



CITY OF DETROIT
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July 16, 2013

VIA HAND DELIVERY

The Honorable Richard D. Snyder
Governor, State of Michigan
Executive Office of the Governor
111 South Capitol Avenue
P.O. Box 30013
Lansing, Michigan 48909

The Honorable Andrew Dillon
Treasurer, State of Michigan
Michigan Department of Treasury
4th Floor Treasury Building
430 West Allegan Street
Lansing, Michigan 48992

Re: Recommendation Pursuant to Section 18(1) of PA 436

Dear Governor Snyder and Treasurer Dillon:

I write as the emergency manager ("Emergency Manager") for the City of Detroit, Michigan ("Detroit" or the "City"), serving in accordance with Public Act 436 of 2012 of the State of Michigan, also known as the Local Financial Stability and Choice Act, Michigan Compiled Laws §§ 141.1541-141.1575 ("PA 436"). Pursuant to section 18(1) of PA 436 and for the reasons set forth in detail below, I hereby recommend that the City be authorized immediately to file a case, and proceed to adjust its debts, under chapter 9 of title 11 of the United States Code (the "Bankruptcy Code").

Since my appointment as Emergency Manager, I have endeavored to keep you informed of all of my activities to address the financial emergency faced by the City. In addition to providing the reports required by PA 436, I have maintained open lines of communication with both of you and the members of your staffs relating to the progress of my restructuring efforts and the challenges I have faced in that process. I believe that both of you have been well informed of the City's financial condition and its restructuring activities and negotiations that have been pursued to date, including those efforts that began before my appointment. Nevertheless, to support my recommendation, this letter: (a) provides a brief background on the

DAVE BING, MAYOR

dire situation faced by the City; (b) summarizes certain of the efforts taken to date to rectify the City's financial emergency; and (c) concludes by discussing the need for chapter 9.

Based on the current facts and circumstances, I have concluded that no reasonable alternative to rectifying the City's financial emergency exists other than the confirmation of a plan of adjustment for the City's debts pursuant to chapter 9 of the Bankruptcy Code because the City cannot adopt a feasible financial plan that can satisfactorily rectify the financial emergency outside of a chapter 9 process in a timely manner.

Situational Overview

Inadequate City Services and Infrastructure Impacting Quality of Life

The City is in the midst of a severe financial emergency. After decades of fiscal mismanagement; plummeting population, employment and revenues; decaying City infrastructure; and deteriorating City services, Detroit today is a shell of the thriving metropolis that it once was. Basic infrastructure is failing, such as the City's streetlights, many of which do not work. Crime is endemic. The City is plagued by blight and a diminishing quality of life. City operations, ordinances, policies and procedures must be streamlined and overhauled to implement best practices and eliminate waste and inefficiencies. Related to this, the City's technology systems, none of which are integrated, are in desperate need of upgrades, as they have been neglected for years. The lack of modern systems undermines many of the initiatives to establish essential improvements to City services and reduce operational costs.

For an extended period of time, the City has simply failed to make the investments required to provide its residents with an adequate quality of life, as limited resources have been diverted elsewhere. The City's urgent need to address large and growing legacy liabilities, and other substantial debts, is self-evident. Failure to address these liabilities will prevent the City from devoting sufficient resources to providing basic and essential services to its residents. Indeed, significant additional resources are required to improve public health and safety. The City must devote a larger share of its revenues to: (a) effectively provide basic, essential services to current residents; (b) attract new residents and businesses to foster growth and redevelopment; and (c) ultimately begin what will be a long process of rehabilitation and revitalization for the City. The City's debt and legacy liabilities must be significantly reduced to permit this reinvestment. Failure to do so directly endangers the health, safety and welfare of all residents of the City.

Growing Debt and Legacy Liabilities

The City's current obligations are unsustainable and prevent the investments needed to revitalize the City and promote public health and safety. The City has over \$18 billion in accrued obligations, including: (a) \$3.5 billion in underfunding pension liabilities based on the most recent actuarial analysis; (b) \$5.7 billion in other post-employment benefit ("OPEB")

liabilities (\$6.4 billion if the present value of future expected benefits is used); (c) \$1.13 billion in general obligation ("GO") liabilities (consisting of \$650.7 million in unsecured GO debt, plus \$479.3 million in secured GO debt); (d) \$1.43 billion in liabilities under pension-related certificates of participation ("COPs"); (e) \$343.6 million in swap liabilities related to the COPs; (f) approximately \$6.4 billion in obligations backed by enterprise revenues or that are otherwise secured; and (g) \$300 million in other liabilities.

