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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

**FORM 10-Q**

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QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF  
THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2005

Commission File Number 1-3924

**MAXXAM INC.**

(Exact name of Registrant as specified in its charter)

**Delaware**  
(State or other jurisdiction  
of incorporation or organization)

**95-2078752**  
(I.R.S. Employer  
Identification Number)

**1330 Post Oak Blvd., Suite 2000**  
**Houston, Texas**  
(Address of Principal Executive Offices)

**77056**  
(Zip Code)

Registrant's telephone number, including area code: **(713) 975-7600**

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes : No

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Rule 12b-2 of the Act).

Yes : No

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No :

Number of shares of common stock outstanding at November 4, 2005: 5,967,942

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**MAXXAM INC. AND SUBSIDIARIES**

**CONSOLIDATED BALANCE SHEET**  
(In millions of dollars, except share information)

	<u>September 30,</u> <u>2005</u>	<u>December 31,</u> <u>2004</u>
	(Unaudited)	
<b>Assets</b>		
Current assets:		
Cash and cash equivalents .....	\$ 91.6	\$ 18.3
Restricted cash, marketable securities and other short-term investments (\$29.7 and \$28.2, restricted, respectively) .....	113.7	18.3
Trade and other receivables, net of allowance of \$0.7 and \$0.6, respectively .....	14.7	16.5
Inventories:		
Lumber .....	7.5	17.0
Logs .....	21.4	7.2
Real estate and other assets held for sale .....	17.8	21.1
Prepaid expenses and other current assets .....	16.7	16.6
Total current assets .....	283.4	115.0
Property, plant and equipment, net of accumulated depreciation of \$200.5 and \$183.4, respectively .....	364.2	370.2
Timber and timberlands, net of accumulated depletion of \$224.3 and \$218.6, respectively .....	209.8	213.6
Real estate .....	51.2	52.5
Deferred income taxes .....	95.1	94.8
Restricted cash, marketable securities and other investments (\$5.9 and \$15.6, restricted, respectively) .....	11.0	15.6
Intangible assets .....	3.1	3.8
Long-term receivables and other assets .....	26.4	33.2
	\$ 1,044.2	\$ 898.7
<b>Liabilities and Stockholders' Deficit</b>		
Current liabilities:		
Accounts payable .....	\$ 14.4	\$ 14.4
Accrued interest .....	12.7	24.9
Other accrued liabilities .....	58.3	39.9
Short-term borrowings and current maturities of long-term debt .....	84.1	51.4
Total current liabilities .....	169.5	130.6
Long-term debt, less current maturities .....	925.6	912.0
Accrued pension and other postretirement benefits .....	44.8	41.8
Losses in excess of investment in Kaiser .....	516.2	516.2
Other noncurrent liabilities .....	65.0	71.7
Total liabilities .....	1,721.1	1,672.3
Commitments and contingencies (see Note 8)		
Stockholders' deficit:		
Preferred stock, \$0.50 par value; \$0.75 liquidation preference; 2,500,000 shares authorized; Class A \$0.05 Non-Cumulative Participating Convertible Preferred Stock; 668,964 and 669,019 shares issued, respectively; 668,119 and 668,174 shares outstanding, respectively .....	0.3	0.3
Common stock, \$0.50 par value; 13,000,000 shares authorized; 10,063,359 shares issued; 5,967,942 and 5,976,487 shares outstanding, respectively .....	5.0	5.0
Additional capital .....	225.3	225.3
Accumulated deficit .....	(685.9)	(666.4)
Accumulated other comprehensive loss .....	(96.7)	(96.6)
Treasury stock, at cost (shares held: preferred – 845; common – 4,095,417 and 4,086,872, respectively) .....	(124.9)	(124.7)
Total stockholders' deficit .....	(676.9)	(657.1)
	\$ 1,044.2	\$ 1,015.2

The accompanying notes are an integral part of these financial statements.

