

IN THE CHANCERY COURT OF THE STATE OF TENNESSEE
TWENTIETH JUDICIAL DISTRICT, DAVIDSON COUNTY

STATE OF TENNESSEE, ex rel.,)	
PAULA A. FLOWERS,)	
Commissioner of Commerce and)	
Insurance for the State of Tennessee,)	No. 03-3731-IV
)	
Petitioner,)	
v.)	
)	(FILED IN COURT: 5/27/2005)
EXCHANGE INSURANCE COMPANY,)	
a Tennessee domiciled insurance company,)	
)	
Respondent.)	Hearing Date [Reserved] [August 3, 2005, 10:00 a.m.]

**REHABILITATOR’S MOTION TO APPROVE PLAN AND PROPOSED PLAN OF
REHABILITATION**

Petitioner Paula A. Flowers, Commissioner of Commerce and Insurance for the State of Tennessee, as Rehabilitator of Exchange Insurance Company (“EIC”), and Special Deputy Rehabilitator Kathy Fussell, (“the Rehabilitator”), together petition and move the Court through counsel to approve the Plan of Rehabilitation of EIC (hereinafter “Plan”), under Tenn. Code Ann. § 56-9-303(e), at the hearing date to be prescribed by the Court in connection with the simultaneously filed Rehabilitator’s Motion to Set Hearing and Approve Notice of Plan of Rehabilitation:

MOTION TO APPROVE PLAN

1. The Rehabilitator has filed a Plan of Rehabilitation, Exhibit A hereto, designed to shift all EIC’s remaining policy obligations to another insurer and to end EIC’s operation and authority as a Tennessee insurer. Tenn. Code Ann. § 56-9-303(e) states in relevant part:

If the rehabilitator determines that reorganization, consolidation, conversion, reinsurance, merger or other transformation of the insurer is appropriate, the rehabilitator shall prepare a plan to effect such changes. *Upon application of the rehabilitator for approval of the plan, and after such notice and hearings as the court may prescribe, the court may either approve or disapprove the plan proposed, or may modify it and approve it as modified. Any plan approved under this section shall be, in the judgment of the court, **fair and equitable to all parties concerned**.* If the plan is approved, the rehabilitator shall carry out the plan.

The Rehabilitator moves the approval of the Plan because the Plan submitted herewith is fair and equitable to all parties concerned, based on the following facts and legal considerations:

2. Summary: The policyholders' interests and insurance coverage by EIC are protected by the plan to substitute National Lloyds Insurance Company (NLIC) as the insurer or surety for EIC. Finishing the wind-down of EIC's insurance business that started in 2003, the Plan will transform EIC by causing its insurance policies to be assumed by NLIC, another qualified company, under the Assumption Agreement attached to the Plan, and discontinuing EIC's authority to conduct an insurance business. The Plan makes adequate arrangements for payment and administration of EIC's outstanding contractual obligations to policyholders, surety obligees and insurance-related creditors by shifting these obligations to NLIC. The Plan substitutes NLIC, which has already been reinsuring part of EIC's policies and managing its run-off business through an affiliate, as insurer in place of EIC. This change will continue services and payment arising from the past and currently in-force insurance business of EIC. EIC will make a commercially reasonable payment out of its cash assets amounting to approximately one-third of its cash assets, the exact amount of which will be based on the actuarial projection and claims reserves estimates for the business being assumed by NLIC as of the assumption date.

3. Due to the run-off of EIC's business since 2003, the only in-force policies currently are connected with official bonds and policies for notaries in Tennessee. Other policies

have terminated, but former policyholders and claimants may have made claims within the times required by their policies that still have to be resolved. The contractual obligations on or deriving from policies will all transfer to NLIC. The oil and gas surety bond line of business has been discharged with the obligee Tennessee Department of Environment and Conservation and thus need not transfer to NLIC. The Rehabilitator expects no policyholder to be adversely affected by this transaction, since they will have the same policyholder rights against NLIC as they do against EIC, for all contractual policy terms. No known outstanding contractual policy or surety liability will be reduced by this transaction. NLIC will communicate to policyholders that their policy was assumed by them, and provide and maintain contact numbers and telephone numbers or forwarded phone numbers to permit continued policy services to the insureds. All 95 Tennessee county clerks, with whom the notary bonds issued by EIC were filed, shall be notified of the transaction and pendency of the plan to substitute NLIC for EIC, so that they may make appropriate notation on any EIC bonds that may be on file and still effective in those counties. All 95 counties will receive this notice because EIC records do not reflect in which particular counties the EIC notary bonds may have been filed.