The City's substantial long-term obligations and legacy liabilities impede its ability to operate within its budget. Debt service for the City's general fund related to limited tax and unlimited tax GO debt and the COPs was \$225.3 million for fiscal year 2012, and is projected to exceed \$247 million in fiscal year 2013 and to increase further in the future. Currently, more than \$0.38 of every tax dollar that the City collects goes to service legacy costs, debt and other obligations rather than toward providing services for the City's residents and businesses. Without adjustment, that number is expected to grow to almost \$0.65 of every dollar by 2017.

This level of debt is simply unsustainable. This situation has been managed to date only by deferring other obligations, cutting services to the bone and ignoring the substantial and obvious need for reinvestment in the City. Residents have paid for this approach with a diminishing quality of life in a City that, over time, has increasingly struggled to protect the health, safety and welfare of its citizens.

Growing Budget Deficits

For many years, the City's expenditures have exceeded its revenues, and the City has deferred paying certain obligations just to make ends meet. Excluding the proceeds of debt issuances (e.g., \$75 million in fiscal year 2008; \$250 million in fiscal year 2010; \$129.5 million in fiscal year 2013), the City has incurred operating deficits for each of the past six years (through fiscal year 2013), and the City's accumulated deficit continues to grow. As of the end of fiscal year 2012, the City had an accumulated unrestricted general fund deficit of \$326.6 million, an increase of \$130 million over fiscal year 2011. This deficit increased by an additional \$47.4 million in fiscal year 2013 (excluding the impact of a recent debt issuance generating approximately \$137 million in proceeds for the City). In the absence of the recent debt issuances, the City's accumulated deficit would have been over \$650 million for fiscal year 2012 and approximately \$700 million of fiscal year 2013. Absent structural changes, at its current run rate, the City's accumulated deficit could grow to over \$1.3 billion by fiscal year 2017.

The City has funded its continuing deficits in a variety of unorthodox and financially imprudent ways, including: (a) the deferral of pension contributions (resulting in larger funding deficits and requirements for additional contributions in later periods); (b) the issuance of both short-term and long-term debt; (c) the deferral of trade payments; (d) borrowing by the City's general fund from other funds, deferrals and cash pooling; and (e) significant furloughs and reductions-in-force. As of June 30, 2013, the City's general fund had outstanding deferrals and

amounts due to other funds and entities of approximately \$272 million. Instead of solving the City's financial troubles, these tactics mask the City's true financial condition and continue to bury the City in an ever deepening financial crisis that exacerbates the City's already precarious condition.

Continued Liquidity Problems and Negative Cash Flows

The City also has experienced continued liquidity problems and year after year of negative cash flows, which trends are expected to continue absent intervention. All of the borrowing and cash conservation tactics — including the deferrals described above, as well as wage cuts, employee furloughs/layoffs and other operational cuts — have not stemmed the losses.

With respect to the City's cash flows, the City had negative cash flows of \$115.5 million in fiscal year 2012, excluding the impact of proceeds from short-term borrowings. The City had positive net cash flows of \$41.5 million in fiscal year 2013, but only as a result of deferring approximately \$119 million of current and prior year pension contributions and other payments, among other cash conservation measures. Absent intervention and/or restructuring, the City: (a) is projecting negative cash flows of \$198.5 million in the current fiscal year 2014; and (b) will be left in a net cash position (after required property tax distributions) of negative \$11.6 million as early as December 2013.

The City has not been — and currently is not — paying debts as they come due. The City has deferred payment of certain of its General Retirement System ("GRS") and Police and Fire Retirement System ("PFRS") pension funding contributions, and it accrues interest on such deferrals at a rate of 8%. As of June 30, 2013, the City had deferred approximately \$106 million in GRS and PFRS pension contributions in the aggregate. Moreover, the City's estimated liability with respect to OPEBs is \$6.4 billion, which is almost entirely unfunded. To conserve cash for City operations, including payroll, the City did not make the scheduled \$39.7 million in payments on its pension-related COPs that were due on June 14, 2013. The City is insolvent.

