International Journal of Finance Education 1(1): 19-54.

The Creation of FirstCity Financial Corporation: A Clinical Study of the Bankruptcy Process

Ramesh K. S. Rao
University of Texas, Austin

Susan White
University of Maryland

Abstract: This paper examines the bankruptcy of First City Bancorporation of Texas and its subsequent emergence, through a merger, as FirstCity Financial Corporation (FCFC). It illustrates several interrelated issues: a) how informational asymmetries and disagreements among the various claimants were efficiently resolved through the use of a Court's Expert, b) why a merger was critical for the success of the reorganization plan, c) the process by which the claims were valued, and d) the steps taken by the Court to ensure that the "best interests test" was satisfied under the reorganization plan.

Keywords: bankruptcy, confirmation, FirstCity, best interests test, reorganization.

1. Overview

1.1. General

A fundamental concept underlying the theory of the financially distressed firm is that if the firm is "worth more dead than alive" it should be liquidated under Chapter 7 of the Bankruptcy Code; if the post-reorganization firm value exceeds its current value, it should be rehabilitated under Chapter 11. This economic logic is straightforward, but its implementation is often not simple. A necessary step in a Chapter 11 bankruptcy proceeding is that the reorganization plan must be confirmed or approved by the Court. Each plan must be accepted by formal voting.[1] In addition, the "best interests test" [1129 (a)(7), Bankruptcy Code] must be satisfied: each class of claims or equity interests must have accepted the plan or will receive or retain under the plan property of a value that is at least equal to what that holder would receive or retain if the firm were liquidated. The confirmation process thus relies critically on the economic values of the claims issued in the reorganization.

The post-reorganization claims are not traded at the time of the legal proceedings and the absence of external market valuations makes the process complex and less precise. The outcome of the voting is impacted by the ongoing recontracting and negotiation during bankruptcy which reflects the[1,2] Incentive misalignments and the informational asymmetries in financially distressed firms complicate the negotiation and valuation process.[3] Equityholders have incentives to continue the firm as long as possible. On the other hand, senior creditors have an incentive to block the reorganization. Even private parties, working with managers, have incentives to influence the estimates; the cash flow estimates are endogenous [“hardwired”, Kaplan and Ruback (1995)].

Absent market valuations and with informational asymmetries, competing interests, and other legal/procedural requirements, the bankruptcy proceeding becomes an *administrative* process wherein valuations are arrived at through negotiations and “judicial weighting of competing economic interests” [Gilson et. al (2000)].

1.2. Scope of Study

This paper examines the bankruptcy of First City Bancorporation of Texas and its eventual reorganization through a merger with J-Hawk, a firm specializing in distressed assets, as FirstCity Financial Corporation (FCFC).[4] The Creditors’ Committee and judge Harold Abramson approved the

---

1. At least one class of claimholders must accept a plan for it to be confirmed. Acceptance for a single class is defined as acceptance by a two-thirds majority of creditors in that class. A majority of the total claimholders must favor a plan in order for it to be accepted. Impaired creditors are those who would either receive alternative securities or would have part or all of their claim dismissed. Even if all impaired classes do not accept the plan, it may still be confirmed as long as at least one impaired class of claims has accepted a plan. Under the “cramdown procedure” [§1129 (b) of the Code] an impaired class may be required to accept a plan as long as that class and all the classes below it in priority are treated according to the absolute priority rule which requires that investors be paid according to their seniority, with senior debt and secured creditors first, then junior debtholders, then preferred shareholders and finally equity holders.
2. An early discussion of the incentives of the various parties to renegotiate during the confirmation process is contained in Miller (1977).
3. See e.g., Franks and Torous (1989), Bernardo and Talley (1996), Rao, Sokolow and White (1996) and Weiss and Wruck (1997)]. The bankruptcy code allows managers to remain in place during the bankruptcy (the debtor-in-possession, *DIP*) and management has the right to propose a reorganization plan. This creates incentives for incumbent managers to propose reorganization rather than a liquidation using optimistic cash flow projections. Indeed, Hotchkiss (1995) finds evidence consistent with this forecasting bias. In analyzing pre-reorganization cash flow projections and comparing them to post-reorganization performance, Hotchkiss finds that these firms consistently underperformed.
4. First City Bancorporation of Texas, Inc., Debtor; Case No. 392-39474-HCA-11; in the United States Bankruptcy Court for the Northern District of Texas, Dallas Division.

reorganization plan in April 1995. The Court confirmed the merger in May, and FCFC emerged from bankruptcy on July 3, 1995. This complex case had numerous heterogeneous claimants.[5] To resolve the myriad contentious problems the various constituencies agreed to, and the Court appointed, a Court's Expert (an author of this paper) to hear the concerns of the parties proposing alternate plans, and to conduct an independent economic evaluation. This case draws on the vast amount of information gathered under this arrangement. This clinical study illustrates the administrative process of bankruptcy, highlights how the Court conducted its "judicial weighting" in ensuring that the best interests test was satisfied, and explains why the merger partner was critical for the success of the confirmed plan.

1.3. Paper Organization

Section 2 reviews the history of events leading up to First City's bankruptcy. Section 3 discusses the competing bankruptcy plans proposed by First City management and third parties, including First City's creditors, a reorganization process that involved over five hundred lawyers representing creditors, equityholders, the FDIC, plaintiffs from shareholder lawsuits and affirmative [6] To reduce informational asymmetries and to facilitate evaluation of the different plans, First City Bancorporation produced an Omnibus Disclosure Statement.[7] The purpose of the Omnibus Statement was to ensure that when read with each Plan Proponents Disclosure Statements, it can provide "adequate information" as the term is defined in section 1125 of the Bankruptcy Code. It was intended to enable creditors and shareholders "to make an informed decision regarding whether to accept or reject each of the proposed competing plans for the reorganization of First City…" (p.1 of the Omnibus Statement). Section 4 discusses informational asymmetries and incentive misalignments that were exacerbated not only because the Omnibus did not provide objective and reliable information but also because the reorganization was contingent on the FDIC settlement

5. There were several lawsuits pending. There were affirmative action claims, Director and Officer Liability Claims, claims filed by the FDIC, by EDS Corporation, the Bank of New York, Employment Discrimination Claims, Employee Benefit Claims, a class action suit alleging misrepresentation and omissions in First City's Proxy statements, 90 claims filed by individual bondholders, 293 claims filed by equityholders, 10 claims by depositors involving banks, 953 former employee claims for severance pay, trade claims for $680,000, various indemnification claims, etc.
6. Information about the number of lawyers from First City President, Mr. Robert Brown, in private communication.
7. "Omnibus Disclosure Statement for each of the Competing Plans of Reorganization for First City Bancorporation of Texas, Inc. Under Chapter 11 of the Bankruptcy Code", December 23, 1994.

agreement. This section highlights some sources of contention and discusses the steps taken by the Court to reduce contention and informational asymmetries. Section 5 shows why a merger was a superior resolution to First City Bancorporation's financial distress, and Section 6 discusses FCFC's successful emergence from bankruptcy. Section 7 concludes the paper.

2. First City Bancorporation of Texas

2.1. Background

First City originally owned 59 state and national banks and other non-banking subsidiaries primarily in large Texas cities. Although the original corporation had assets of $10.6 billion, its solvency was threatened in 1987 by an ailing Texas economy. With the assistance of the FDIC and an infusion of capital from a group of investors headed by A. Robert Abboud, the bank was re-organized in 1988.[8] Appendix 1 provides a timeline of significant events.

Only two years after the 1988 reorganization, First City's financial condition deteriorated again. The Company had high operating costs, and the credit quality of its loan portfolio was weak. The decline was triggered by a downturn in Texas real estate values, which was in turn attributed to the FDIC and Resolution Trust Corporation (RTC) selling off their large Texas real estate portfolios.

In March 1991, C. Ivan Wilson replaced Abboud as chairman of the board. The new management began a recovery plan which included increasing liquidity at its banks, cutting expenses, closing international operations, using resources of the healthier banks to shore up the weaker ones, improving asset quality, reducing the size of the management team, and raising capital, possibly through the sale of banks. The plan was at least partially successful.[9]

---

8. After serving as Chairman of First Chicago Corp. and president of Occidental Petroleum, Abboud and a group of investors bought First City Bancorporation. Abboud put up $5 million of his own money along with $970 million from the FDIC. See "The Nine Lives of Bob Abboud; Number Three", *Business Week*, February 15, 1988.
9. In the summer of 1992 First City developed its own non-FDIC assisted recapitalization plan, called Plan C. Plan C included debt deferral by the bank's bondholders, sale of 13 banks which represented about a third of First City's assets, renegotiation of bank building lease agreements, and raising $120 million from outside sources. Unlike the reorganization that occurred several years earlier, which included over $1 billion in FDIC assistance, First City's Plan C did not require FDIC aid. First City successfully implemented parts of the plan. It negotiated debt deferral with its bondholders, found buyers for the 13 banks for $50 million, renegotiated leases which settled $266 million in future liabilities and would have meant an $83 million reduction in lease reserves for its remaining banks, which would have been added to the banks' capital. The bank also had letters of intent for $90 million of new capital, and was working on the remaining $30 million required.

Liquidity increased from $80 million in March 1991 to $1.5 billion in October 1992. Each bank became able to stand alone financially. Expenses were cut by $50 million a year, and 40% of the highest-ranking executives left the organization. Asset quality improved through the sale of non-performing loans, and First City had reached agreements settling all of its major outstanding lawsuits.