4. After the assumption of the policies, the EIC corporation will be returned to its own management and ownership, and will be required by the Plan to cease all insurance business and return its certificate of authority to the Commissioner. The surviving corporate entity, with the remainder of EIC's assets, would wind down under its own corporate governance and ownership pursuant to general corporate principles.

5. Progress of Rehabilitation/Background - EIC began voluntary rehabilitation in December 2003 in a financially impaired, although not insolvent, state. EIC was in the process of "running off" its insurance business. It had already stopped writing any new policies and its

management functions and assets dedicated to the business had largely been turned over to NLIC and NLASCO Services, Inc. (NLASCO) by April 2003. EIC has not sold any new policies since 2003 and it has no further management capabilities or employees. NLIC and NLASCO have been performing insurance related management under the overall authority of the EIC Rehabilitator.

6. Throughout rehabilitation, EIC's financial position expressed through statutory accounting used for insurance regulation has stabilized and *steadily improved*. Even though EIC has no operational capacity to act as a stand-alone insurance company, it now has more than enough surplus to pay for the assumption of its remaining insurance liabilities. The latest unaudited financial statement for EIC is as of March 31, 2005 and indicates an adequate surplus of \$1,499,644. (Admitted Assets of \$1,887,986 minus liabilities of \$388,342). The unaudited financial statement for EIC as of February 28, 2005 indicated surplus of \$1,476,850. (Admitted Assets of \$1,922,192 minus liabilities of \$445,342). This compares to policyholders' surplus described in the Petition for Rehabilitation of just \$84,941, reported as of March 31, 2003; \$182,380 as of December 31, 2003; \$996,683 as of September 30, 2004; and \$1,469,309, reported as of December 31, 2004 in EIC's Annual Statement for 2004 filed with the Department of Commerce and Insurance.

7. The status of EIC's Insurance and Surety Business Lines is as follows:

Property and Casualty Policies - The property/casualty insurance that EIC had issued was reinsured by NLIC from April 1, 2003 and forward. Losses incurred prior to that date are payable from EIC assets. No further property/casualty insurance policies were written by EIC after April 1, 2003. All policies issued by EIC have expired, as they had one-year coverage terms, but there are contractual liabilities associated with the business for reported and unknown claims, for which the Assumption Agreement is desired.

Notary Bonds Remain in Effect - EIC has not issued any new notary bonds since the first half of 2003, but many of the notary bonds previously issued by EIC are still in effect, due to

their standard term of 4 years concurrent with the term of the notary public in Tennessee. As of May 1, 2005, just under 2900 notary bonds had unexpired terms. EIC's Notary Public bonds are written in favor of the State, typically for a penal limit of \$10,000, and filed in the counties, for the principals' faithful performance of the office of notary public. The Notary Public bonds also contain Errors and Omissions (E&O) coverage. These bonds typically issued for a small one-time premium. The E&O coverage is in favor of persons for negligent acts of the notaries committed during the coverage period, if a claim is filed during the coverage period or applicable statute of limitations pertaining to the insured. Losses from coverage before April 1, 2003 currently are payable from EIC's assets. The Assumption Agreement will transfer EIC's liabilities and duties associated with the notary surety bond and E&O business for reported and unknown claims, and without curtailing the existing terms of these coverages.

Oil and Gas Bonds Resolved — The EIC Rehabilitator has resolved any and all liabilities to the State of Tennessee, Department of Environment and Conservation (TDEC), Oil and Gas Board over bonds that EIC issued over a course of years respecting oil and gas wells. *TDEC has returned the bonds to EIC and canceled them, with mail notice to the principals involved.* The resolution with TDEC has had a beneficial effect on the financial position of EIC, and novation of these surety exposures will not be required.

Also, during Rehabilitation, the Rehabilitator has taken steps to commute reinsurance treaties and turn more of its assets into cash.