**MAXXAM INC. AND SUBSIDIARIES**

**CONSOLIDATED STATEMENT OF OPERATIONS**  
(In millions of dollars, except per share information)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
	(Unaudited)			
Net sales:				
Forest products .....	\$ 42.6	\$ 49.6	\$ 136.8	\$ 149.2
Real estate .....	52.3	20.3	105.2	55.1
Racing .....	10.9	11.6	34.0	38.6
	105.8	81.5	276.0	242.9
Costs and expenses:				
Cost of sales and operations:				
Forest products .....	33.0	36.9	111.9	109.7
Real estate .....	12.9	8.5	29.3	20.0
Racing .....	9.7	10.0	29.3	32.2
Selling, general and administrative expenses .....	22.2	19.1	50.5	53.6
Gain on sales of timberlands and other assets .....	-	(0.2)	(0.1)	(0.2)
Depreciation, depletion and amortization .....	8.3	8.7	26.1	26.6
	86.1	83.0	247.0	241.9
Operating income (loss):				
Forest products .....	(2.1)	1.0	(8.0)	3.2
Real estate .....	30.7	3.2	48.4	10.3
Racing .....	(1.8)	(1.5)	(2.9)	(1.7)
Corporate .....	(7.1)	(4.2)	(8.5)	(10.8)
	19.7	(1.5)	29.0	1.0
Other income (expense):				
Investment and interest income (loss) .....	4.3	(0.3)	9.6	5.3
Other income (expense) .....	(0.2)	0.3	-	3.7
Interest expense .....	(18.9)	(18.0)	(55.0)	(54.0)
Amortization of deferred financing costs .....	(0.6)	(0.6)	(3.1)	(1.7)
Income (loss) before income taxes .....	4.3	(20.1)	(19.5)	(45.7)
Income tax expense .....	-	(0.1)	-	(0.1)
Net income (loss) .....	\$ 4.3	\$ (20.2)	\$ (19.5)	\$ (45.8)
Basic income (loss) per common and common equivalent share .....	\$ 0.72	\$ (3.37)	\$ (3.26)	\$ (7.66)
Diluted income (loss) per common and common equivalent share .....	\$ 0.62	\$ (3.37)	\$ (3.26)	\$ (7.66)

The accompanying notes are an integral part of these financial statements.

**MAXXAM INC. AND SUBSIDIARIES**

**CONSOLIDATED STATEMENT OF CASH FLOWS**  
(In millions of dollars)

	Nine Months Ended	
	September 30,	
	2005	2004
	(Unaudited)	
<b>Cash flows from operating activities:</b>		
Net loss	\$ (19.5)	\$ (45.8)
Adjustments to reconcile net loss to net cash provided by (used for) operating activities:		
Depreciation, depletion and amortization	26.1	26.6
Non-cash stock-based compensation expense	0.3	2.3
Net losses (gains) from marketable securities and other investments	(4.6)	0.7
Equity in loss (earnings) of unconsolidated affiliates, net of dividends	0.7	(0.3)
Amortization of deferred financing costs and discounts on long-term debt	3.1	1.7
Increase (decrease) in cash resulting from changes in:		
Reserve for environmental remediation	–	1.9
Receivables	3.0	1.1
Inventories	(3.3)	(1.8)
Prepaid expenses and other assets	(0.1)	0.4
Accounts payable	–	0.1
Other accrued liabilities	15.6	4.4
Accrued interest	(12.2)	(14.2)
Long-term assets and long-term liabilities	6.4	7.4
Other, net	(0.7)	0.9
Net cash provided by (used for) operating activities	14.8	(14.6)
<b>Cash flows from investing activities:</b>		
Net proceeds from the disposition of property and investments	0.1	0.2
Net proceeds from the sale of marketable securities and other investments	26.9	21.3
Net proceeds from restricted cash	8.4	13.2
Capital expenditures	(16.2)	(27.3)
Return of investment in joint venture	0.5	–
Other, net	0.1	0.3
Net cash provided by investing activities	19.8	7.7
<b>Cash flows from financing activities:</b>		
Proceeds from issuances of long-term debt	38.0	3.1
Redemptions and repurchases of, and principal payments on, long-term debt	(21.5)	(37.2)
Borrowings under revolving and short-term credit facilities	25.5	42.6
Debt issuance costs	(3.1)	(0.8)
Treasury stock purchases	(0.2)	–
Net cash provided by financing activities	38.7	7.7
<b>Net increase in cash and cash equivalents</b>	73.3	0.8
<b>Cash and cash equivalents at beginning of the period</b>	18.3	9.8
<b>Cash and cash equivalents at end of the period</b>	\$ 91.6	\$ 10.6
<b>Supplemental disclosure of non-cash investing and financial activities:</b>		
Repurchases of debt using restricted cash	\$ –	\$ 4.8
<b>Supplemental disclosure of cash flow information:</b>		
Interest paid, net of capitalized interest	\$ 67.2	\$ 68.3

