



**National Warranty Insurance Risk
Retention Group (in Provisional
Liquidation) (“NWIC”)**

Report of the Joint Provisional
Liquidators

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1 Executive Summary

NWIC is a risk retention group incorporated in the Cayman Islands and operating from Lincoln, Nebraska for the purpose of writing insurance for its members to cover their obligations under vehicle service contracts (“VSCs”). It also provides claims handling and administrative services in respect of such VSCs.

Shortly after their appointment, the JPLs determined that there were sufficient doubts about NWIC’s solvency and decided that creditors’ interests would be best protected by NWIC ceasing to write new business, and by suspending the payment of claims.

The appointment of the JPLs was precipitated by threatened legal action against NWIC by the DeltaGroup and, should this succeed, NWIC would undoubtedly be insolvent. Even without the DeltaGroup claims, there are grave concerns about the underlying profitability of the other insurance contracts and the reliability of NWIC’s claims handling and reserving procedures. As a result, there is virtually no possibility of NWIC continuing as a going concern.

The liquid assets of NWIC are estimated at \$24.5 million with possible additional recoveries from reinsurance and tax refunds. The JPLs are unable to estimate the recoveries, if any, that may be possible from litigation against the Directors or NWIC’s former professional advisors.

The JPLs have carried out a preliminary actuarial analysis of the reserves required for non-DeltaGroup business, which indicate a mid-point best estimate of total outstanding losses and reserves of \$66 million.

It follows that, in an official liquidation, creditors are unlikely to receive more than a 50% distribution, even if the DeltaGroup claims fail, and substantially less should they succeed. These estimates are based on current assets available and do not take into account future expenses of running NWIC’s operations, the cost of the liquidation and legal costs.

The JPLs are acutely aware of the potential for expenses to make substantial inroads into the assets available for creditors, especially since the monthly costs of continuing to operate NWIC’s offices in Lincoln are estimated to be \$500,000 per month.

Several of the major insured groups are unable to fund claims payments from their own resources so that their ability to continue in business is dependent on receiving funding from NWIC. The failure of such groups could lead to additional claims against NWIC and the JPLs and prejudice the interests of the related VSC holders.

Therefore, the JPLs have entered into negotiations with the major insured groups (representing over 95% of non-DeltaGroup creditors) and DeltaGroup to try to agree a course of action which will allow some funds to flow to the insureds to relieve their current liquidity problems and thereafter result in a compromise agreement and/or scheme of arrangement. It is hoped that the results of these negotiations will be able to be submitted to the Cayman and the US Courts for ratification and approval in the near future.



NWIC's winding up proceeding not only has the complexities of cross-border and cross-jurisdictional issues, it also has the complication that NWIC was registered to do business in every mainland State in the US. As a result, the many thousands of car owners and dealers affected by NWIC's current situation have made their State Insurance departments the first point of reference complaints.

It will take some time to sort out the issues surrounding NWIC, the next stage of which will be the hearing of the Winding-Up Petition in the Grand Court of the Cayman Islands on August 1, 2003.

2 Glossary of Terms and Abbreviations

"Allen and Overy"	The JPLs' legal counsel in New York, New York, USA.
"APA"	American Prime Asset - a member of NWIC and a company in the DeltaGroup.
"ASC"	Automotive Services Company – a member of NWIC.
"Mr. Bullmore"	Theo Bullmore – the Managing Partner of KPMG in the Cayman Islands and one of the JPLs.
"CIMA"	The Cayman Islands Monetary Authority
"Mr. Costin"	Dennis Costin - a director of NWIC.
"Creditor Group"	ASC, Triad, IWMC and Warranty Gold
"DeltaGroup" or "Delta"	The Delta group of companies including APA and SC&E
"Delta Dispute"	As per the definition in the Winding-up Petition of 4 June
"Directors"	Don Erway and Dennis Costin, the current directors of NWIC.
"Mr. Erway"	Don Erway - the founder and a director of NWIC
"IWMC"	Independent Warranty Management Corporation, a member of NWIC.
"JPLs"	Mr Bullmore and Mr Whicker, Joint Provisional Liquidators of NWIC
"Mr. Moats"	Rex Moats - the in house legal counsel of NWIC.
"Maples and Calder"	The JPLs' legal counsel in the Cayman Islands.
"NWIC"	National Warranty Insurance Risk Retention Group (in Provisional Liquidation)
"PORCs"	Producer Owned Reinsurance Companies.
"\$"	US Dollar – the legal currency of the US
"SC&E"	SC&E Management Services. A member of NWIC and a company in the DeltaGroup.
"Triad"	Triad Marketing Group, a member of NWIC.
"US"	United States of America
"VSCs"	Vehicle Service Contracts – a contractual agreement between an obligor, usually a car dealership, and car owner covering specific types of repair to the owner's car.
"Warranty Gold"	A member of NWIC.
"Mr. Whicker"	Simon Whicker - a Partner of KPMG in the Cayman Islands and one of the JPLs.
"Woods and Aitken"	The JPLs' legal counsel in Lincoln, Nebraska, USA