Measures Already Taken by the City to Address Financial Challenges

Faced with several years of expenditures exceeding revenues, the City has taken aggressive steps to cut costs from its operations. These measures included, by way of example: (a) entering into a financial stability agreement with the State of Michigan and the resulting creation of a financial advisory board to oversee the City's operations and conduct limited reforms; (b) reducing the number of City employees by more than 22% since fiscal year 2010; (c) implementing revised City employment terms ("CETs") for non-union employees and union employees under expired collective bargaining agreements; (d) increasing certain tax and utility rates; (e) enhancing tax collection initiatives; and (f) reducing other expenditures. By these

reforms, the City estimates that it has been able to realize more than \$200 million in annual savings.

Unfortunately, these savings are insufficient to stem the bleeding. Raising new revenues is not a viable option. The City cannot access funds in the capital markets given its financial status at this time, and doing so would only exacerbate its unsustainable debt load. Both as a legal and practical matter, the City cannot increase revenues by raising taxes. The City's current tax rates are at their current statutory maximums. Even if the City somehow could raise taxes, the vast majority of its residents lack the financial wherewithal to bear them. For example, a study earlier this year showed that 47 percent of the City's taxable parcels were delinquent on their 2011 property taxes. In any event, Detroit cannot survive and grow if it remains a high tax, low service city.

Just as the City lacks new revenue sources, it lacks any further leeway to address its financial emergency through operational cuts. The City cannot significantly reduce expenditures by further reducing employee headcount or cutting services beyond the skeleton coverage currently provided, particularly given the archaic state of the City's technological systems and certain mandates in the City's Charter. As just one example, the City's police force already is being paid below market salaries, and is required to combat extraordinary crime rates using outdated and/or inadequate equipment. In 2012, the City's violent crime rate was five times the national average and the highest of any city with a population in excess of 200,000. Further cuts would only exacerbate this safety crisis in the City.

The City's Circumstances Constitute an Ongoing Financial Emergency

The City's circumstances have been well documented. On February 19, 2013, a financial review team appointed by Governor Snyder (the "Financial Review Team") submitted its report, concluding "that a local government financial emergency exists within the City of Detroit because no satisfactory plan exists to resolve a serious financial problem." See <http://www.freep.com/assets/freep/pdf/C4201116219.PDF>. The Financial Review Team's report details many of the issues described above, which led the Governor to make a finding of a financial emergency within the City, and in turn led to my appointment as Emergency Manager. I have further detailed these issues in (among other places) my Financial and Operating Plan and my June 14 Creditor Proposal (both as defined and described below).

The Efforts of the Emergency Manager to Address the City's Financial Emergency

Initial Evaluations and Development of Financial and Operating Plan

Upon my appointment as Emergency Manager in March of this year, we immediately began the process of developing a comprehensive restructuring plan for the City, as well as addressing the City's other urgent needs. At the outset of my term, we met with scores of interested parties, government officials and professional advisors to gather information about the

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City's restructuring needs and priorities and participated in interviews and press conferences with local, regional and national news outlets to provide information to the public and promote transparency. I established the Emergency Manager's office and hired limited support staff.

Notably, from day one, I have spent significant time working with the City's financial and legal advisors to cast a critical eye on all of the City's financial obligations and operational issues to develop a realistic assessment of the City's problems, obstacles, needs and opportunities. In particular, I directed these advisors to help me develop the terms of a comprehensive plan to: (a) ensure that the City is able to provide or procure governmental services essential to the health, safety and welfare of its citizens; (b) assure the fiscal accountability and stability of the City; and (c) promote private investment in the City and revitalization of the community in a sustainable fashion.

As a first step in this process, I worked with the City's advisors to develop a financial and operating plan for the City (the "Financial and Operating Plan"), which placed the City's challenges in context and defined a series of key restructuring goals and initiatives. The Financial and Operating Plan, dated May 12, 2013, was submitted to Treasurer Dillon as required by section 11(2) of PA 436 and is available on the City's website at http://www.detroitmi.gov/Portals/0/docs/EM/Reports/City%20of%20Detroit%20-%20Final%20Financial%20&%20Operational%20Plan%20_45%20Day%20Pl.pdf. The Financial and Operating Plan, by its terms, was a "preliminary report based on the Emergency Manager's work [as of that] date and remain[ed] subject to material change as this work progresses."