2.2. The Bankruptcy Filing

The FDIC performed a valuation review of First City and concluded that the system would lose $1.35 billion if all the banks were liquidated, with an FDIC loss of about $698.2 million. On October 30, 1992, the FDIC declared the First City banks insolvent, seized its assets and placed them in a receivership account. The FDIC first claimed that it would incur losses of $476.9 million because of the insolvency of First City Houston and Dallas. It assessed each of the 18 remaining First City banks a proportionate share of the anticipated loss and demanded immediate payment. The assessment was greater than each of the remaining banks' capital, allowing the FDIC to also declare those banks insolvent.[10] The next day, some of First City's unsecured creditors filed an involuntary Chapter 11 bankruptcy petition against First City. First City's balance sheet at the time of bankruptcy filing is presented in Table 1.

10. This FDIC policy has been since legally challenged. In a July 28, 1994 ruling, a Washington, D.C. federal judge ruled that the FDIC cannot seize solvent banks in the process of shutting down insolvent ones. This action, known as cross-guaranteeing between sister banks, was part of the 1989 Financial Institutions Recovery, Reform and Enforcement Act (FIRREA). The court, however, ruled that such an action would require government compensation if the subsidiary bank was operated as a separate entity and had no reasonable expectation of becoming involved in the parent bank's business.

Table 1: First City Bancorporation of Texas Balance Sheet

Table 1 details First City Bancorporation of Texas' (old First City) financial situation, showing its negative equity position.

First City Bankcorporation of Texas Inc.,
Estimated Statement of Assest and Liabilities as of 11/30/94

ASSETS	(in Millions)
Cash and Non-cash assets in Possession of Debtor	$ 36
TOTAL ASSETS	$ 36
LIABILITIES	
Obligations to creditors and claimants	$ 70
Proposed Krim Settlement[a]	$ 10
TOTAL LIABILITIES	$ 80
ESTIMATED EQUITY IN ESTATE	$ (44)

[a] The Krim Settlement refers to a $10 million settlement of a lawsuit against First City. Jerry Krim had filed a $225 million lawsuit against FirstCity, alleging mismanagement

2.3. Lawsuit and Countersuit

First City challenged the FDIC valuation assessment by later instituting a $3 billion lawsuit against the FDIC. First City charged that the FDIC wrongfully closed the banks, it was denied due process, the banks were wrongly assessed, the regulators were negligent and First City’s property was fraudulently transferred. First City’s suit demanded $1 billion in compensation plus treble damages. The FDIC countersued, seeking $364.7 million for misdeeds of its previous management.[11] The FDIC suit claimed that First City siphoned off dividends from its subsidiary banks.

11. Three former First City executives were jailed for defrauding the bank: Frank Cihak, former vice chairman was sentenced to 13 years in prison for siphoning off $9 million in bank funds along with his co-conspirators, Lloyd Swift who was sentenced to eight years and William Allen who was sentenced to 70 months.

2.4. The FDIC Settlement Agreement

First City's lawsuit against the FDIC eventually resulted in a cash settlement offer, in June 1994, under which First City could receive cash and other bank assets from the FDIC. Under the proposed settlement agreement First City would receive a dividend of about $200 million ($135 million in cash and about $65 million in non-cash assets with a book value of $48 million).[12] First City would receive additional settlements of about $70 million through the closure of loss-sharing agreements with the 20 former First City banks, the FDIC and the new owners of the FirstCity banks.[13] Another $40-$45 million could be returned to First City after all litigation claims were settled.[14] The settlement however, was *contingent* on the confirmation of a reorganization plan.

2.5. Incentives to Settle

Without a settlement of the FDIC lawsuit, First City had a negative equity position of $44 million (Table 1) but if a reorganization plan could be confirmed, the cash inflow from the FDIC would raise the net equity of First City to around $130 million. First City's post-settlement balance sheet (assuming confirmation) is presented in Table 2. This *potential* for an asset inflow to FirstCity arising from the FDIC Settlement Agreement formed the basis for the subsequent reorganization of First City. The next challenge was to ensure that the Court would confirm a reorganization plan.

12. The non-cash assets consisted of $27.2 million in loans and $20.8 million in Other than Real Estate (ORE). The ORE had a market value of $32 million. The loans consisted of $11 million performing loans and $16.2 non-performing loans.
13. Loss sharing agreements were agreements between the FDIC and banks that purchased the former First City banks. The FDIC guaranteed recovery by the acquiring institutions of about $2 billion in loans made by First City before the closing of the banks.
14. This consisted of $50 million in a claims reserve fund, First City's estimate of $10 million paid out of this fund to settle claims, plus interest of up to $5 million on the remainder.

Table 2: First City Balance Sheet under the Settlement Agreement

Table 2 details First City's financial position with the dividend to be paid by the FDIC as part of Settlement between old First City and the FDIC. The balance sheet shows positive net worth.

First City Bancorporation of Texas, Inc.
Pro Forma Statement of Assets
And Liabilities after payment of Initial Dividend
As of 11/30/94

ASSETS			(In Millions)	
Initial dividend distribution from FDIC Receiverships[a]			$	200
Adjustments to Fair market value for GCR Assets[b]				
GCR Value	$	64		
Fair Market Value (First City estimate)	$	49		
				(15)
Less Amounts Previously Distributed				-11
Cash and Non-Cash Assets in Possession of Debtor				36
TOTAL ASSETS			**$**	**210**
LIABILITIES				
Estimated payment to Creditors and Claimants			$	70
Proposed Securities Litigation Claims Settlement[c]				10
TOTAL LIABILITIES			$	80
ESTIMATED EQUITY AFTER INITIAL DIVIDEND AND PAYMENT OF LIABILITIES			**$**	**130**

[a] As part of its settlement with the FDIC, First City received a dividend of $200 million from the $434.5 surplus generated by the sale of the old First City banks. First City would receive additional settlements of about $70 million through the closure of loss-sharing agreements with 20 former First City banks, the FDIC and the new owners of the First City Banks. Another $40-45 million could be returned to First City after all litigation claims were settled, which was the expected surplus in a fund held to satisfy such claims. This statement is contingent on court confirmation of the bankruptcy plan. If the plan were not confirmed by a specified date, there would be no settlement.

[b] GCR (gross cash recovery assets) are non-cash assets within the First City bank receiverships which are valued by the FDIC at amounts higher than their market value.

[c] This amount is part of the settlement of many claims against First City, agreed to before the reorganization plan could be accepted.

While legal proceedings continued, the FDIC put the 20 banks up for sale, receiving bids totaling $434.5 million more than the banks' deposits, an amount which would mean the FDIC would incur no losses as a result of its repossession of First City Bancorporation (also referred to as "Old First City").

In fact, the sale of the banks plus the sale of old First City's other assets would leave the FDIC with a surplus.[15] The sale price was considerably higher than expected, and 50% more than the price old First City expected, and 50% more than the price old First City expected when it was planning to sell 13 of its banks under its pre-FDIC closure plan.[16] The FDIC attributed the higher bidding than expected to *"a better market for banking franchises and improved perceptions of the economy."*[17] Texas' banking in particular was considered to be on the rebound. First City – minus its 20 banks – was left with its non-bank assets, its claims on the surplus generated by the FDIC sale of the banks and net operating loss carryforwards (NOLs) available to a reorganized First City.

3. The Competing Bankruptcy Plans

3.1. Some Early Plans

Several groups initially competed to bring First City out of bankruptcy. In November 1994, three groups filed plans in Dallas bankruptcy courts to revive the bank: First City management, 21 International Holdings of New York and a joint venture of J-Hawk, and Cargill Financial Services. 21 International, owner of the 21 Club in New York, planned to incorporate First City into its auto finance business. In December 1994 Advanta Corp. expressed an interest in bidding for First City, but withdrew its interest later that month. In January, 21 International withdrew its bid for First City.

3.2. "The Joint Plan"

Subsequently, First City filed a unique plan of reorganization (the "Joint Plan") that contained three alternatives: the Primary Merger Alternative (PMA), the Secondary Standalone Alternative (SSA), and a

15. Texas Commerce Bank (TCB), a unit of New York's Chemical Banking Corp., bought 73% of old First City's assets, including its Houston and Dallas banks, for $347 million. TCB laid-off about 1,800 old First City employees and closed down the Houston headquarters when it consolidated old First City's assets into its own. Frost National Bank of San Antonio bought 6% of First City's assets for $38 million, and Mercantile Bank of Brownsville bought 5% of the assets for $14 million. Other purchasers included Victoria Bank & Trust, First National Bank of Lubbock, Texas, Alice Bank of Texas, FBOP Corp. of Oak Park, Ill., First National of Olney, Texas, and Corpus Christi National Bank. About 40 groups bid for all or part of First City's assets.
16. This sale was terminated when the FDIC closed the old First City banks.
17. "FDIC Sells First City Bancorp of Texas to 12 Banks", Bloomberg News Service, January 27, 1993.

Under, the PMA (management's preferred plan), post-bankruptcy First City (i.e., First City minus its 20 banks) would merge with J-Hawk Corporation to form a new company specializing in valuing distressed assets.[18] If the PMA were not implemented, the Plan would adopt the SSA, which was simply the Joint plan, but without a merger with J-Hawk. This alternative was included because it was deemed a viable plan in and of itself, and because its implementation as an alternative would avoid a repetition of the expensive plan confirmation process. The SSA would provide substantially less revenues and net income than the PMA, with revenues of $31.7 million in 1996, declining to $8.8 million by 1998 and zero thereafter, with revenues from the collection of loans and sale of assets received in the FDIC lawsuit. This contrasts with revenues of $25.2 million under the PMA, with revenues increasing every year, to $34.7 million by 2000.