3 Background

3.1 NWIC's business

NWIC is a Risk Retention Group formed under the US Federal Risk Retention Act of 1981, incorporated and regulated in the Cayman Islands. In addition, NWIC was registered to do business as a Risk Retention Group in all of the mainland States in the US. The Risk Retention Act in the US directs that a Risk Retention Group can only issue policies to its members. Accordingly every policyholder is also a member.

NWIC's main business is insuring its members against liabilities arising under Vehicle Service Contracts ("VSCs") or Warranties issued by its members. NWIC itself is not permitted to issue policies directly to the general public. This means that there is always at least one entity between the VSC holders and NWIC. These intermediate entities are referred to as the primary obligor on all VSCs or warranties and they, and not NWIC, are liable for any claims in the first instance.

The members of NWIC are made up of marketing agencies, vehicle dealerships and companies that market VSCs or warranties. These VSC programs typically cover a time period of between three months up to seven years. As a Risk Retention Group, NWIC is like, but is not, an insurance company; the word "insurance" is used in its name because the concept of Risk Retention Groups is alien to many people.

NWIC has been in operation since 1984 and has always traded out of Lincoln, Nebraska. It currently occupies a leased office near the centre of Lincoln and employs approximately one hundred and thirty people.

3.2 NWIC's financial problems

The financial and legal situations facing NWIC were covered in some detail in the Winding-up Petition filed on 4 June 2003 and the supporting affidavits of Mr Erway and Mr Moats, respectively. However, the JPLs now consider that NWIC's financial position is significantly worse than the Court was originally advised.

The JPLs have confirmed that major financial difficulties confronting NWIC result from NWIC's dispute with two of its Group members, APA and SC&E, both of which are controlled by the DeltaGroup.

NWIC also has other current, future and contingent liabilities relating to business underwritten with other members and these liabilities have raised doubts about the solvency of NWIC.

NWIC held about half of its assets in cash or liquid bank balances, which enabled it to continue to meet its liabilities as they fell due. However, it would appear that NWIC lacks sufficient reserve assets to meet future and contingent liabilities.

This situation would appear to have arisen due to the claims on the VSCs being significantly greater in value than the original reserve amounts that were set aside to meet expected losses. Furthermore, NWIC's recording of operations did not keep pace with its expanding business.

The Delta Dispute itself would appear to have started late in 2002 when NWIC anticipated it was not going to be able to meet all of its liabilities in connection with the VSCs that had been written by the DeltaGroup companies. At that time, NWIC approached DeltaGroup for assistance in meeting the likely shortfall.

One other member, Warranty Gold, was approached by NWIC towards the end of 2002 for financial assistance in order to address a funding shortfall on some of Warranty Gold's books of business. The shortfall was to be funded primarily out of revenue expected to be produced from the selling of future VSCs.

Without an improvement in the VSC claims ratio, it was only a matter of time before NWIC's assets and future revenue became insufficient to meet its liabilities. The Delta Dispute caused NWIC to address its problems and accelerated the identification of the depth of NWIC's financial difficulties.

One crucial factor in NWIC's current situation is that it has lost the support of its members. Many active members have lost confidence in the current management of NWIC and would not be willing to continue to direct business its way even if it should be able to avoid liquidation. This means that there is little realistic hope of NWIC being able to continue as a going concern.

4 NWIC's financial position

4.1 Position as at 31 May 2003

The JPLs' staff have conducted several interviews with NWIC's Directors, its President and in-house Counsel.