8. Effect of the Plan - EIC proposes to pay for a simple one-time assumption and novation transaction that will shift the contractual policy and remaining surety liabilities to NLIC as stated in the Agreement of Assumption, and allow EIC, by approval of the terms of the Plan of Rehabilitation, to be relieved of further such liability. Similarly the corporate EIC entity will end its authority to conduct an insurance business, but will have sufficient remaining assets to be returned to its owners for disposition consistent with their restored corporate powers and for application to any minor remaining corporate liability not assumed by NLIC.

9. EIC has been conserved so as to have adequate financial assets to cover its obligations, but it lacks any operational capacity to act as an ongoing insurance company. The purpose of the Rehabilitation Plan is the benefit afforded by preserving any unexpired ongoing insurance rights of recovery and notary bond coverage, and by not requiring policyholders or

claimants to take any different actions or to alter their contractual relationships to preserve coverage from a viable insurer, even though EIC itself will exit the insurance business. No claims bar date need be established, and the performance of EIC's duties and payment obligations will be assumed by another insurance company that is highly experienced with EIC's business. The Plan does not elevate any claimants over other claimants, and in arranging for the survival of the outstanding insurance/surety coverage, properly gives claimants the same or superior treatment to their status were EIC to be liquidated under Tenn. Code Ann. § 56-9-306 *et seq.* Liquidation would otherwise disrupt or cancel the ongoing coverage by force of law, so rehabilitation provides a better result.

10. The complete terms of the Agreement of Assumption govern exactly what obligations NLIC will be taking over from EIC if the Court approves the transaction. Two paragraphs in particular, describe the scope of NLIC's obligations and the scope of its substitution for EIC. They are:

1.01. EIC hereby cedes to NLIC and NLIC hereby assumes as direct obligations by assumption reinsurance, all the forms of insurance policies and certificates associated with the Insurance Business (hereinafter referred to as the "Assumed Policies"), subject to the terms and conditions of this Agreement of Assumption (the "Agreement"). On the designated Assumption Date, as established below, NLIC shall be the successor to EIC thereunder as to EIC's insureds, as if named in place of EIC, with respect to the Insurance Business matters, including all rights, obligations, privileges, and prerogatives previously held by EIC prior to the Assumption Date, as hereinafter defined.

* * *

2.01. From and after the Assumption Date, NLIC as the replacing insurance carrier assumes all the liability under the Assumed Policies for all claims incurred prior to, on, or after the designated Assumption Date, including the liabilities for a block of Dwelling, Fire, Homeowners and Notary Bond business which was terminated in 2003 or has been non-renewed, excluding all oil and gas bonds issued by EIC and having the Tennessee Department of Oil and Gas as a beneficiary as designated on Exhibit A, with the exception of, and excluding any bad faith, deceptive practice, including gross negligence or extra

contractual damage claims of any type arising out of the acts or omissions of EIC (as described herein "Assumed Claims"). NLIC shall pay one hundred percent (100%) of all losses and attendant expenses of whatever type incurred by EIC relating to any Assumed Claim incurred under any such Assumed Policy arising prior to, on, or after the designated Assumption Date.

(Agreement of Assumption, Paragraphs 1.01 and 2.01). The "Insurance Business" being transferred is defined on the Exhibit A attachment to the Agreement of Assumption, as "All insurance, including bonds, issued by EIC and still having claims or coverage outstanding; provided, however, that nothing contained in the Assumption Agreement shall obligate NLIC in any manner whatsoever with respect to oil and gas bonds issued by EIC and having the Tennessee Department of Oil and Gas as a beneficiary."

11. Consideration - The amount of money to be paid to NLIC for this agreement is found in Paragraph 3 of the Agreement of Assumption:

The consideration for NLIC assuming the Insurance Business under this Agreement is as follows:

EIC will transfer to NLIC cash equal to current open case reserves as of the Assumption Date plus in addition to \$90,000 which represents IBNR for Notary Bonds.

By way of example, were the Assumption Date to have been dated March 31, 2005, according to the monthly balance sheet, the payment to NLIC would have been \$428,912 out of EIC's surplus of \$1,499,644.

12. The Assumption Date cannot occur until this Court has approved EIC's ability to perform this agreement. The Assumption Date is defined as "the date that the Insurance Business subject to this Agreement is assumed by NLIC, and shall be as nearly as possible 12:01 a.m. Central Daylight Time on the 14th day after approval of this Agreement and of EIC's performance hereunder by the Court." Paragraph 1.02, Agreement of Assumption.