Appendix 2 discusses details to the SSA. Suffice it to say here that the primary source of value in the PMA was the merger possibility. Section 5 elaborates on the sources of value in the PMA.

3.2.1. The Basic Structure of the PMA

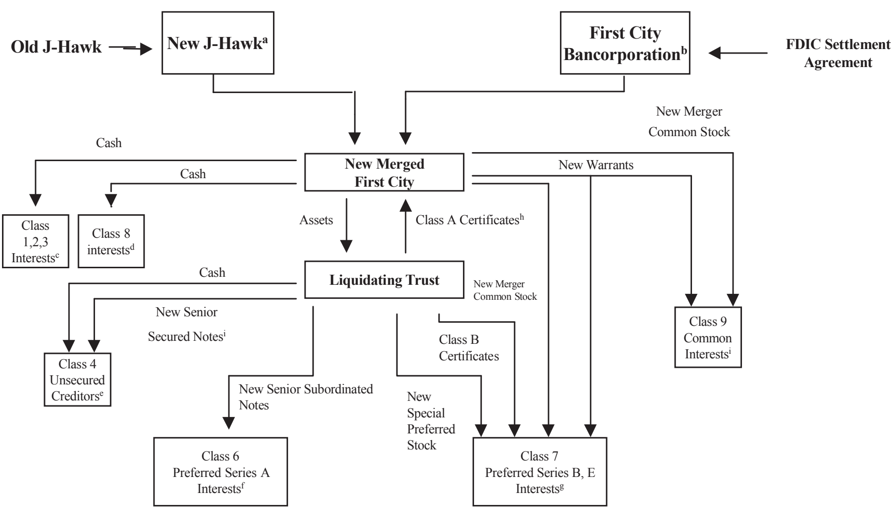
FirstCity Financial Corporation (FCFC) would be created by merging First City with "New J-Hawk", a spun-off segment of J-Hawk Corporation (Figure 1). New J-Hawk would contribute all of its assets (book value $20 million) to the merger. First City would contribute $20 million equity from the FDIC settlement, assets not used to settle claims, and around $650 million in net operating loss (NOL) carry forwards. J-Hawk would bring in Cargill Financial Services Corporation (CFSC) as an equity partner.[19] CFSC would provide up to $100 million in subordinated debt or equity to partnerships to be organized by new First City.

FCFC would make cash payments and issue new securities to the claimants either directly or indirectly through a liquidating trust. Virtually all of FCFC's assets would be assigned to the Liquidating Trust that, in turn, would issue Class A certificates to FCFC. FCFC would in turn take the Class A certificates and issue common stock and warrants to First City's creditors and shareholders. FCFC would begin with 5 million outstanding shares

18. J-Hawk was founded in 1986 and, by 1994, it became one of the largest independent providers of distressed asset services. In 1994 J-Hawk had about 100 employees in its five offices in Texas, South Carolina, Connecticut, Pennsylvania, and Virginia. Other than its Texas headquarters, all the offices are temporary – opened as convenient locations to service its portfolios, and closed once the portfolios are sold.
19. CFSC was a wholly owned subsidiary of Cargill, Inc., one of the world's largest privately-held companies. CFSC would pay certain of J-Hawk's fixed expenses and half of all approved valuation expenses incurred in J-Hawk's search for prospective portfolio purchases.

(estimated book value $40 million). J-Hawk would own 2,460,511 of these shares (about 49.9% of the stock), with First City equityholders owning about 43% of the company. The new company reserved 230,000 shares (about 5%) of common stock in a stock option plan. CFSC would receive about 100,000 shares (2% of FCFC shares).

Figure 1: The Primary Merger Alternative (PMA)
The figure shows the contributions of J-Hawk and First City Bancorporation to FCFC, and shows the position of the liquidating trust. It details the various claims on First City Bancorporation assets, and the distributions that each claimant would receive under the Primary Merger Alternative (PMA). The figure describes both the claims and the settlements received by



[a] J-Hawk contributed about half of the equity in FCFC from its existing assets, book value of $20 million.
[b] First City Bancorporation of Texas contributed about half of the equity ($20 million) in FCFC, primarily from its settlement agreement with the FDIC and with its assets that were not seized by the FDIC.
[c] Class 1 (Priority Claims), Class 2 (Secured Claims) and Class 3 (Settled claims of various claimants) were unimpaired classes in the bankruptcy settlement. Class 1 and 2 claims were paid
in full. Class 3 claimants were paid according to the agreed upon settlements. Class 3 claims included the EDS claim of $10.5 million, BONY claim on $5.5 million, a group of 55 additional claimants, and the FDIC.
[d] Part of the settlement to Class 8 (subordinated claims) included $7 million cash plus interest, and minus fees and expenses, plus First City's stock interest in Citizens State Bank in Sealy, Texas.
[e] Class 4 interests Unsecured Claims) were paid $49.1 million in cash. They also received $16.9 million in new senior secured notes, maturing in 6 months and paying 7% interest. The settlement also included $65 to $70 million owed to unsecured creditors. 90% of their claim

[f] Class 6 (Series A Preferred Stock, 635,650 shares) claims were valued at $103,968,504. These claimants received new senior subordinated notes in payment of their claim. Class 6 interests received $105.6 million in new senior subordinated notes, paying 8% interest and due 2 years after the first interest payment was made.
[g] Class 7 (Series B Preferred Stock, 2,347,396 shares, valued at $172,240,224 and Series E Preferred Stock of 102,404 shares valued at $8,315,776). These claimants received new special preferred stock, Class B certificates, new merger common stock and new warrants. Class 7 received $30.8 million in new preferred stock with a 15% dividend, par value of $.01/share, nominal stated value of $14.22/share, and to be redeemed three years after the first interest payment was made. Class 7 also received $33 million in Class B certificates, paying $62.8 million three years after the first interest payment was made. They received 1,722,638 common shares of FCFC, 35.1% of the total shares outstanding; 250,000 warrants, 50% of the warrants issued by FCFC, with a $30 exercise price, representing 5% of outstanding shares; and any residual from FCFC's asset pool.
[h] Almost all of First City's assets were assigned to the liquidating trust. The liquidating trust would, in turn, issue Class A certificates, which represented the remainder after its preferred stock and bond securities to First City claimants, to FCFC. FCFC in turn issued stock and warrants to Class 7 and 9 interests.
[i] Class 9 (Common Interests). The residual equity holders of old First City (holders of 18,942,219 common shares) would receive new merger common stock and new warrants. These interests received 738,273 common shares of FCFC (15% of the total) and 250,000 warrants,
50% of the warrants issued by FCFC with a $30 exercise price (5% of outstanding shares). Common shareholders also would receive any residual from FCFC's asset pool. Class 10 (Common Equivalents) claimants, holders of old First City options and warrants, received no distribution, and their claims were cancelled.

3.2.2. Treatment of Allowed Claims under the PMA

A bankruptcy plan requires a firm to be separated into claimant classes, Figure 1 shows the type of each claim against First City, and the settlement proposed under the PMA. The liquidating trust was fully responsible for settling old First City's claims, and immunized the new company from claims from these creditors beyond what they received from the liquidating trust. Any assets left over after creditors were paid would become assets of FCFC. First City common shareholders would receive equity and warrants in new First City.

3.3. The Creditors' Plan

The Creditors' reorganization plan contained two options: Option A – continued litigation with the FDIC, and Option B – the consummation of a modified FDIC Settlement and the liquidation of First City's assets under the exclusive control of the creditors until such time as they are paid in full.

Option A was aimed at providing First City with a quick exit from Chapter 11 because it did not depend on a settlement with the FDIC. Under Option B, if the FDIC settlement was not approved by the Court or consummated by the effective date, the creditors would be paid back with the assets First City had on hand and expected to recover either through a revised settlement or litigation against the FDIC.

4. Resolving Dissention and Information Asymmetries

4.1. Disagreements about the Plans

The Creditors Committee claimed that its proposal was superior because it: a) forced the FDIC to settle immediately, or else litigation would resume, b)
continued First City as a corporation, c) was not dependent on J-Hawk's d) paid the creditors in full without the need to wait until 1997 to see if the FDIC would honor the settlement agreement, e) allowed for the distribution of equity securities, but no cash dividends or other cash payments until the creditors had been paid in full. Creditors and some shareholders objected to the Joint Plan primarily because they believed First City was settling its $1 billion lawsuit with the FDIC for too little. Creditors were also concerned about what it considered excessive salaries and bonuses to be paid to new management, post-merger, under the PMA.

The Creditors criticized the Joint plan arguing "the FDIC Agreement not only has an outside closing date of three years but also enjoins the Debtor from taking any action for three years in the event the agreement does not immediately close…. the Debtor's thought process (i.e. to do nothing) is self evident."

The Joint Plan proponents had their own criticisms of the Creditors' Plan. They noted that since the Creditors' Option B requires significant concessions from the FDIC, which the FDIC has continually refused to make, the Creditors Committee's Plan is really contained in Option A, the 'litigation option' in which the Reorganized Debtor under the control of the creditors would go back to litigating with the FDIC. The Joint Plan noted that "There would be nothing available for distribution to Equity Security Holders unless and until there was a favorable outcome to the litigation."