These interviews revealed that there is such a serious lack of reliable financial information available from NWIC's financial systems to the extent that the Directors are unable to determine from NWIC's own records whether it is solvent or insolvent.

This problem is characterised by the fact that the Directors are unwilling to sign the financial statements of NWIC for 31 December 2002 year end audit, which to date remains outstanding.

Several projections of NWIC's liabilities (present, future and contingent) have been completed by the underwriting function of NWIC, but the Directors and Officers have been unable to agree upon the accuracy of these projections. These projections all indicate serious concerns that NWIC's liabilities (excluding Delta) are at such a level that NWIC's assets will be insufficient to meet such liabilities in due course.

4.2 Position as at 20 June 2003

The information supplied to date and reviewed by the JPLs has not been of sufficient reliability to enable the JPLs to make a definitive determination as to the accurate financial position of NWIC. Review of the financial data is continuing and future reports will incorporate detailed analysis once this has been prepared.

Although NWIC currently holds relatively large cash balances and would be able to pay its current debts in full as they fall due, on a balance sheet basis NWIC's present, future and contingent liabilities are likely to be significantly greater than the assets available to meet them.

It had been calculated by NWIC's management that, assuming there is no change in claim experience, the cash held by NWIC would probably run out within the next 12 months or so, even if it continued to take on new business. Over the last 18 months, claims payments have averaged more than \$12 million per month and the monthly costs of providing the administrative function for paying such claims has been running at more than \$500,000 per month.

NWIC has a reinsurance policy, although the level which losses must reach before NWIC may have a claim on the policy is very high. The JPLs are currently assessing the potential for making a claim against the reinsurer.

4.3 Major Balance Sheet items

4.3.1 Assets

4.3.1.1 Cash Position as at 20 June 2003

On 3 June 2003, prior to being placed into Provisional Liquidation, NWIC redeemed the majority of its investments and transferred the resulting cash balances to a bank in the Cayman Islands. These balances and those of the other US bank accounts totalled \$23,147,636 as at 20 June 2003.

4.3.1.2 Control of Bank accounts

The JPLs issued letters to all of the relevant banks seeking to take control of NWIC's bank accounts and balances. The JPLs have been successful in either obtaining control of, or at least freezing, the following accounts:

- All accounts registered in the name of NWIC (on balance sheet accounts).
- All accounts held in trust for Warranty Gold programs.

The JPLs were unable to obtain control over certain US bank accounts including the Delta escrow accounts, for the following reasons:

- There is uncertainty at some of the relevant banks as to the validity and jurisdiction of the Cayman Court Orders appointing the JPLs over accounts held at banks in the United States of America.
- The accounts are not all registered in the name of NWIC.
- NWIC through its representative Mr. Erway is not the only signatory on the account.

Steps have been taken to freeze these accounts, however, pending confirmation of the status of the funds held therein.

4.3.2 Liabilities

4.3.2.1 Actuarial review - KPMG

Due to the lack of reliable financial information, the JPLs considered it essential to bring in an actuary to test and review the NWIC projections and perform an actuarial review of NWIC's liabilities.

Between 24 and 27 June 2003, an actuary from KPMG Actuarial Services Department in the Cayman Islands attended the offices of NWIC in Lincoln, Nebraska with the aim of producing a report on NWIC's anticipated loss projections. The main conclusion is that total estimated insurance losses as at 24 June 2003 probably fall in the range \$57.9 million to \$73.8 million.

4.3.2.2 Liabilities on DeltaGroup business

NWIC has not accounted for any potential liability to DeltaGroup on its balance sheet. Given the nature of the Delta Dispute, the JPLs are aware that there may be a liability to DeltaGroup of up to approximately \$160 million. Section 6.1 below gives more detail regarding the situation with DeltaGroup.

4.4 Off balance sheet reserve accounts

The total purchase price of a VSC is divided into many parts and allocated to several different parties. The dealer that sells the VSC takes a commission, as do marketing agents. NWIC was paid a portion for the administrative function that it performed and also took a premium relating to the insurance coverage NWIC was providing to its policyholder. The funds that remained after all commissions and other deductions had been taken are referred to as the 'reserves', and these funds were often placed into 'reserve accounts'.