13. Although NLIC takes on further policy and contractual liabilities of EIC in order to fulfill the outstanding insurance or surety benefits remaining against EIC, NLIC is not assuming every conceivable prior liability of EIC. There are some limitations on the liabilities that NLIC assumes from EIC.

A. NLIC explicitly is not assuming any liabilities or duties with respect to EIC's prior surety bond business related to oil and gas wells. The Rehabilitator resolved all claims that the Tennessee Department of Environment and Conservation (TDEC) might make on the EIC bonds in 2004. The Rehabilitator has previously compromised and paid to the satisfaction of the TDEC any amounts that TDEC claimed to be entitled to under any oil and gas well bonds in favor of TDEC. Also, TDEC returned the canceled bonds to EIC so that no further bond claims would be possible. The oil and gas bond business of EIC had never been reinsured or assumed by NLIC, and the Rehabilitator deems that any such bonds have been satisfied. Therefore, no oil and gas surety bond liability is assumed by NLIC in the Assumption Agreement, and it is the Rehabilitator's position that these bonds represent no further liability to EIC. Consistent with statutory accounting principles that account conservatively for the assets and liabilities of an insurance company, EIC books no further liability for oil and gas bonds. TDEC will receive notice of this Plan.

B. NLIC does not assume responsibility for possible extra-contractual or non-contractual claims of policyholders or third parties against EIC, in the language excluding: "any bad faith, deceptive practice, including gross negligence or extra contractual damage claims of any type arising out of the acts or omissions of EIC." (Paragraph 2.01, cited above). Such claims, if they existed, would arise outside of the four corners of the insurance contracts and obligations EIC had to its policyholders and third party claimants, and due to conduct beyond the

control of NLIC. Moreover, the Rehabilitator is unaware of such claims existing, so it is commercially reasonable for NLIC to exclude such a coverage, and to cause responsibility, if any, to remain with the EIC corporate entity, which may defend against any such allegations out of its own remaining assets.

14. The consequence of the Assumption Agreement proposed would complete the transfer and assumption by NLIC of all EIC's outstanding policy liabilities and the management and administration of all such claims. NLIC shall become fully substituted as the insurer for the obligation of EIC on and pursuant to the assumed insurance business and policies. The policies to be assumed and novated include any and all property and casualty insurance ever issued by EIC, and any and all notary bond surety policies, and the policyholders whose policies have been assumed by NLIC shall be vested with rights of policyholders and beneficiaries against NLIC that they had with respect to EIC. NLIC shall furnish all policyholders, agents, and any persons known to have made a claim that is being assumed, with updated contact information, addresses, phone and web site, and will maintain a link for the phone numbers and mailing addresses of EIC so that all contacts with EIC with respect to policies and coverage will be forwarded and received by NLIC.

15. NLIC's Qualification to Assume EIC Business - NLIC is a licensed property and casualty insurer, domiciled in Texas, reporting net surplus of \$71,714,634 at year end 2004. The Rehabilitator is satisfied that NLIC has the financial strength and operational capacity to enter into the transaction with EIC. The Assumption Agreement is intended to relieve EIC of further administrative or financial obligations associated with the insurance and remaining surety business. The existing run-off agreement with NLIC and its affiliate, NLASCO Services, Inc., to oversee and administer the run-off of the EIC in-force business as of March 31, 2003, and the

related settlement of claims incurred prior to April 1, 2003, continues, and since April 1, 2005 has been extended month to month for \$4,167.00/month payment by EIC. NLIC is a natural candidate for the proposed Assumption Agreement because of the efficiency and experience it has from its current involvement in EIC's insurance policies through the reinsurance and administrative agreements. The Rehabilitator deems the price for the Assumption Agreement to be reasonable as the price is related to EIC's calculated claims reserves, an estimate of the financial risk and loss expenses that NLIC would be assuming.

16. The Rehabilitator deems that EIC has no other policyholder liabilities besides those to be assumed by NLIC, because the other lines of business of EIC have been fully settled, discharged or canceled during the rehabilitation period. This includes the settlement or discharge of any and all bonds that may have been issued by EIC to the State of Tennessee, Department of Environment and Conservation. Further non-policyholder liabilities have been paid or discharged or accounted for in the financial statements of EIC so that they have been minimized or shifted to the corporation of EIC that will emerge from the contemplated Rehabilitation.