4.2. The Courts' "Judicial Weighting"

These and other serious disagreements presented a major challenge not only to the Debtors, Creditors and other claimants, but also to the bankruptcy Judge, Harold Abramson. How would the Court handle (in the context of confirmation) the problems arising from the complexity and informational asymmetries among the debtor, creditors, and the government? How would the extreme contention among the various constituencies be resolved?[20] How would the Court evaluate the veracity of the information in the competing plans? How would the Court determine, before confirming a plan, whether the best interest test was, in fact, satisfied? These matters were important for at least four reasons – first, as noted in Section 2.5, the FDIC surplus was being depleted by FDIC bankruptcy costs ($2.5 million per month). Second, resolving differences among the disparate groups with independent investment banker teams would cost the estate an additional $3 million,[21] third, how would the Judge ensure that the best interests test was met? Finally, unless the contention was resolved, the potential for an appeal of the Courts' eventual ruling was significant.

4.3. Reducing Contention and Informational Asymmetries

To reduce complexities from incomplete information and bargaining problems, Judge Abramson, relying on the Federal Rules of Evidence 706, appointed a Court's expert to act as a common party for the various constituencies, and to conduct an economic analysis of the various alternatives. This would obviate the need for expensive testimony from experts for each constituency. His motivation was that a "pooling" of all relevant information with a "disinterested person" [Bankruptcy Code Section can provide a more objective valuation analysis. The expert was given free access to all parties and allowed to request privileged and confidential written and oral information available from any party – the DIP (debtor in possession), equityholders, creditors, securities litigation claimants, tax consultants, the FDIC, and the Creditors' Committee. He was also given permission to seek outside accounting help. The expert was asked to evaluate the economic structure of competing plans after obtaining information from the various parties, conduct independent investigations and analyses, and to make a

20. A columnist dubbed First City "Fist City" because of the contentious nature of the stakeholders in the company. ("First City Bancorp. Common Seen Worth $3 a Share in Liquidation", Bloomberg News Service, October 6, 1994.)
21. This estimate and discussion of the potential for an appeal is from a 1/10/95 letter to Judge Abramson from the Law Firm of Harvey Greenfield, Counsel for the class action litigants ("the Krim litigation").

recommendation to the Judge with a valuation of claims under the recommended plan. The Court empowered the Expert to initiate, at his sole discretion, contact with any attorney, to seek any and all information from the parties and to resolve differences though either meetings in person or in telephone conferences. The Expert was authorized to examine Texas Commerce Bank's records (loss sharing agreements). Further, the Court directed the FDIC to share its confidential information with the Expert, as necessary, information that neither the equityholders nor the creditors had. If the Expert and the attorneys could not resolve any issues it was to be brought to the Court for a resolution.[22]

The objectives of the court at the confirmation hearing were to determine whether: a) Holders of claims and equity interests would receive greater distributions under the management's plan versus Chapter 7 liquidation, and b) The confirmed plan was fair and equitable with respect to, and did not discriminate unfairly against, any impaired class of claims.

4.4. Comparing the Competing Reorganization Plans

The subsequent discussion explains how the Court's Expert compared the Joint Plan with the Creditors' Plan. Let V_{PMA}, V_{SSA},V_{OpA} and V_{OpB} represent the economic value of the PMA, the SSA, Creditors' Option A and Option B respectively. Let P_{PMA} , $P_{SSA,}$ P_{OpA} , P_{OpB} represent the probability that the respective plan would be implemented.

Since the Joint Plan contains two alternatives (to liquidation), its economic value:

$$E(V_J) = P_{PMA}*V_{PMA} + P_{SSA}*V_{SSA.}$$

Similarly, the economic value of the two alternatives in the Creditors' Plan is:

$$E(V_C) = P_{OpA}*V_{OpA} + P_{OpB}*V_{OpB}.$$

It was assumed (with concurrence by the attorneys) that both the SSA and the Option B alternatives were equally likely to be implemented under their respective plans ($P_{SSA}= P_{OpB}$), thus implying that $P_{PMA}/ P_{OpA} = 1$. It was further agreed, in discussions with the Creditors' Committee, that $V_{SSA} = V_{OpB}$. It follows that $E(V_J) > E(V_C)$ if (V_{OpA}/ V_{PMA}) is less than unity. Thus, the problem was reduced to the following: If $V_{PMA}>V_{OpA}$, the Joint Plan is

22. The practice of appointing a Courts' Expert although not routine, is not uncommon. Generally, this procedure leads to a Court's confirmation decision because the judge's choice of expert is approved by the relevant competing parties.

economically superior. If $V_{PMA} < V_{OpA}$, the Creditors' Plan has more economic value.[23]

4.5. The Best Interests Test

By cumulating the value of all claims, the market value of the PMA as submitted to the Court was estimated to be $359,000,000. To evaluate whether the confirmed plan satisfies the court-required "best interests test" a summary of values received under three restructuring alternatives is contained in Table 3. The estimates in Table 3 clearly demonstrate that the old First City/J-Hawk merger plan provides the most over all value, and is in the best interest of old First City creditors. That is, the PMA satisfies the requirements of the best interests test. As shown in Table 3, the Liquidation option only provides a partial payment of $40,300,000 to Class 4 creditors, and no payments to the remaining creditors. The SSA provides full payment to Class 4 creditors and partial payment to remaining creditors, a total of $243,424,329. The PMA provides full payment to all debt holders, a total of $299,985,851 and additionally provides $58,904,633 in equity to the new corporation.

23. Under this procedure for comparing the plans, the question of how to value the Creditors' Option B became moot. The Court Expert had maintained that the Creditors' Option B numbers were not consistent with the discussion in their disclosure statement.

Table 3: Valuation of Claims

Table 3 summarizes the valuation of each of the First City claimants under the various alternatives.

Claim	**Value under PMA**	**Value under SSA**[f]	**Value in Liquidation**[g]
J-Hawk (2,460,511 shares of new merger common stock - 2,460,511 x $23.94)[a]	$58,904,633		
Class 4 interests (Old First City creditors)[b]	66,090,287	$66,090,000	$40,300,000
Class 6 interests (old Class A preferred stockholders)[c]	105,623,929	88,582,895	
Class 7 interests (old Class B preferred stock)[d]		87,651,434	
New special preferred stock	30,791,698		
Class B certificates	33,180,727		
New merger common stock	41,239,954		
New warrants	2,692,500		
Class 9 interests (common stockholders)[e]	20,366,756	1,100,000	
Total Value	**$358,890,484**	**$243,424,329**	**$40,300,000**

[a] J-Hawk contributed half the equity of FCFC from its existing assess. The shares of FCFC were valued at $23.94 a share by the Court's Expert. This valuation of the stock and warrants is

[b] Class 4 interests were paid $49.1 million in cash and $16.9 million in senior secured notes, maturing in 6 months and paying 7% interest. Cash flows would be $49,100,000 immediately and $17,491,500 in six months. Discounted at 5.9%, the 26-week Treasury bill rate, as of March 1, 1995, the discounted value of the cash flows is $60,090,287.

[c] Class 6 interests received $105.6 million in new senior subordinated notes, paying 8% interest and due two years after the first interest payment was made. The cash flows are $2,079,370 in quarterly interest payments, with principal amount of $51,984,250 paid after one year, followed by quarterly interest payments of $1,039,685 for the second year and repayment of the remaining $51,984,254 in principal at the end of the second year. Using a discount rate of 7% (slightly higher than the risk-free rate of 5.9%), the present value of the cash flows is $105,623,929.

[d] Class 7 interests received $30.8 million in new preferred stock with a 15% dividend, par value of $.01 a share, nominal stated value of $14.22 a share, and to be redeemed three years after the first dividend payment was made. They also received $33 million in Class B certificates, paying $62.8 million three years after the first interest payment was made, along with 1,722,638 common shares of FCFC, 35.1% of the total shares outstanding and 250,000 warrants, 50% of the warrants issued by FCFC, with a $30 exercise price, representing 5% of outstanding shares; and any residual from FCFC's asset pool. Cash flows for the preferred stock would be $1,312,500 every quarter for 3¼ years. The last payment would be interest plus $35 million repayment, a total of $36,312,500. With a discount rate of 20.13% (calculated in Appendix 3), the present value of these cash flows is $30,761,698. Class B certificate holders would receive a payment of $62,800,000 in 3¼ years after the formation of FCFC, with a present value of $33,180,727, using a discount rate of 20.13%. New common stock and warrants is valued in Appendix 3.

[e] Class 9 interests received 738,273 common shares of FCFC, about 15% of the total. They also received 250,000 warrants, 50% of the warrants issued by FCFC, with a $30 exercise price, representing 5% of outstanding shares; and any residual from FCFC's asset pool.
[f] The secondary alternative valuation is valued in Appendix 2 of this paper.
[g] Note that this is the valuation amounts for impaired creditors. Administrative claims and Class 3 claims were paid in full, a total amount of $5,600,000, discounted at 7.5%. The liquidation alternative valuation was provided by First City Bancorporation and is discussed in Appendix 2.

The benefit to equity holders from J-Hawk's involvement is the difference between the class 9 equity values in the merger plan versus the standalone plan, $20,366,756 minus $1,100,000, or $19,266,756.

5. Factors Favoring the PMA

The Court Expert eventually concluded and recommended to the Court that the Joint plan: a) economically dominates the Creditors' Plan because the PMA was superior to the Creditors' Option A, and b) that the PMA created about [24] Some of the (not mutually exclusive) factors that formed the basis for this recommendation are discussed below.