There are different ways in which the funds that relate to the VSCs have been treated and accounted for. For the Delta business, there are several hundred reserve accounts that are held in the names of PORCs, and these are administered by SC&E Administrative Services on behalf of the dealers and agents. They are not held in the name of NWIC.

Warranty Gold had an arrangement whereby the funds were placed in accounts on trust for the benefit of the VSC holders. The balances of these accounts as shown in section 6.2.2 are not held on NWIC's balance sheet.

Some programs, however, were administered whereby NWIC took all of the funds into its own account, and then made a journal record of what the reserve balance should be. In these cases, for example Triad business, the reserve balances of the VSCs were co-mingled with NWIC's assets.

5 The JPLs' initial actions

5.1 Chronology of main events

- 6 June 2003 – Provisional Liquidation order made.
- 6 June 2003 – First Press Release.
- 9 June 2003 – Decision made to stop paying claims and writing new business.
- 13 June 2003 – Revised Provisional Liquidation Order made.
- 18 June 2003 – Second Press Release.
- 20 June 2003 – Third Press Release.
- 20 June 2003 – Commencement of section 304 proceeding and issuance of Temporary Restraining Order in US Bankruptcy Court.
- 24/27 June 2003 – Actuarial review performed to assess level of losses.
- 24 June 2003 – Discussions with members commenced regarding potential proposals.
- 30 June 2003 – Continuation of section 304 Temporary Restraining Order to 11 July.
- 9 July 2003 – Fourth Press Release.
- 11 July 2003 – Stipulation for Preliminary Injunction on same terms as the section 304 Temporary Restraining Order and continuance of hearing date to 5 August.

5.2 Initial indications of insolvency

On 6 June 2003, following the making of the Provisional Liquidation Order, two of the JPLs' staff travelled to NWIC's place of business in Lincoln, Nebraska in order to take control of NWIC and its assets.

Several meetings were held with NWIC's key management and staff over the weekend of 7 and 8 June 2003 in order for the JPLs' staff to gain an understanding of NWIC's business affairs and also to assess the urgent issue of the financial position of NWIC.

At this time, the Directors of NWIC could not confirm that NWIC was solvent. Indications were received from initial enquiries with senior management that NWIC may already be insolvent, even without the potential impact of the Delta Dispute on NWIC. Accordingly, the JPLs took the decision on the morning of 9 June 2003 to cease writing any new business, including insuring its members in respect of any new VSCs. To further protect the assets of NWIC, the decision was also made the same morning to stop authorising or paying any further claims.

It was envisaged that these decisions would be a temporary measure whilst the JPLs made a determination of the financial condition of NWIC. However, the preliminary actuarial review carried out by the JPLs supports the conclusion that NWIC is likely to be insolvent.

5.3 Further indications of insolvency

Since making the initial decision on 9 June 2003 for NWIC to cease paying claims and writing new business, the JPLs have devoted a significant amount of time in an effort to clarify the financial position of NWIC and determine whether NWIC is indeed insolvent.

The early indications of insolvency have been confirmed by way of a number of separate issues that have come to the notice of the JPLs, notably:-

- NWIC's own underwriting department's loss projections.
- KPMG's actuarial review broadly confirming the basis and results of these loss projections.
- The position of the DeltaGroup being adversarial with no prospect of further funding.
- The position of the other major members of NWIC and their lack of confidence in NWIC's management.
- Indications that NWIC's claims experience exceeded expectations, confirmed by high average claims rates.

6 Legal issues

6.1 DeltaGroup

The agreements with and involving DeltaGroup, and its companies APA and SC&E, were fully described in the Winding-up Petition filed with the Court on 4 June 2003. The Delta Dispute, as it was defined, was stated to be the single most important issue confronting NWIC. There are a number of interdependent agreements and contracts dated 20 February 2003 which sought to clarify and extend the two agreements of 10 January 2003 and the positions of the DeltaGroup, NWIC and related parties.

The JPLs and their legal advisors spent a considerable amount of time reviewing and considering the Bordereaux Agreement and the Contribution Agreement, both dated 10 January 2003. The majority of the time has been spent analysing whether these two agreements together constitute a valid and enforceable novation of the underlying insurance risks and liabilities, thereby removing NWIC from any liability on these particular books of business. No definitive legal conclusion has been reached on this point.

