis. What they didn't do, and which you wisely asked, was when payroll was earned v. paid. I expect that it had never come up before and the EY guys may not have known that it is paid two weeks in arrears.
  - My experience is that managers tend to incur obligations in the ordinary course of business unless it is absolutely clear that they cannot pay them when they come due. Usually, this "absolute clarity" is fuzzy enough that an expectation of collections, loan amendments, additional funding, etc. do not stop entities from doing business. When appropriate attorneys are consulted to make certain that the entity's managers are not operating outside the boundaries of what is OK.
  - That isn't true with payroll. Managers need to be certain that payroll obligations incurred can be paid when due. You are wise to be concerned about it.
  - I think that EY should continue to prepare forecasts on the cash receipts/disbursements method. As noted earlier, the DPS books lag months behind so getting anything from the CFO that will be helpful to you in this regard isn't going to happen.
  - I think that you probably taught the EY guys a good lesson about payroll and they won't make that mistake again.
- Finally, Gaurav said that no contingency planning for shutting the schools early has been done. He views that result as too horrible to allow to happen. He's right but that doesn't mean that it won't happen. You've given the Governor a week to get the legislations moving to get the money

that you need to keep the schools open for the full year.

- o I suggest that after the allotted standstill period that you advise the Governor or his designee that absent a commitment from the State to provide the funds needed to keep the schools open that you will need to begin contingency planning for the early shut down of the District.
- o The actual time that you have before having to shut the schools is at least two weeks before you run out of money. If the schools do need to go dark it won't be acceptable to simply turn out the lights and go home. Selected essential employees will need to remain on the job and vital services (e.g., security, utilities, emergency repairs) will need to be continued.
- o There also would be the question of whether to shut all schools. Unfortunately, the District's cash position is so poor that you probably wouldn't have the luxury of keeping some schools open (e.g., high school seniors).
- o My own gut feel is that the State absolutely cannot afford to allow the Detroit Schools to go dark. But, you're the man who's got the responsibility and you may need to play hardball to get what you need. "Trust me" doesn't work when you're the man who will shoulder the blame for running out of money and not being able to pay payroll.
- o While shutting the schools would be horrible it is a better option than the alternative.

I hope that this is helpful to you. If you would like to speak before your meeting tomorrow I will be in my car for about an hour beginning at 7:30 – feel free to call at 248.613.8245. Or, I could give you a call in the afternoon when I am returning or in the early evening. Your option if you want to chat; please don't feel obligated.

Kind regards,

Al

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