Development of Creditor Proposal and Negotiations with Creditors

In the month following the submission of the Financial and Operating Plan, I worked with the City's advisors to complete a comprehensive plan to rectify the City's financial emergency, assure the City's financial accountability and revitalize the City's operations. Developing such a plan required substantial efforts to: (a) evaluate the true financial state of the City (including by developing a more realistic assessment of legacy liabilities and likely revenue streams); and (b) analyze the specific operational and reinvestment needs of the City. The outcome of this work is reflected in the Proposal for Creditors, dated June 14, 2013, a copy of which is enclosed with this letter and is available on the City's website at <http://www.detroitmi.gov/Portals/0/docs/EM/Reports/City%20of%20Detroit%20Proposal%20for%20Creditors1.pdf> (the "June 14 Creditor Proposal").

The June 14 Creditor Proposal contains extensive information regarding the state of the City's finances and operations and a comprehensive proposal to restructure the City's obligations. In addition to describing Detroit's current economic circumstances, the 128-page June 14 Creditor Proposal describes a thorough overhaul and restructuring of the City's operations, finances and capital structure, as well as proposed recoveries for each creditor group.

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The June 14 Creditor Proposal is based on revised ten-year financial projections that provide a realistic basis for evaluating the City's financial wherewithal to address creditor claims and achieve its restructuring goals.

Meeting to Discuss June 14 Creditor Proposal

On June 14, 2013, at an approximately two-hour meeting, I presented an Executive Summary of the June 14 Creditor Proposal to approximately 150 invited representatives of the City's creditors, including representatives of: (a) the City's funded debt; (b) the insurers of such debt; (c) all of the City's unions (representing over 45 bargaining units); (d) certain retiree associations; (e) the GRS and the PFRS; and (f) many bondholders. Attendees received copies of both the Executive Summary and the full June 14 Creditor Proposal. At the conclusion of the meeting, my advisors and I invited all creditor representatives to meet and engage in a dialogue with City representatives regarding the proposal. I indicated that I would welcome modifications and alternative ideas consistent with the City's (a) urgent need for reinvestment to improve essential City services and (b) current and projected cash flows.

Individual Follow-Up Meetings

Having provided the facts and proposals contained in the June 14 Creditor Proposal to its creditor body *en masse*, the City followed up with individual meetings with attendees during the period between June 14, 2013 and the date hereof. The City offered to meet with as many creditor representatives as were interested in doing so.

These negotiations and follow-up meetings with creditors included the following:

- On June 20, 2013, the City's advisors conducted meetings with representatives of all of the City's unions and four retiree associations to: (a) present a more in-depth look at the City's analysis of its retiree health and pension obligations; (b) suggest proposals for the modification thereof that the City could fund within its means going forward; and (c) solicit the unions' and retirees' views on their preferred way to address the dramatic, but necessary, benefit modifications.
- On June 25, 2013, City advisors met with representatives and advisors for (a) all six insurers of the City's funded bond debt, (b) the GRS and the PFRS and (c) U.S. Bank, National Association ("U.S. Bank"), the trustee or paying agent for the bulk of the City's bond issuances. At this meeting, the City provided a detailed, comprehensive review of the City's finances and its financial and operating plan. In addition, from June 25, 2013 to June 27, 2013, the City's advisors held individual follow-up meetings with each insurer that requested such a meeting.

- On July 9, 2013 and July 10, 2013, the City held extensive follow-up diligence sessions with business people and financial advisors for the GRS, PFRS and debt insurers focused on the City's ten-year projections, operating plan and restructuring initiatives.
- On July 10, 2013, the City held follow-up diligence sessions with representatives and advisors of the GRS and PFRS and the unions related to the City's ability to continue to provide for the underfunded GRS and PFRS pensions and the ramifications to the pensions.
- On July 11, 2013, the City held follow-up diligence sessions with business people and advisors for the unions to engage in discussions on retiree benefit issues.
- The City's negotiations with the counterparties to its pension-related swap contracts (which have been ongoing since 2012) intensified in recent weeks and included: (a) several in-person and telephonic meetings among the City, swap counterparties and their respective advisors; (b) the exchange of various economic offers between the parties; and (c) the generation of numerous draft agreements memorializing such offers.