The judgment entered in this action in favor of EIC against a third-party, Pollyanna Dotson, a non-insurance policy based asset, will belong to EIC, and is not being assigned to NLIC as part of the consideration for the Agreement of Assumption. Everything not assumed by NLIC will remain with EIC.

17. EIC Corporate Structure. According to company records, EIC is 81% owned by Romelco, Inc., a closely held corporation owned by the M&M Cohen Family Partnership. The addresses of these entities, as well as the Chairman of the Board of Directors of EIC, Martin Cohen, is at 6330 Torrington Road, Nashville, TN 37205. The remaining shares in EIC are

owned by numerous individuals. EIC has listed 28,481 shares, of which 22,784 are held by Romelco, Inc., another 4,081 by the Family Trust under will of Charles H.J. Feigenbaum, also at 6330 Torrington Road, Nashville, 313 each by Joseph Seth Weinstein and David Nathan Weinstein, 492 by EIC itself, and the rest in small holdings of 1 to less than 10 shares by 434 record owners. The principal owners of the holding company had run EIC for many decades. The Plan does not contemplate that they would be able to return EIC into an operating insurer. EIC will have a corporate existence after the Plan is consummated only for purposes of winding down the corporation. The Plan is not expected to be opposed by Romelco, Inc. All stockholders will have the Notice of the Plan hearing mailed to their last address of record.

18. The Plan meets the “fair and equitable” legal standard for approval. Courts in neighboring jurisdictions have held that this “fair and equitable” standard presents a two-point test: whether (1) the creditors of the insurer will receive through a rehabilitation plan at least the same amount that they would receive under a plan of liquidation, and (2) the rehabilitation plan does not unfairly or illegally discriminate among the creditors or treat lower priority claims better than higher priority claims. *Neblett v. Carpenter*, 305 U.S. 297, 304, 59 S.Ct. 170, 83 L.Ed 182 (1938), *Foster v. Mutual Fire, Marine and Inland Ins. Co.*, 531 Pa. 598, 614 A.2d 1086 (1992). Put simply, “creditors must fare at least as well under a rehabilitation plan as they would under a liquidation [plan]” *Foster v. Mutual Fire, Marine and Inland Ins. Co.*, 614 A.2d 1086, 1093-94 (1992)) However, “[t]he rehabilitation, in order to be legitimate, does not have to restore the company to its exact original condition. So long as the rehabilitation properly conserves and equitably administers ‘the assets of the involved corporation in the interest of investors, the public and others [with] the main purpose being the public good’ the plan of rehabilitation is appropriate.” *Id.* at 1094, quoting *2A Couch on Insurance 2d* § 22.10. For

example, in Tennessee, a plan of rehabilitation was upheld in *Neff v. Cherokee Ins. Co.*, 704 S.W.2d 1, (Tenn. 1986) in which the plan's intended payment of ongoing policyholder claims properly maintained the statutory priority for Cherokee's direct policyholder obligations over its reinsurance obligations to other insurers, the latter being categorized as lower priority general creditor obligations. As recognized by the Tennessee Court of Appeals, "the public interest generally favors rehabilitation" in order to benefit policyholders and the public's interest in insurance coverage. *State ex rel. Pope v. Xantus HealthPlan of Tennessee, Inc.*, 2000 Westlaw 630858 at 11 (Tenn.Ct.App.).

19. The Rehabilitator, upon the recommendation of Kathy Fussell, Special Deputy Rehabilitator, believes that the interested parties and policyholders of EIC will benefit by the substitution of an operating insurance company, NLIC. Even though the Rehabilitator believes (and EIC financial statements reflect) that EIC's reserves would be financially sufficient for its expected liabilities, the transaction in the Plan is advantageous for EIC. Because EIC has no employees or management support of its own, the Plan advantageously cuts off unknown liabilities and changes of risk development, and the expense of future administrative support for a dwindling volume of claims for a set price. The Plan provides that EIC not resume issuance of policies because EIC does not have the administrative infrastructure to run an active business. The Rehabilitator and Special Deputy Rehabilitator accordingly request this Court's approval of the Plan terms attached as Exhibit A.