Veracity of Cashflow Estimates. The cash flow projections in the Joint Plan were made jointly by J-Hawk and First City's management. In its earlier business, J-Hawk first valued its potential acquisitions by estimating projected cash flows, appraising the properties, physically inspecting the sites, and using this information to determine a purchase price for each asset. Since its inception, J-Hawk had acquired over $1 billion in principal amount assets at a cost of $471.5 million. It had provided its investors with a 51% return on equity in 1993 and 28.6% in the first nine months of 1994. This track record, attributed to a great extent to its skills at forecasting flows from distressed assets, provided credibility to the Plan forecasts.

Management Team. First City owned a large portfolio of distressed assets, and intended to use J-Hawk's expertise to manage those assets. J-Hawk and First City's management had a comparative advantage in the distressed assets business. The management of First City, especially its President, Robert Brown, had an intimate knowledge of the assets held by First City and it was believed that this would be an invaluable asset in the handling of the liquidating trust. This specialized information coupled with the J-Hawk's experience in distressed assets was viewed as a key advantage for FCFC.

24. The NPV of J-Hawk's investment under the PMA was estimated to be almost $37million.

Synergies of Scope. The First City-J-Hawk merger was seen to provide several competitive advantages for the new firm. FCFC would offer a wide range of services including portfolio valuation, management services, and disposition of assets. Many of its competitors were involved in only one or of these areas. In addition, it would conduct operations in all parts of the country, giving it an advantage over competitors who were limited to either a specific type of distressed asset or a certain geographical area.

Involvement by J-Hawk's Prior Business Partner. J-Hawk had previously participated in joint ventures in distressed asset purchases and sales with Cargill Financial Services Corporation (CFSC), a wholly owned subsidiary of Cargill, Inc., one of the world's largest privately-held companies. Under the PMA, CFSC had the right to participate as an equity investor in potential asset purchases. CFSC's involvement was considered a major plus in the merger plan.[25]

Regulatory Environment. The consolidation of financial institutions provided J-Hawk with continuing sources of distressed assets.[26] The FDIC and RTC had fewer distressed assets for sale now, and their role as the primary sellers of distressed assets had been largely replaced by commercial banks and insurance companies. Continuing consolidation in the banking industry and increasing regulatory pressure to dispose of non-performing and underperforming assets was seen as providing continuing business for new First City. It was estimated that FCFC would acquire $70 million in distressed assets per quarter, with growth of 2% per quarter, which is consistent with J-Hawk's current level of business activity. The projected gross margin is 25%. FCFC would finance future acquisitions following its existing capital structure, with FCFC contributing 2% equity, CFSC 2% equity, senior lenders 70% debt and CFSC 26% subordinated debt.

Acccess to Capital. Merging with First City gave J-Hawk better access to the public debt and equity markets, allowing it to raise new capital to expand its growing businesses. The new company would continue to need senior debt financing in order to continue growth in the distressed assets business. FCFC's partnership with CFSC was designed to ensure a continuing source of new funds. FCFC was expected to benefit from its association with CFSC though its access to that company's large financial resources.

---

25. CFSC's primary business is investing in funds, trading financial instruments and assets, securitizations, leasing, and investing in emerging markets. CFSC, founded in 1984, manages about $6 billion in assets through its 17 worldwide offices.
26. Financial institutions like commercial banks and insurance companies must allocate more regulatory capital to underperforming and non-performing assets, making it more cost effective for the institutions to sell such assets.

6. Emerging from Bankruptcy

In perfect financial markets with symmetric information, the process of evaluating whether a company should be liquidated or reorganized is, in principle, an exercise in the valuation of future cash flows. The situation, however, is dramatically complicated in a world with informational asymmetries, heterogeneous claimants, contracting rigidities, and government entities. The difficulties stem from the absence of common information, outcomes that are to be adjudicated and determined dynamically during the bankruptcy process, and contract payoffs determined not by the original contract provisions but through negotiation among the lawyers. Moreover, many contracts' payoffs are endogenous (moral hazard, political risk, nonmarketability of claims etc.) and, in the language of Grossman (1995), they suffer from "incomplete equitization" and lack objective market valuations. The question then becomes one of exactly how the reorganization plans are to be evaluated by the Court.

This paper discusses First City's bankruptcy from beginning to the end, illustrating the administrative process under which the Court conducted its "judicial weighting" in an extremely contentious environment with severe information asymmetries and competing interests. The creation of FCFC has been described as a "…very rare case" as "most banks in First City's position were liquidated and went away."[27]

Recognizing the complexities arising from the lack of common information, Franks, et. al. (1996) suggest that the role of the bankruptcy code must be to promote low-cost information production. In this regard, Section 101 (14) of the Bankruptcy Code, which provides for the use of a Court's Expert to aid the judge in his judicial weighting, may be justified on the basis of efficiency arguments in a world of informational asymmetries, unclear legal outcomes, and voluntary departures from originally contracted provisions.

With very high administrative costs and extreme complexity in First City's economic and legal environment, virtually no party had reasonable confidence in its own projections and lacked the knowledge to mount any serious attack on the projections of other parties. Consider the fact that the goal of the Omnibus Disclosure Statement was to reduce informational asymmetries. First City had prepared the Omnibus Disclosure Statement. There was, in general, no independent audit of the financial information contained in the Omnibus Statement and the numbers were derived from "…numerous sources including, but not limited to, the Debtors Books and Records, the Debtors' Schedules and Statement of Affairs, Proofs of Claim and Other documents filed with the bankruptcy court, and certain documents obtained through discovery from the Federal Deposit Insurance Corporation in both its corporate

27. See "Nothing Succeeds like Distress", *Business Week*, December 23, 1996.

capacity and as a receiver of the former First City Banks and Collecting bank, ...” (p.3, Omnibus). Neither First City, the plan Proponents nor counsel for the First City of its Plan Proponents would warrant or represent that the information provided was without inaccuracy. Further, both the Bankruptcy Court and the SEC explicitly stated that they would not take a position on the accuracy and adequacy of statements in the Omnibus Disclosure Statement. How then, could the Court evaluate the reasonableness of competing claims and proposals? This is a non-trivial matter because the Court’s confirmation decision would have both efficiency and equity (fairness) implications. Moreover, the Court’s decision would further be subject to post-confirmation appeals.

The Judge’s use of a Court’s Expert to evaluate the available information, generate new information, do independent evaluations of competing positions, served as a mechanism for negotiating some agreement among seemingly intransigent factions (Section 4.4.). The Judge’s judicial weighting was based on recommendations derived from better information, independent analyses, specific agreements among the lawyers, and most importantly, the outcome of a process that all parties had agreed to ex ante. It was presumably useful in making an informed judgment about the merits of alternative plans. Absent agreement among the various parties to abide by the Judge’s decision to employ a Court expert, the litigation would have been prolonged. The economic costs associated with continuing litigation was enormous and an inefficient resolution of the matter could have potentially destroyed all entire economic value that currently exists.[28] Moreover, the timing of the FDIC offer was critical for the success of the reorganization. The FDIC offer was triggered by the fact that the real estate markets were assessing the assets at far more than either First City or the FDIC had expected (Section 2.5.). The Court Expert mechanism was critical for estimating the cash flows from the Liquidating Trust (Section 5.2.). This not only speeded up the process and reduced bankruptcy costs, but also lowered the possibility of post-confirmation appeals.

It is well known that mergers can be important in bankruptcy reorganizations and this case illustrates some reasons why – the merger partner’s prior track record, its expertise and its business alliances offered the reorganized company management expertise, access to additional funds, and other competitive advantages (Section 4.5.). The merger partner and incumbent management had a clear advantage over creditors and other groups in justifying projected cash flow estimates that were critical for plan

28. The competing plans were filed in December 1994 and the confirmation of the reorganization was in May 1995. However, there were prior reorganizations, and it is difficult to meaningfully compare the time First City spent in bankruptcy with other similar companies in bankruptcy. Hard data is difficult to come by anecdotal evidence suggests that the average time for a large bankruptcy resolution is about 4 years.

confirmation. Issuing securities through a liquidating trust (rather than directly from FCFC, Figure 1) was designed to immunize J-Hawk and CFSC from claims arising from First City's bankruptcy. Surprisingly, in light of the enormous uncertainty about the feasibility of using $650 million in NOLs, it was agreed to value the reorganized firm as if these tax benefits would not materialize (fn.29, Appendix 2)).

The result is an example of the use of Chapter 11 bankruptcy proceedings as the law originally intended. Bankruptcy gave First City Bancorporation a "second chance." Chapters 11 allowed the firm to divest its banking assets, retain the non-bank assets, including a portfolio of distressed real estate, and become a well-functioning company. The bankruptcy process resulted in greater value to all the participants than would have occurred in a liquidation, which might have been the result of FDIC closure of the First City banks.

The joint plan proved to be a success. FCFC officially began business on July 3, 1995, with former J-Hawk executive James R. Hawkins as chairman and C. Ivan Wilson, former First City chairman, as vice chairman of the new company. Former J-Hawk executive James T. Sartain is president, and Robert Brown, former First City president, is president of the unit overseeing the liquidating trust. After its emergence from bankruptcy, FCFC received an initial installment of $170 million ($130 million in cash and $40 million in assets) from the FDIC in July 1995, of which $66 million was immediately used to repay old First City creditors. The remainder of the settlement from the FDIC would be paid out over the next five years. On July 12, FCFC repurchased about $200 million in loans and real estate from Texas Commerce Bancshares and Cull-Frost Bankers. This purchase ended the loss sharing agreements the FDIC had with the banks and allowed the FDIC to turn over an
additional $90 million in assets to FCFC.