Barriers to Reaching Agreement

Although these creditor meetings generally were constructive and were conducted by the City in good faith, the City has been unable through this process to achieve both: (a) sufficient consensual savings from its major creditor constituencies to ameliorate its cash crisis; and (b) sufficient contract amendments to successfully restructure its finances. Likewise, there is no realistic prospect of reaching agreements with all affected constituencies in a timely fashion (or at all). Given the vast and fragmented pool of potential creditors, the City cannot practicably negotiate a consensual restructuring with all of its creditors outside of a court process.

For example, the negotiation of changes to pension and retiree benefits with the City's retiree constituency is impracticable without court intervention because: (a) the approximately 20,000 retirees entitled to receive retiree benefits from the City cannot be bound by out-of-court negotiations between the City and the 47 discrete union bargaining units that might or might not represent these retirees; and (b) in any event, the majority of those units have expressly refused to represent such retirees.

Moreover, the City generally is unable to negotiate with bargaining representatives with the authority to bind the City's bondholders. Either (a) U.S. Bank acts solely as a paying agent (and not as a trustee) with respect to a given series of bonds; (b) the debt is uninsured, such that no insurer of the City's funded bond debt (any such insurer, a "Bond Insurer") has the right to control an out-of-court restructuring of the debt; or (c) the debt is insured but the Bond Insurer

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has no control rights (provided that the Bond Insurer has not made a payment under its respective policy). In addition, to date, no bondholder group holding a majority of any of the 60 series of debt has organized so that the City could negotiate with them. Under these circumstances, negotiations regarding the out-of-court restructuring of the City's bonds is impracticable because in many instances the City is unable to negotiate with a single contact with the authority and willingness to bind its bondholders.

Despite these impediments to achieving an out-of-court resolution with creditors, as set forth above, the City nevertheless attempted, in good faith, to negotiate with many key creditors, presenting its proposals to all known constituencies, soliciting feedback and engaging in meetings with all parties willing to come to the table. The City responded to all requests for additional information and to all questions it received in these negotiations. The fragmented and often non-binding nature of these negotiations has frustrated the City's ability to achieve a consensual restructuring of its debt. Certain parties rejected the City's proposals altogether. In other cases, creditors made untenable "counterproposals" suggesting that they should not be materially impaired or should not be impaired at all. These proposals were made notwithstanding explicit or implicit agreement that the City's debt and other legacy liabilities must be reduced.

Even in the face of numerous obstacles, the City was able to make some progress in creditor negotiations. For example, the City's good faith attempts to negotiate with the counterparties to its swap contracts have been productive. These discussions were temporarily sidetracked when a certain swap insurer blocked the City's access to wagering tax revenues (which were pledged in 2009 as collateral to resolve a prior termination event under the swap contracts). The insurer's actions stalled negotiations and forced the City to protect its interests by commencing litigation, seeking, among other things: (a) the recovery of damages suffered by the City; and (b) the release of revenues held by U.S. Bank, as custodian. The City obtained a temporary restraining order in this matter, but litigation with the swap insurer remains in progress. After the initial flurry of litigation activity, negotiations with the swap counterparties continued, leading to an agreement in principle to resolve the significant swap claims and related issues potentially impacting the City's liquidity. This agreement with the swap counterparties is beneficial to the City, but, by itself, it falls far short of addressing all of the City's restructuring needs.

In light of the overall inability or failure of many stakeholders to respond to the negotiations and the limited successes in creditor negotiations to date, and considering the urgency of the City's situation, a global consensual resolution will not be achieved in a timely fashion. We have evaluated other alternatives to address the City's financial emergency, but none of these alternatives would resolve the critical problems faced by the City and its residents.