The accompanying notes are an integral part of these financial statements.

## MAXXAM INC. AND SUBSIDIARIES

### CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### 1. Basis of Presentation

The information contained in the following condensed notes to the consolidated financial statements is condensed from that which would appear in the annual consolidated financial statements; accordingly, the consolidated financial statements included herein should be read in conjunction with the consolidated financial statements and related notes thereto contained in the Form 10-K. Any capitalized terms used but not defined in these Condensed Notes to Consolidated Financial Statements are defined in the "Glossary of Defined Terms" contained in Appendix A. All references to the "Company" include MAXXAM Inc. and its majority and wholly owned subsidiaries (but exclusive of Kaiser and its subsidiaries), unless otherwise noted or the context indicates otherwise. All references to specific entities refer to the respective companies and their subsidiaries, unless otherwise specified or the context indicates otherwise. Accounting measurements at interim dates inherently involve greater reliance on estimates than at year end. The results of operations for the interim periods presented are not necessarily indicative of the results to be expected for the entire year.

The consolidated financial statements included herein are unaudited; however, they include all adjustments of a normal recurring nature which, in the opinion of management, are necessary for a fair presentation of the consolidated financial position of the Company at September 30, 2005, the consolidated results of operations for the three and nine months ended September 30, 2005 and 2004, and the consolidated cash flows for the nine months ended September 30, 2005 and 2004.

#### *Financial Difficulties of Certain Forest Products Entities*

Regulatory and environmental matters as well as legal actions have played and are expected to continue to play a significant role in the Company's forest products operations. Scotia LLC has previously experienced delays in the approval of its THPs as the result of regulatory compliance and litigation challenges, and expects these difficulties to persist. Moreover, the Company expects a recurrence of the additional delays that have recently been experienced in harvesting on previously-approved THPs due to regulatory oversight by the North Coast Water Board (see below). The foregoing matters have in the past adversely affected timber harvest levels and timber harvesting and other costs; these effects are expected to continue.

The North Coast Water Board is requiring Palco and Scotia LLC to apply various waste discharge reporting, mitigation and erosion control requirements in respect of timber harvesting activities in several watersheds, and is likely to impose additional measures in the future. The North Coast Water Board in December 2003 directed its staff to formulate WWDRs for the Freshwater and Elk River watersheds on the Scotia LLC Timberlands. As harvesting activities on the Scotia LLC Timberlands cannot readily be moved between watersheds due to, among other things, historic harvest patterns, adjacency restrictions, and the age classes of trees, development of WWDRs and the other matters described in the "Forest Products Operations—Water Quality" section of Note 8 are expected to result in reduced harvest in the future. The staff of the North Coast Water Board has circulated for public review and comment draft WWDRs for the Freshwater and Elk River watersheds. If these draft WWDRs are approved in their current form, there would likely be a significant adverse impact on current and future harvest levels.