Respectfully submitted,

SIGNED/

SARAH A. HIESTAND (BPR 14217)
Senior Counsel
Attorney General, Financial Division

P.O. Box 20207
Nashville, TN 37202
(615) 741-6035 fax (615) 532-8223

SIGNED/

HUGH O. BROCK, III (BPR 22645)
Chief Counsel for Insolvency and Receivership
Tennessee Department of Commerce and Insurance
500 James Robertson Parkway, 9th Floor
Nashville, TN 37243
(615) 741-6173 fax (615) 532-2862

Attorneys for Paula A. Flowers, Commissioner of
Commerce and Insurance for the State of
Tennessee, as Rehabilitator of Exchange Insurance
Company, and Kathy Fussell, Special Deputy
Rehabilitator

EXHIBIT A

PROPOSED PLAN

The following conditions of the Plan are proposed by the Rehabilitator of Exchange Insurance Company, through her Special Deputy Rehabilitator, to be approved by this Court pursuant to Tenn. Code Ann. § 56-9-303(e):

1. EIC will be authorized and directed to implement an Agreement of Assumption with National Lloyds Insurance Company, A Texas insurance company writing property and casualty and surety insurance (NLIC), authorized to write insurance in the State of Tennessee. The Agreement of Assumption will substitute NLIC as insurer/surety for all notary bond business and property/casualty policies of EIC, all as particularly described in the Agreement of Assumption. A copy of the Agreement of Assumption, that has been executed subject to approval of this Court, is attached as Plan Exhibit “1” (the “Assumption Agreement”) and is incorporated herein by this reference; and

2. The Rehabilitator shall, as more particularly described in the Assumption Agreement, transfer a portion of the cash assets of EIC to NLIC on the Assumption Date as described in consideration for NLIC assuming the direct policy obligations and all attendant administrative responsibilities of EIC that are more particularly set forth in the Assumption Agreement. Assets of EIC not expended on the transaction would belong to EIC. EIC will transfer to NLIC cash equal to current open case reserves as of the Assumption Date plus \$90,000 which represents IBNR (incurred but not reported liability) for Notary Bonds.

3. Upon the Assumption Date established by the Assumption Agreement and the payment made by EIC, the Rehabilitator deems that no further insurance policy or surety bond liability of EIC will be outstanding, all such lines of business and prior liability having been either assumed by NLIC, or previously extinguished by payment or satisfaction, as in the case of EIC’s oil and gas bonds. The Rehabilitator requests that this Court confirm and order as an element of the Plan that all further direct coverage by EIC of any insurance or surety bond business be canceled simultaneously with the Assumption Date referenced in the Assumption Agreement.

4. The Rehabilitator on behalf of EIC will surrender its certificate of authority to the Department of Commerce and Insurance and cancel the certificate of authority, and EIC will not be authorized to issue any more insurance or surety policies in Tennessee nor to transact further insurance business from the date and time (Assumption Date) that the policyholder liabilities and obligations are transferred to and assumed by National Lloyds. Thereafter, the corporate existence of EIC may continue for such time as is required to wind down the corporation, which shall be performed thereafter expeditiously by the board of directors of EIC independently of any Court proceeding.

5. The Rehabilitator shall be empowered to execute any and all related documents, approvals, and to do any other acts on behalf of EIC that may be required to effectuate and

I hereby certify that a true and exact copy of the foregoing Motion to Approve Plan and Plan of Rehabilitation has been delivered by U.S. Mail postage prepaid to:

Respondent

Mr. Martin Cohen
Chairman, (inactive) Board of Directors
Exchange Insurance Company
6330 Torrington Road
Nashville, Tennessee 37205

Other Notice parties:

Marcia F. Cohen, Registered Agent
ROMELCO, Inc. (81% owner of EIC)
6330 Torrington Road
Nashville, TN 37205

Mr. Robins S. Ledyard
Bass, Berry & Sims
315 Deaderick Street, Suite 2700
Nashville, TN 37238-3001
615-742-6259 fax 615-742-6293
Courtesy copy

Management Agreement Contacts:

National Lloyds Insurance Company
Greg Vanek, President
P.O. Box 2650
Waco, Texas 76702-2650
Fax (254) 399-0765

NLASCO Services, Inc.
Attn: Gordon Robinson
900 Austin Avenue, 12th floor
Waco, Texas 76701
Fax (254) 756-0050

Pat Beard, Esq.
Beard & Kultgen
5400 Bosque Blvd., Suite 301
Waco, Texas 76710
Fax (254) 776-3591

this 27th day of May, 2005.

SIGNED

SARAH ANN HIESTAND

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