Recommendation to Seek Relief under Chapter 9

Unable to negotiate an out-of-court resolution that simultaneously addresses the City's dire financial situation while laying the foundation for a strong and prosperous City going forward, and having exhausted all other available options, I hereby recommended, in accordance with section 18(1) of PA 436, that the City be authorized to file for relief under chapter 9 of the Bankruptcy Code. This recommendation is based on my determination that, without such a filing, no reasonable alternative to rectifying the financial emergency of the City exists because the City cannot adopt a feasible financial plan that can satisfactorily rectify the financial emergency in a timely manner, as described herein.

I believe that chapter 9 provides a framework that will permit the City to rectify its financial emergency. Chapter 9 will enable the City to negotiate with and bind creditors in a way that has proven to be impossible outside of chapter 9. For example, the City intends to seek the appointment of an official committee of retirees that can negotiate for and bind retirees. The plan of adjustment process set forth in the Bankruptcy Code likewise creates a mechanism by which the City may bind all of its creditors, even if all creditors do not assent to the City's restructuring plan. Given the impracticability of negotiating with the City's various stakeholders outside of chapter 9, and in light of the City's cash crisis and the urgent need to move forward with its restructuring, the time to seek chapter 9 relief is now.

Based on my discussions with the City's advisors, I believe that, if authorized to proceed under chapter 9 as requested herein, the City will have satisfied all five of the chapter 9 eligibility requirements and will be in a strong position to address any eligibility issues in court as necessary. In particular, the five elements of chapter 9 eligibility are the following:

- The City must be a municipality, which it is.
- The City must be specifically authorized, in its capacity as a municipality or by name, to be a debtor under chapter 9 by State law, or by a governmental officer or organization empowered by State law to authorize such entity to be a debtor under chapter 9. PA 436 authorizes the commencement of a chapter 9 case by the Emergency Manager upon the Governor's authorization.
- The City must be insolvent. As described herein, it is.
- The City must desire to effect a plan to adjust its debts. As described herein, the City desires to, and must, adjust its debts in chapter 9 to alleviate its financial emergency and to implement its restructuring plan.
- The City also must meet one of four remaining alternate requirements, two of which are particularly relevant here. First, the City is unable to negotiate with creditors

because such negotiation is impracticable for the various reasons described above. In addition, despite the impracticability, the City has negotiated in good faith with the creditors willing to engage in a discussion, but has failed to obtain the agreement of creditors holding at least a majority in amount of the claims of each class that the City intends to impair under a chapter 9 plan. For both of these reasons, the City satisfies the final element of eligibility for chapter 9.

If the City is authorized to proceed under chapter 9, I intend to move the chapter 9 case along as expeditiously as possible. A focused effort on pursuing a chapter 9 plan will provide the City with the opportunity to achieve a reasonably prompt path out of bankruptcy and towards the bright and prosperous future that it deserves.

Please note that, if the City is authorized to proceed under chapter 9, I will continue to serve as the Emergency Manager with the powers afforded by PA 436. In addition, under section 18(1) of PA 436, I will act exclusively on the City's behalf in a chapter 9 case. In that capacity, I will continue to provide regular updates to you, to other stakeholders and to the public as necessary or appropriate. Indeed, given that after 18 months I may be removed from my position as Emergency Manager under PA 436, my goal is to implement a plan of adjustment and conclude the City's chapter 9 case no later than September 2014. I also intend to pursue ongoing operational and performance reforms within this timeframe.

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In sum, despite aggressive cost cutting measures already implemented by the City and despite good faith negotiations (where they could be had), no reasonable alternative for the restructuring of the City's operations and obligations exists other than through chapter 9. Without chapter 9 relief, there is no clear path for rectifying the City's financial emergency and the City's deteriorating financial cycle will not only continue, but accelerate. As such, I respectfully recommend that the City be authorized to proceed under chapter 9 so that we may, at last, stop the City's downward spiral and correct the City's financial condition in a sustainable fashion.

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I am available at your convenience to discuss the content of this letter with both of you and your staffs and to answer any questions you may have. I recognize that the recommendation made in this letter is somewhat unprecedented, but it is my firmly held finding, as Emergency Manager, that a chapter 9 bankruptcy filing is the only available means to comprehensively rectify the City's unsustainable financial condition. I look forward to your response with respect to this matter of utmost importance to the City of Detroit and to the great State of Michigan.

Sincerely,



Kevyn D. Orr
Emergency Manager

Enclosure