7. Conclusion

The First City Reorganization points to the importance of recognizing that standard valuation procedures that apply to a viable company with traded claims may not, by themselves, be adequate for evaluating the value of contingencies, the contracting and negotiation during the administrative process of bankruptcy was far more important in evaluating the economics of the competing plans. The economic analysis was based on modifications of cash flow forecasts included in the disclosure statements, with new information and additional terms and conditions "agreed upon" as "reasonable" among the lawyers and the bankruptcy court. It would be useful to study other large bankruptcies to identify common elements of the reorganization process that can provide useful information for firms, academics, legal analysts, and policy makers.

References:

Bernardo, Antonio E. and Eric L. Talley (1996), "Investment Policy and Exit-Exchange Offers within Financially Distressed Firms", *Journal of Finance* (51) pp. 871-888.

Betker, Brian L. (1995), "An Empirical Examination of Prepackaged Bankruptcy", *Financial Management*, Vol. 24, No. 1, Spring, pp. 3-18.

"Omnibus Disclosure Statement for each of the competing plans of reorganization for First City Bancorporation of Texas, inc. Under chapter 11 of the Bankruptcy Code", December 23, 1994, United States Bankruptcy Court, Northern District of Texas, Dallas Division.

"Committee of Unsecured Creditors' Disclosure Statement With Respect to its First Amended Plan of Reorganization for First City Bancorporation of Texas, Inc, Under Chapter 11 of the United States Bankruptcy Code, as Modified", December 23, 1994.

"The Joint Plan of Reorganization by First City Bancorporation of Texas, Inc., the Official Committee of Equity Security Holders of First City, and J-Hawk Corporation", December 24, 1994.

Franks, Julian R. and Walter N. Torous (1989), "An Empirical Investigation of U.S. Firms in Reorganization", *Journal of Finance* (44), pp. 747-769.

Franks, Julian R., K. G. Nyborg and W. N. Torous (1996), "A Comparison of US, UK, and German Insolvency Codes", *Financial Management*, Autumn, 86-101.

Gilson, Stuart C., E. H. Hotchkiss and R. S. Ruback (2000), "Valuation in Bankrupt Firms", *The Review of Financial Studies*, v.13, no. 1, 43-74.

Grossman, Sanford (1995), "Dynamic Asset Allocation and the Information Efficiency of Markets", Presidential Address, *Journal of Finance,* Volume 50, Issue 3, 773-787.

Hotchkiss, Edith Shwab (1995), "Postbankruptcy Performance and Management Turnover", *Journal of Finance* (50), pp. 3-21.

Kaplan, Steven N. and Richard Ruback (1995), "The Valuation of Cash Flow Forecasts", *Journal of Finance*, September.

Miller, Merton H. (1977), "The Wealth Transfers of Bankruptcy: Some Illustrative Examples", *Law and Contemporary Problems* 41.

Miller, Merton H. (1991), "Tax Obstacles to Voluntary Corporate Restructuring", *Journal of Applied Corporate Finance* 4, no.3, 20-23.

Rao, Ramesh K.S. with D.S. Sokolow and D. White (Fall 1996), "Fiduciary Duty a la Lyonnais: An Economic Perspective on Corporate Governance in a Financially Distressed Firm", *Journal of Corporation Law*, Vol.22, Number 1.

Weiss, Lawrence A. and Karen H. Wruck (1998), "Information Problems, Conflicts of Interest and Asset Stripping: Chapter 11's Failure in the Case of Eastern Airlines", *Journal of Financial Economics* (48), pp. 55-98.

Wruck, Karen H. (1990), "Financial Distress, Reorganization and Organizational Efficiency", *Journal of Financial Economics*, v27(2).

Appendix 1: First City Timeline

April 1988 - First City Bancorporation is organized as a multi-bank holding company headed by A. Robert Abboud, chairman of the board.

1990 - First City becomes financially distressed.

March 1991 - C. Ivan Wilson replaces Abboud as chairman of the board.

Summer 1992 - First City proposes "Plan C", its re-organization plan that does not require FDIC participation.

October 30, 1992 - First City banks in Houston and Dallas declared insolvent by FDIC.

October 31, 1992 - Remaining First City banks are declared insolvent. Unsecured creditors file involuntary Chapter 11 bankruptcy petition against First City.

November 24, 1992 - Creditors Committee appointed by the bankruptcy court.

November 29, 1992 - First City files suits against the FDIC in Dallas civil court.

December 2, 1992 - First City files adversary petition against FDIC to obtain records and certain assets.

January 27, 1993 - FDIC announces sale of the 20 First City bridge banks.

February and March 1993 - FDIC closes the bridge banks and places them into receivership. Assets and liabilities of the banks are transferred to the buyers.

March 8, 1993 - Equity Committee appointed.

June 11, 1993 - First City filed additional administrative claims against the FDIC.

September 24, 1993 - First City files a lawsuit against the FDIC, charging that the FDIC wrongfully seized the bank's assets.

October 8, 1993 - First City and the FDIC agree to suspend the lawsuit in order to begin settlement talks.

December 17, 1993 - Tentative settlement of the suit between First City and the FCIC announced.

June 1994 - Proposed agreement reached between First City and the FDIC.

November 1, 1994 - Three groups file plans in Dallas bankruptcy court: First City management, 21 International and J-Hawk/Cargill Financial Services.

December 5, 1994 - J-Hawk and First City file a joint bankruptcy plan.

December 23, 1994 - Equity committee announces its support for the joint merger plan.

February 24, 1995 - Deadline for voting on the First City/J-Hawk plan.

March 16, 1995 - Announcement of the approval of the First City/J-Hawk plan.

April 17, 1995 - Creditors committee agrees to the joint plan.

May 1995 - Bankruptcy court agrees to the joint plan.

July 3, 1995 - First City merges with J-Hawk, becoming FirstCity Financial Corp.

August 11, 1995 - First City Financial Corp. buys Diversified Financial Systems and Diversified Performing Assets.

Appendix 2: The Secondary Standalone Alternative (SSA) and the Liquidation Alternative

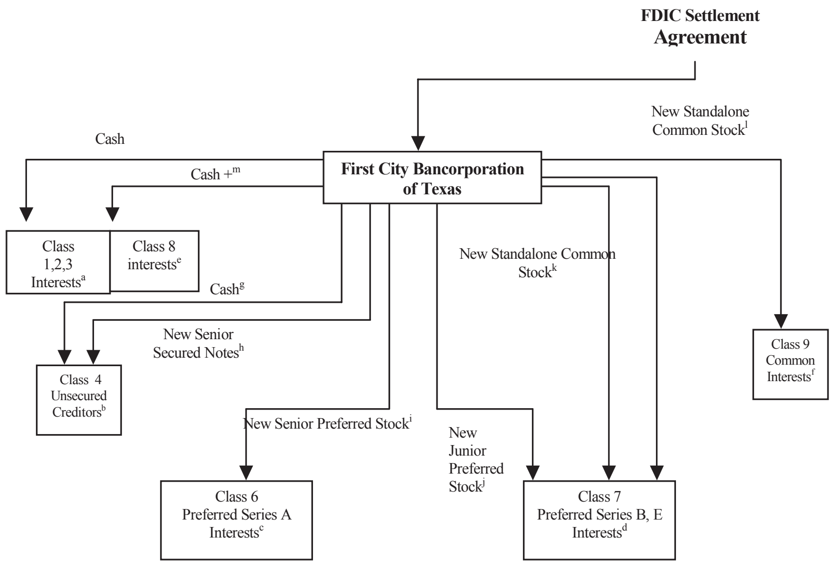
New Standalone First City would also be a company specializing in managing distressed assets. After settling its bankruptcy obligations, it would seek out new ventures or liquidate. The standalone plan is illustrated in Figure A2-1. As with the merger plan, administrative and unsecured creditors would be paid as detailed in the primary plan. Class A preferred stock would be converted into new senior preferred stock. Class B and E preferred stock would be converted into new junior preferred stock equal to $55 per share.

This plan has many of the same uncertainties as the merger plan, for example in the valuation of assets and amounts to be received from the FDIC. Management of New Standalone First City would be uncertain. Under the merged plan J-Hawk's management would take over new First City operations. Other uncertainties included final settlement amounts of the various pending lawsuits, loss sharing agreement settlement (or no settlement) amounts, availability of tax loss carryforwards, interest rates, rates on investments in marketable securities, and a possibly delayed effective date for the settlement.

Asset contributors to New Standalone First City would be First City Bank Corporation of Texas[29] and the FDIC.[30] A summary of distributions from the SSA is contained in Figure A2-1.

29. Existing Assets plus $650,000,000 in NOLs.
30. $200,000,000 in initial receivership distribution ($124,500,000 in cash, $10,500,000 paid by the FDIC receiver on behalf of First City, $65,000,000 in assets, including real estate of $20,777,000 and loans of $27,223,000) plus additional future distributions based on the liquidation of FDIC receiverships ($110,000,000 with loss sharing agreement or $125,000,000 without loss sharing agreements.

Figure A2-1: The Secondary Standalone Alternative (SSA)
The figure shows the claims on First City's assets and proposed distributions to each class of claimants under the standalone plan.