As WWDRs had not been formulated, the North Coast Water Board for some time failed to release for harvest a number of Scotia LLC's THPs that had already been approved by the other governmental agencies which approve Scotia LLC's THPs. In February 2005, the Executive Officer of the staff of the North Coast Water Board released sufficient THPs to allow the harvest of up to 50% of the CDF Harvest Limit for these two watersheds. On March 16, 2005, the North Coast Water Board ordered the enrollment of additional THPs that would allow the harvest of up to 75% of the CDF Harvest Limit for these two watersheds. Third parties subsequently appealed this decision to the State Water Board. On June 16, 2005, the State Water Board heard this appeal and rendered a decision, which had the effect of disallowing further harvesting on the additional 25% of the CDF Harvest Limit approved by the North Coast Water Board on March 16, 2005. The State Water Board's decision also has the effect of disallowing further harvesting in the Freshwater and Elk River watersheds until WWDRs for these watersheds are adopted by the North Coast Water Board. Palco has appealed the State Water Board's June 16, 2005, decision in a California state court. A hearing on the appeal has not yet been scheduled.

On September 2, 2005, the North Coast Water Board set hearings on the draft WWDRs for September 14 and 15, 2005. On September 9, 2005, Palco and Scotia LLC filed a petition in California state court seeking an order mandating

that the North Coast Water Board not take any further action on the proposed WWDRs. The petition alleges defects in the proposed WWDRs and the North Coast Water Board's hearing procedures. Palco and Scotia LLC also requested a temporary restraining order and preliminary injunction to prevent the North Coast Water Board from taking any further action until their petition is heard. The temporary restraining order was granted and the preliminary injunction hearing is scheduled for November 9, 2005.

The unreleased and disallowed THPs in the Freshwater and Elk River watersheds represented a significant portion of the harvest that had been planned for the first nine months of 2005. The ongoing regulatory, environmental and litigation matters faced by Palco and Scotia LLC, exacerbated by the developments described in the previous paragraph, have materially adversely impacted the cash flows of both Palco and Scotia LLC. Furthermore, it is likely that additional delays in the development of the Freshwater and Elk River WWDRs will occur. Should the Freshwater-Elk River WWDRs not be approved during 2005 or in the first few months of 2006, or be approved with additional restrictions on harvest, there could be a material adverse impact on Palco's and Scotia LLC's future cash flows from operations.

As previously announced, the estimates of Scotia LLC indicated that its cash flows from operations, together with the Scotia LLC Line of Credit and other available funds, would likely be inadequate to pay all of the interest due on the July 20, 2005, payment date for the Timber Notes. As the July 20, 2005, payment date approached, it became apparent that Scotia LLC's estimates would prove correct and that the cash shortfall as of the payment date would be approximately \$2.2 million. Based upon a review of its alternatives under the circumstances, consultation with its own legal and financial advisors, and consideration of the status of discussions with the advisors of the Noteholders Committee, Scotia LLC requested that Palco make an early payment, equal to the shortfall, in respect of certain logs that had already been delivered to and purchased by Palco from Scotia LLC. Palco approved and delivered the early log payment, which allowed Scotia LLC to fund the July 20, 2005, cash shortfall and pay all of the \$27.9 million of interest due (\$25.9 million net of interest due in respect of Timber Notes held by Scotia LLC).

Scotia LLC's ability to pay all of the \$27.7 million of interest due (\$25.8 million net of interest due in respect of Timber Notes held by Scotia LLC) on the January 20, 2006, payment date will depend upon many factors, including Scotia LLC's harvest levels for the remainder of 2005, cash flows from operations through the January 20, 2006, payment date, together with access to the Scotia LLC Line of Credit. At September 30, 2005, the maximum availability under the Scotia LLC Line of Credit was \$55.4 million, and borrowings outstanding were \$49.5 million. There can be no assurance that Scotia LLC will have sufficient liquidity to make this interest payment.

In March 2005, UBS agreed to assist Scotia LLC in seeking to restructure its obligations with respect to the outstanding Timber Notes. In June 2005, Scotia LLC agreed to be responsible for certain payments and other obligations of the Noteholder Committee relating to their legal counsel and financial advisors. On September 23, 2005, Scotia LLC terminated its agreement to be responsible for further payments, effective immediately in the case of the legal counsel and effective October 23, 2005, in the case of the financial advisor. Scotia LLC terminated its agreement upon the recommendation of a special committee of independent managers since it concluded that insufficient progress had been made in negotiations with the Noteholder Committee and was advised that holders of less than 15% of the Timber Notes (measured by principal amount) had agreed to confidentiality provisions necessary in order to participate in a process intended to lead to a restructuring agreement. Scotia LLC continues to evaluate its liquidity alternatives in respect of the January 20, 2006, payment date and beyond.