The JPLs sought to have an early meeting with representatives of DeltaGroup and such a meeting took place of 13 June 2003 at the offices of KPMG in Lincoln, Nebraska. Certain members of the management of NWIC were hoping to meet with the DeltaGroup representatives at the same time as the JPLs but the JPLs were advised by DeltaGroup that NWIC's management would not be welcome at the meeting.

The meeting was useful to the JPLs in confirming their understanding of the nature of the dispute with NWIC. In addition, DeltaGroup left the JPLs in no doubt that there would be no more funding made available to NWIC to rescue it from the current financial position. On the contrary, DeltaGroup take a very adversarial stance with regards to the documentation dated 10 January and 20 February referred to above and have stated that they wish to force NWIC into liquidation in order to bring finality to their relationship with NWIC.

Representatives of DeltaGroup had previously met with CIMA and the JPLs' attorney on 11 June 2003 in Cayman to communicate their position directly to the regulator.

Based on information given to the JPLs by DeltaGroup, their claims against NWIC could be as high as \$160 million, although no formal claim has yet been received by the JPLs. No conclusions have been reached at this stage as to the potential liability NWIC may have to DeltaGroup.

The attorneys for the JPLs are currently liaising with the DeltaGroup's attorneys regarding the reconciliation and status of Delta escrow accounts.

6.2 Warranty Gold

6.2.1 Legal dispute regarding nature of balances in certain US bank accounts

The JPLs' decision on 9 June 2003 to stop the authorisation of claims payments for VSC holders led to discussions with Warranty Gold, for whom NWIC administers several books of business.

On 12 June an agreement was reached pursuant to which Warranty Gold began paying the claims of its VSC holders from its own resources. On 16 June Warranty Gold discontinued the payment of claims and on 20 June Warranty Gold commenced proceedings against NWIC in the Grand Court of the Cayman Islands for declaratory and injunctive relief relating to certain administrative and trust agreements concerning its VSC program with NWIC.

On 24 June, in relation to an application for urgent interim relief by Warranty Gold, Mrs. Justice Levers made an order which had the effect of directing the JPLs to pay the claims of Warranty Gold's VSC holders which had been authorised for payment by NWIC on or before 9 June.

Warranty Gold's application for declaratory and injunctive relief has been adjourned whilst the parties consider the available options. The JPLs are addressing these issues in a non-adversarial manner and it is likely that further directions will be sought from the Grand Court shortly.

6.3 US Bankruptcy Code section 304

In order to protect the assets of NWIC located in the US, on 20 June 2003, the JPLs obtained a Temporary Restraining Order from the US Bankruptcy Court under section 304 of the US Bankruptcy Code.

The Temporary Restraining Order assists the Grand Court and the JPLs as it stays proceedings in the US against NWIC, effectively importing into the US a stay of proceedings similar to that ordered by Mrs. Justice Levers on 6 June 2003. The Temporary Restraining Order is not a permanent order, but is a temporary form of relief. The relief granted in the Temporary Restraining Order has been extended until 5 August 2003, at which time the US Bankruptcy Court will conduct a hearing to consider making such relief more permanent. Interested parties will have an opportunity to object or request a modification of such relief.

7 Negotiations with members/creditors

On 23 June 2003 the Creditor Group met at NWIC's offices to discuss their options concerning the future of their relationship with NWIC.

The JPLs estimate that the Creditor Group represents approximately 95% of non-DeltaGroup creditors.

Following this meeting, the Creditor Group held a conference call with the JPLs to bring to their attention the detrimental effect that the non-payment of claims is having on their businesses, their concern about the level of assets that would be consumed by a prolonged liquidation and their desire to reach an interim agreement under which the JPLs could release sufficient funds to pay underlying VSC claims currently due and expected within the following month.

During the ensuing week, the JPLs discussed this option with their attorneys and took the view that a proposal could be explored if it could be shown that it was in the best interests of the creditors generally. Given the unusual nature of such a proposal, the JPLs would need to have not only the agreement of the DeltaGroup but also the approval of the courts both in Cayman and the US.

The specific details of the proposal are currently being drafted and discussed with the relevant parties with the hope of submitting a proposal to both the Cayman and US courts in the near future.

8 Staff issues

The staff at NWIC have continued to be employed as they have assisted the JPLs in understanding the business issues and the financial position. They have also maintained the call centre, fielding calls from dealers, repair facilities, agents and VSC holders who are enquiring as to the current position of NWIC.