[a] Class 1,2,3 claimants were to be treated the same as under the Primary Merger Alternative (PMA).
[b] Class 4 (Unsecured Creditors) claimants were to be treated the same as under the PMA.
[c] Class 6 (Series A Preferred Stock) to receive new senior preferred stock. Estimated recovery: 100%.
[d] Class 7 (Series B and E Preferred Stock) to receive new junior preferred stock and new standalone common stock.
[e] Class 8 (Securities Litigation Claims) were to be treated the same as under the PMA.
[f] Class 9 (Common Interests) were to receive new standalone common stock. Class 10 holders of options and warrants would receive no distribution, the same as under the PMA.
[g] Class 4 claimants would receive \$49.1 million in cash.
[h] Class 4 claimants would receive \$16.9 million in new senior secured notes, maturing in 6 months and paying 7% interest.
[i] Class 6 claimants would receive \$88.6 million, or 635,650 shares, of new senior preferred stock, with a stated value of \$163.56/share, paying an 8% dividend.
[j] Series B holders would receive \$82.6 million in new junior preferred stock, 2,336,971 shares, with a nominal value of \$55/share, a 10% dividend, and redeemable in 10 years. Series E holders would receive \$4 million in new junior preferred stock, 112,829 shares.
[k] Series B holders would receive 4,769,718 shares of common stock in the standalone company, valued at \$1,049,338. Series E holders would receive 230,282 shares of new standalone common stock, valued at \$50,662.
[l] Class 9 interests would receive 5,000,000 shares of new standalone common stock, valued at \$1,100,000.
[m] Part of the settlement to Class 8 litigation interests included \$7 million cash plus interest and minus fees and expenses, plus First City's stock interest in Citizens State Bank in Sealy, Texas.

Balance sheet and income statement data for the standalone plan show that this plan would provide substantially less revenues and net income than the primary merger plan, with revenues of $31.7 million in 1996, declining to $8.8 million by 1998, with revenues obtained from the collection of loans and the sale of assets received in the FDIC lawsuit settlement. Total assets would decline as the company's debts were paid.

The liquidation alternative provided less to creditors than either the PMA or the standalone alternative. Under Chapter 7 liquidation, Classes 1,2 and 3 would receive 100% of their claims, as under the PMA and SSA. Class 4 creditors would receive $50.1 million (undiscounted) of their $66 million claim. The remaining classes would not receive any distributions from the bankruptcy.

Appendix 3: Impaired Claims Valuation

Many of the cash flow projects and valuations assumptions were subject to negotiations and agreement with the various constituencies. Balance sheet and income statement projections for FCFC are contained in Table A3-1. FCFC was slated to begin with $40 million in equity, with about half contributed by old First City, and half by J-Hawk. Old J-Hawk and First City shareholders and old First City preferred shareholders were the shareholders in FCFC. This equity was predicted to grow at 29% to 48% annually, following the growth of net income at rates from 7% to 43% annually. The new company anticipated revenues from distressed asset servicing fees and from its acquisition partnerships to increase from $25.2 million in 1995 to $34.7 million in 2000. Book value per share was expected to climb from $8 at the inception of the new company to $33.20 by 2000. Similarly, earnings per share were expected to grow from $3.29 in the first full year of operation, 1996, to $7.60 by 2000, representing a growth rate of 7% increasing to 37% per year by 2000. This represents a return on equity averaging 27.6% per year and a return on investments averaging 40.4% per year. Table A3-1 also contains information on the projected cash flows for the reorganized First City.

Table A3-1: New Merged First City Projected Schedule of Cash Flow for Ongoing Operations

This table details the cash flows for the merged First City/J-Hawk Operation projected for the next five years.

The table shows growth in revenue and earnings, selected balance sheet and income statement data.

Information is taken from the Joint Plan of Reorganization Disclosure Statement, unless otherwise noted.

As of April 1, 1995 and the Five Years Ending March 31, 2000.

(Amounts in millions of dollars)

		1-Apr 1995 (Inception)	Year Ending 31-Mar 1996	Year Ending 31-Mar 1997	Year Ending 31-Mar 1998	Year Ending 31-Mar 1999	Year Ending 31-Mar 2000
	Balance Sheet Data						
1	Cash	21.3	27.2	34.5	46.4	85.6	123.3
2	Equity in Investments of Acquisition partnerships	17.7	28.2	38.5	47.9	54.3	58.3
3	Other Assets	1.0	1.0	1.0	1.0	1.0	1.0
4	Total assets and New Common Equity	40.0	56.4	74.0	95.3	140.9	182.6

Table A3-1: New Merged First City Projected Schedule of Cash Flow for Ongoing Operations

	Income Statement Data						
5	Trust Assets Service Fees		6.0	3.3	1.1	0.0	0.0
6	Other Servicing Fees		6.4	9.2	11.3	13.0	14.7
7	Equity in Earnings of Aquisition Partnerships		12.8	13.7	15.2	17.2	20.0
8	Total Revenue		25.2	26.2	27.6	30.2	34.7
9	Administrative Expenses		9.8	11.1	11.9	12.2	12.9
10	Income Taxes Expense[a]		0.4	0.4	0.5	0.7	0.9
11	Interest on cash balances		1.5	2.8	6.1	13.2	20.9
12	Net Income		16.5	17.5	21.3	30.5	41.8
	Cash Flow Data						
13	Net income		16.5	17.5	21.3	30.5	41.7
14	Less Partnership income		(12.8)	(13.7)	(15.2)	(17.2)	(20.0)
15	Adjusted Net Income		3.7	3.8	6.1	13.3	21.7
16	Acquisition partnerships Distributions		8.2	9.9	12.7	18.4	24.1
17	Investments		-5.9	-6.4	-6.9	-7.5	-8.1
18	Proceeds from Warrants					15.0	
19	Net Cash Flow		6.0	7.3	11.9	39.2	37.7
	Beginning Cash		21.3	27.2	34.5	46.4	85.6
	Ending Cash		27.3	34.5	46.4	85.6	123.3
20	Average Cash		24.3	30.9	40.5	66.0	104.5
	Per Share Information						
21	Earnings per share[b]		$ 399.20	$ 399.40	$ 399.60	$ 363.45	$ 363.64
22	Book Value per share[c]	$8.00	$ 11.28	$ 14.80	$ 19.06	$ 25.62	$ 33.20
23	Shares Outstanding (mil)	5	5	5	5	5.5	5.5
	Financial Statistics						
26	Return on Equity[d]		34%	27%	25%	26%	26%
27	Tax Provision Rate[a]		2.12%	2.12%	2.12%	2.12%	2.12%
28	Interest rate on cash		6%	9%	15%	20%	20%
29	Return on investments[e]		56%	41%	35%	34%	36%

Table A3-1: New Merged First City Projected Schedule of Cash Flow for Ongoing Operations

	Growth of:					
30	Cash[f]	28%	27%	34%	84%	44%
31	Investments[g]	59%	37%	24%	13%	7%
32	Equity	41%	31%	29%	48%	30%
33	Other servicing fees[h]	-10%	44%	23%	15%	13%
34	Equity in earnings of Aquisition Partner-ships[i]	198%	7%	11%	13%	16%
35	Administrative Expenses[j]	-4%	13%	7%	3%	6%
36	Net Income[k]	239%	6%	22%	43%	37%
37	Adjusted Net Income[l]		3%	61%	118%	63%
	Acquisition Partnerships					
38	Distributions[m]		21%	28%	45%	31%
39	Investments[n]		8%	8%	9%	8%
40	Earnings per share[o]		7%	22%	30%	37%
41	Book Value per share[p]		31%	29%	34%	30%

[a] Rate from Omnibus, page 70. See references. Taxes are low because of the use of net operating losses. FCFC would only have to pay the alternative minimum tax, estimated at 2% of income before taxes.

[b] Line 12/Line 23

[c] Line 4/Line 23

[d] Line 12/(prior year Line 4 + Line 4)/2

[e] [Line #7/((prior year line #2 + Line #2)/2)]

[f] [(Line #1 - prior year line #1)/prior year Line #1]

[g] [(Line #2 - prior year Line #2)/prior year Line #2]

[h] [(Line #6 - prior year Line #6)/prior year Line #6]

[i] [(Line #7 - prior year Line #7)/prior year Line #7]

[j] [(Line #9 - prior year Line #9)/prior year Line #9]

[k] [(Line #12 - prior year Line #12)/prior year Line #12]

[l] [(Line #13 - prior year Line #13)/prior year Line #13]

[m] [(Line #14 - prior year Line #14)/prior year Line #14]

[n] [(Line #15 - prior year Line #15/prior year Line #15}

[o] [(Line #21 - prior year Line #21)/prior year Line #21]

[p] [(Line #22 - prior year Line #22)/prior year line #22]

Classes 4, 6 and 7 receive securities issued by the liquidating trust rather than from FCFC. This provision was designed to immunize FCFC, J-Hawk and CFSC from claims arising from First City's bankruptcy. The liquidating trust issued all securities to satisfy First City claims, with FCFC receiving any residual after all claims were paid. Thus, to value the New Senior Secured

Notes, New Senior Subordinated Notes, New Special Preferred Stock, and Class B Certificates, the information in Table A3-1 is insufficient; one must estimate the expected cash flows from the liquidating trust. Since the Joint Plan made no attempt to separately identify the cash flows from the liquidating trust, these were developed by the Court Expert based on responses to specific questions sent out to the various parties. The cash flows for the liquidating trust are presented in Table A3-2 which shows sources of cash from the FDIC settlement, interest earned on cash balances, proceeds from the sale and collection of loans received in the FDIC settlement.