Scotia LLC and UBS have conducted extensive reviews and analyses of Scotia LLC's assets, operations and prospects. As a result of these extensive reviews and analyses, Scotia LLC's management has concluded that, in the absence of significant regulatory relief and accommodations, Scotia LLC's annual timber harvest levels and cash flows from operations will in future years be substantially below both historical levels and the minimum levels necessary in order to allow Scotia LLC to satisfy its debt service obligations in respect of the Timber Notes. Scotia LLC has announced that its projected average annual harvest level over the ten-year period beginning 2006 is estimated at approximately 100 million board feet per year. This harvest level reflects Scotia LLC management's most recent estimate of the cumulative impact of ongoing regulatory limitations, prescriptions, and other actions and is based upon a number of assumptions which may or may not prove to be accurate. Scotia LLC's management also determined that reductions must be made to its cost structure in line with these anticipated reductions in harvest levels and cash flows. Accordingly, on August 30, 2005, Scotia LLC implemented a restructuring plan reducing its workforce by approximately one third. To the extent that Scotia LLC is unable to restructure its Timber Notes consistent with management's expectations as to future harvest levels and cash flows, or to secure additional liquidity from external sources, the Company expects that Scotia LLC, and, as may be required, Palco, will be forced to take extraordinary actions, which may include: further reducing expenditures by laying off employees and shutting down various operations; seeking other sources of liquidity, such as from asset sales; and seeking protection by filing under the Bankruptcy Code.

As of December 31, 2004 and March 31, 2005, Palco was in default under the Palco Credit Agreement and obtained limited waivers of the default through April 22, 2005. On April 19, 2005, Palco and Britt, as Borrowers, closed the Revolving Credit Facility and the Term Loan. The Term Loan was fully funded at closing and the Borrowers used approximately \$10.8 million of the funds from the Term Loan to pay off amounts previously borrowed under the Palco Credit Agreement and terminated that facility. As of September 30, 2005, \$34.8 million was outstanding under the Term Loan and \$12.1 million was outstanding under the Revolving Credit Facility. Palco estimates that its cash flow from operations will not provide sufficient liquidity to fund its operations until the fourth quarter of 2006. Accordingly, Palco expects to be dependent on the funds available under the Revolving Credit Facility, and expects additional liquidity will be needed, to fund its working capital and other cash requirements in 2005 and 2006. The Revolving Credit Facility and Term Loan are each secured by a security interest in the stock of Palco and substantially all of the assets of the Borrowers (other than Palco's equity interest in Scotia LLC). Both the Term Loan and the Revolving Credit Facility have provisions requiring that the net cash proceeds of specified asset sales be used to prepay amounts outstanding under the loans.

As of September 30, 2005, borrowings under the Revolving Credit Facility were limited to the sum of 85% of Palco and Britt's eligible accounts receivable plus 75% of their eligible inventories (up to a maximum of \$30.0 million, subject to limitations such as the ability of the lender to establish reasonable reserves). Both the Term Loan and the Revolving Credit Facility contain EBITDA maintenance covenants that, if not met, could trigger a mandatory prepayment of outstanding borrowings. The operating cash flow estimates used to establish the EBITDA maintenance covenants are subject to a number of assumptions about future operating cash flow and actual results could differ from these estimates. Accordingly, the availability of these funds is largely dependent on Palco's ability to harvest adequate timber from the Scotia LLC Timberlands and reduce operating costs. Available resources to fund Palco's and Britt's operating needs at September 30, 2005, were \$8.0 million, comprised of the maximum availability under the Revolving Credit Facility of \$7.7 million and unrestricted cash and marketable securities of \$0.3 million.