There are approximately 130 staff remaining although steps are being explored to reduce this number significantly now that there is little future for NWIC as a going concern.

As part of this process, the JPLs are being careful to take relevant legal advice on the specific labour and employment law issues that are in force in Nebraska to avoid NWIC incurring any excessive liabilities.

The JPLs are also liaising with existing management with a view to retaining key employees, particularly in the IT, legal, claims and accounting functions. The staff that remain will be able to assist the JPLs greatly in an orderly winding down of the operations and help keep the associated costs to a minimum.

9 Time and Costs

9.1 The JPLs' time costs

Time costs for the period Monday 1 June 2003 to Friday 20 June 2003 total \$151,899. The JPLs received a retainer from NWIC of \$50,000 on 6 June 2003 which has been set against the figure above.

Two members of the JPLs' staff initially spent eight days in Lincoln at NWIC's offices immediately following the Court Order of 6 June 2003. They reported back to the JPLs in Cayman for four days and then returned with two further staff for a further nine days. A list of the issues being addressed by these staff is given below, although this is not exhaustive:-

- Meeting with Directors and senior management.
- Meeting with State of Nebraska Insurance department.
- Dealing with many enquiries from dealers, lawyers, media and staff.
- Compiling financial information relating to NWIC's position.
- Reviewing reports from NWIC staff relating to loss projections.
- Liaising with JPLs' lawyers on a daily basis regarding Cayman, New York, Nebraskan and general US legal issues.
- Informing the Court and CIMA as to developments.
- Meeting with a number of members to discuss their position with regard to NWIC.
- Reviewing documents relating to the Warranty Gold application in the Cayman Court.
- Reviewing staff allocation planning and taking relevant employment law advice.
- The actuarial report.

9.2 The JPLs' advisors' time costs

The time costs incurred by the counsel advising the JPLs up to 20 June 2003 totals \$97,188.

The breakdown for the three firms is:-

Maples and Calder (Cayman Islands)	\$41,608
Allen & Overy (New York)	\$30,761
Woods & Aitken (Lincoln, Nebraska)	\$24,819

The JPLs have been faced with a number of legal issues in Cayman, New York and Nebraska, as well as in a number of other States. It was considered appropriate to select three law firms who would be able to assist the JPLs in a timely fashion without duplication of advice and effort.

Maples and Calder represent the JPLs in Cayman and are dealing with all of the Cayman Court proceedings on behalf of the JPLs. In addition, they are acting as coordinators of the instructions given to the US attorneys and the advice received from them. This does not include, however, the listing of the Winding-up Petition which is being dealt with by Solomon Harris on behalf of NWIC.

Allen & Overy in New York have significant experience in assisting overseas provisional liquidators to obtain protection in the US over the assets of the companies for which they are responsible and in particular international insurance insolvencies. The JPLs have valued the input from Allen & Overy as the JPLs needed to act quickly to obtain the Restraining Order from the US Bankruptcy Court.

Woods & Aitken worked closely with Allen & Overy, filed all the necessary documentation and made the application to the US Bankruptcy Court in Nebraska on behalf of the JPLs. The section 304 hearing was the first of its kind in Nebraska and the Temporary Restraining Order was the first ever granted in that State. Woods & Aitken are also advising the JPLs on local employment issues.

10 The next steps

10.1 Official Liquidation

The Winding-Up hearing has been set for 1 August 2003 in the Grand Court of the Cayman Islands. At the present time, and having reviewed the information that has been made available to date, the JPLs will be supporting NWIC's winding up application.

10.2 Other alternatives

As stated above in section 7, there are currently discussions with the majority of NWIC's creditor base (by value) regarding a proposal to enable an early distribution to the majority of NWIC's creditors. The JPLs continue to assist NWIC and its members in exploring ways in which the assets of NWIC can best be protected and distributed for the greater benefit of all interested parties. Although the JPLs have not identified any viable alternatives to winding-up for NWIC, they remain receptive to any potential settlement that can provide a better return to the general body of creditors.

Should you have any queries regarding the contents of this report please direct them to Keith Blake at KPMG in the Cayman Islands by email at keithblake@kpmg.ky or by telephone on 1 345 914 4378.