Table A3-2: New Merged First City Liquidating Trust Cash Flows

Table A3-2 details the cash flows for the liquidating trust for new merged First City, as of April 1, 1995, and for the four years ending March 31, 1999

New Merged First City

(Amounts in Millions)

	1-Apr 1995 (Inception)	Year Ending 31-Mar 1996	Year Ending 31-Mar 1997	Year Ending 31-Mar 1998	Year Ending 31-Mar 1999
Sources of Cash					
From Debtor[a]	19.2				
From FDIC Settlement[a]	124.5	20	20		
Interest on cash balances[b]		1.5	1.5	4.6	1.5
Proceeds from sale of:					
Collection of loans		11.3	11.3	5.7	
FDIC and Debtor assets		12.1	19.5	8.8	
Loss Sharing Pool assets		60	60	30	
Loan loss recovery			20		
Total Sources of Cash	143.7	104.9	132.3	49.1	1.5
Uses of Cash					
Interest on Senior note[c]		0.6			
Interest on Subordinated note[d]		8.3	4.2		
Dividends on Special Preferred		5.3	5.3	5.3	1.3
Servicing expenses		6.0	3.2	1.1	
Direct trust expenses		2.5	2.3	2.0	
Investment in new company	20.0				
TCB Loss Sharing Agreement[a]		52.0			
Interest on FDIC note[c]		2.0			
Total uses of Cash	20.0	76.7	15.0	8.4	1.3
Net Cash Flow	123.7	28.2	117.3	40.7	0.2
Beginning Cash Balance	0.0	57.2	(8.5)	56.9	97.7

Table A3-2: New Merged First City Liquidating Trust Cash Flows

Cash Before allocations	123.7	85.4	108.8	97.6	97.9
Cash Allocated to A certificates	66.5	93.9	52.0	0.0	35.0
Cash Allocated to B certificates	57.2	(8.5)	56.8	97.6	62.9
Reconciliation of Class A Certificates					
Proceeds from Trust	66.5	93.9	52.0	0.0	35.0
Payments to Bankruptcy Creditors at Inception					
Administrative Claims	3.0				
Tax and Gap Claims	0.4				
Class 3 Creditors[c]	14.0				
Class 4 Creditors[c]	49.1				
Class 5 Creditors	0.0				
Total Payments to Creditors	66.5				
Principal Payments of:					
Senior Secured Notes[c]		16.9			
Subordinated Notes		52.0	52.0		
Redemption of Special Preferred					35.0
FDIC Note[a]		25.0	0.0	0.0	
Total Principal Payments	0.0	93.9	52.0	0.0	35.0
Total Cash Used by Class A	66.5	93.9	52.0	0.0	35.0

* Numbers taken from the Joint Plan of Reorganization, and from information provided by the Court's Expert

[a] From Omnibus Disclosure Statement, Exhibit 4

[b] Average at 6%

[c] Numbers taken from information from the Court's Expert after the Joint Plan of Reorganization was prepared.

[d] Balance at 8%

FCFC expected to receive cash and assets from the FDIC over a three-year period of time from 1995-1998. The line "Cash Allocated to A certificates" is the money allocated to unsecured creditors and old Series A preferred shareholders, the money left over after higher priority claimants were paid. The unsecured creditors were paid $66.5 million in 1995 at the inception of FCFC, with $57.2 million available to remaining creditors, now also equity holders in FCFC. The unsecured creditors and Series A preferred shareholders creditors were to receive repayment in full of their new debt in 1996 and 1997. Debt repayment included payment of a $25 million note to the FDIC, part of the lawsuit settlement in 1996. Special preferred stock of $35 million, issued to old Series B and E preferred shareholders was scheduled to be redeemed in

1999. This plan called for sizable balances remaining to holders of the B certificates issued to old Series B and E preferred shareholders, as noted in the line "Cash available to B certificates".

An equity discount rate is needed to value new common stock and warrants. The CAPM was used to estimate the discount rate on equity. Beta was estimated using the pure play method.[31] There are few directly comparable firms in the distressed asset disposal business which are publicly traded. This analysis evaluated firms recommended by J-Hawk and others based on the Standard Industrial Classification (SIC) System. Comparable firms first were classified as nondepository credit institutions, insurance agents, brokers and service, real estate, holding and other investment companies, and business services. Table A3-3 lists firms selected as comparable to new First City.

---

31. Project risk was estimated conservatively. The betas listed are equity betas, which means effects of leverage are included in beta; in other words, beta reflects both asset risk and financing risk. Normally, pure play analysis would reduce betas by removing the leverage effects. To be conservative, this was not done. Second, rather than take the average beta for the sample, the highest beta is used, further raising the required rate of return.

Table A3-3: Firms Comparable to FirstCity Financial Corporation
Table A3-3 lists firms found to be comparable to FirstCity Financial Corp., showing the companies' betas and price-earnings ratios.

Firm	Market	Symbol	Beta	P-E
Advanta Corp.	NASDAQ	ADVNB	1.65	12
Alleghany Corp.	NYSE	Y	0.50	8
American General Corporation	NYSE	AGC	1.50	24
Amresco Inc.	NYSE	BCN	0.70	N/A
Beneficial Corporation	NYSE	BNL	1.20	12
Countrywide Credit Industries Inc.	NYSE	CCR	2.20	13
Countrywide Mortgage Investments	NYSE	CWM	0.80	N/A
First American Financial Corp.	NYSE	FAF	0.70	12
Green Tree Financial Corporation	NYSE	GNT	2.49	14
Household International, Inc.	NYSE	HI	2.30	13
Mercury Finance Company	NYSE	MFN	1.49	22
Stewart Information Services Corp.	NYSE	STC	1.40	11
Sumamerica Inc.	NYSE	SAI	2.30	11
United Asset Management Corp.	NYSE	UAM	1.60	18
World Acceptance Corp.	NASDAQ	WRLD	0.03	25

In this sample, the average beta of the comparable firms is 1.39, the highest beta is 2.49, the average price earnings (P/E) ratio is 15 and the lowest P/E is 8 times.

The historic average risk-free rate is 3.7% and the historic average market return is 10.3%.[32] From the CAPM: $E(R_i) = R_F + \beta_i[E(R_m) - R_F] = 0.037 + 2.49[0.103 - 0.037 = 20.13\%$ The annual rate of 20.13%, or quarterly rate of 5.0325% was used in the equity calculations.

Dividend Growth Model

The analysis also assumes that no dividends are paid until the end of the 4th year, the last period for which financial statements are provided. Half of the projected net income of $41,800,000[33] at the end of the fourth year is assumed to be paid out as dividends. This is a fairly high dividend payout ratio and will

32. These estimates are from "Stock, Bonds, Bills and Inflation 1993 Yearbook", Ibbotson Associates, Chicago, Ill. These numbers are the average for the period 1926-1992. This figure is the average on all common stocks and provides a more conservative return estimate than if the return on small stocks is used. The return on small stocks during this period was 12.2%.
33. This number is from Table 3, net income for the year 2000.

lead to more conservative estimates of value. The amount of the dividend, \$20,900,000 is assumed to be paid out quarterly, giving a quarterly dividend of \$5,225,000. It is also assumed that the warrants are exercised in year 4, adding 500,000 shares to the existing 5,000,000 shares outstanding. This means dividends per share will be \$0.95.[34]

The dividend growth rate (g) is estimated to be equal to the retention ratio times the return on equity. The retention ratio is 50%. The return on equity, as calculated from the financial statements in Table 3 is 34% in year 1, 27% in year 2, 25% in year 3 and 26% in year 4. The average ROE is 27.6%. To be conservative, the lowest ROE of 25% is used in the analysis. These numbers produce a dividend growth rate of 12.5% a year, or a quarterly dividend growth rate of 3.125%: $g = (0.50)(.25) = .1250$

The value of the stock at the end of the 15th quarter is discounted to the present using the equity rate of return is \$50.00(0.4788), or \$23.94.[35]

The value of a share of FCFC common stock is \$23.94. The total value of new common stock to Class 9 interest is 738,273 shares times \$23.94, or \$17,674,256. The value of the remaining 250,000 warrants issued to common shareholders is 250,000(\$10.77), or \$2,692,500. The total value to new First City shareholders is the sum of these, or \$20,366,756.

Value of New First City Warrants

It was agreed that the warrant would be valued at its minimum value (stock price minus the exercise price). Compounding the value of the stock at a rate of one fourth of the equity return of 20.13%, the value at the end of the 16th period (4 years) is \$52.50. The value for a warrant at the end of four years is \$52.50 - \$30, or \$22.50 and its present value using the equity rate of return of 20.13%, is \$10.77.

FCFC common stock can also be valued using Price/Earnings (P/E) ratios. The P/E ratio is a widely used common stock analysis statistic. P/E ratio is equal to price per share divided by earnings per share. It can be used to value stock using the following relationship:

P/E ratio x Earnings per share = Price per share

34.
$$Div_{16} = \frac{\frac{\$41{,}800{,}000(0.5)}{4}}{5{,}500{,}000} = \$0.95/\text{share}$$

35. The value of the new common stock is:
$$S_{15} = \frac{Div_{16}}{k_s - g} = \frac{\$0.95}{0.0503 - 0.0313} = \$50.00$$

Here, S_{15} is the stock price at the beginning of the first dividend payment period, Div_{16} is the first dividend paid, k_s is the equity rate of return and g is the dividend growth rate.

The Earnings per share (EPS) for each year projected by the PMA are:

Year 1: \$3.29
Year 2: \$3.51
Year 3: \$4.26
Year 4: \$5.54
Year 5: \$7.60

Using a conservative (average) P/E ratio from the comparative firms in this appendix, and using the lowest EPS given above, the price per share is estimated as:

Price per share = (15)(\$3.29) = \$49.33.

The present value of this amount at the effective date of the merger is:

$\$49.35/PVF0_{.0503,\ 16} = \$49.35(0.4560) = \$22.50$