Subsequent to September 30, 2005, Palco borrowed the maximum available under the Revolving Credit Facility and on October 26, 2005, Palco, Britt and certain of their affiliates entered into the Omnibus Amendment, which amended the Term Loan and the Revolving Credit Facility to, among other things, temporarily increase the amount of the Revolving Credit Facility from \$30.0 million to \$35.0 million and temporarily increase the advance rate applicable to the Borrowers' inventory from 75% to 80%. The increase in the inventory advance rate is subject to satisfactory inventory appraisals and the amount of the increase in such advances is capped at \$1.5 million. The increase in the amount of the Revolving Credit Facility and the increase in the inventory advance rate will be gradually phased out in January through March 2006. The Omnibus Amendment also revises financial covenants applicable to the Revolving Credit Facility and the Term Loan. MGI furnished cash collateral of \$2.0 million as additional security for the Borrowers' obligations under the Revolving Credit Facility and the Term Loan Facility. This cash collateral will be released on April 1, 2006, so long as the Borrowers have achieved earnings and borrowing availability targets to be determined by the Lenders.

Palco's available cash resources, including proceeds from and availability under the Term Loan and Revolving Credit Facility have been primarily utilized during the first nine months of 2005 in the following areas: (i) \$10.8 million was used to pay off amounts previously borrowed under the Palco Credit Agreement; (ii) approximately \$ 6.2 million was used to fund capital expenditures related to Palco's new state-of-the-art sawmill in Scotia, California; (iii) \$9.9 million was used as collateral to secure Palco's workers compensation liabilities; (iv) \$13.5 million was used to build log inventory levels; and (v) the remainder was used to pay advisor fees and to fund working capital shortfalls. Palco's ability to generate sufficient liquidity to fund its short term liquidity needs will depend upon many factors, including Palco's ability to achieve planned production rates at its new sawmill. While production levels at the new sawmill continue to improve, the new sawmill is not yet operating planned capacity and is not expected to achieve planned production rates for the remainder of 2005. Accordingly, additional liquidity will be needed at Palco to fund working capital requirements in 2005 and 2006, but there can be no assurance that Palco will be able to secure additional liquidity. In the event that Palco were unable to secure the necessary liquidity, it would be forced to take extraordinary actions, which may include: further reducing expenditures by laying off employees and shutting down various operations and seeking protection by filing under the Bankruptcy Code.

On April 21, 2005, Moody's lowered its ratings on the Class A-1 Timber Notes from Baa2 to Ba3; the Class A-2 Timber Notes from Baa3 to B1; and the Class A-3 Timber Notes from Bal to B1. On June 20, 2005, Moody's further lowered its ratings on all classes of the Timber Notes to Caal. S&P announced on April 7, 2005, that it had lowered Palco's credit rating to CCC- (which rating it affirmed on April 28, 2005). As a result of the S&P credit rating actions related to Palco, Palco was required to post a \$9.9 million letter of credit with the State of California to secure its workers



compensation liabilities, which reduced Palco's availability under the Revolving Credit Facility by a corresponding amount. See Note 4 for further discussion of availability under Palco's debt facilities.

The liquidity issues being experienced by Scotia LLC and Palco could result in claims against and have adverse impacts on MAXXAM Parent, MGHI and/or MGI. For example, under ERISA law, were Palco to terminate its pension plan, MAXXAM Parent and its wholly owned subsidiaries would be jointly and severally liable for any unfunded pension plan obligations. The unfunded obligation attributable to Palco's pension plan as of December 31, 2004, is estimated to have been in the range of approximately \$35 million based upon annuity placement interest rate assumptions at that time. In addition, it is possible that certain transactions could be entered into in connection with a potential restructuring or reorganization of Palco or Scotia LLC, such as a sale or other transfer of all or a portion of the equity ownership in Palco and/or Scotia LLC, a sale or other transfer of a substantial portion of Palco's and/or Scotia LLC's assets and/or a cancellation of some or all of Palco's and/or Scotia LLC's indebtedness, which could require the utilization of all or a substantial portion of, or the loss of a significant portion of, the Company's net operating losses for federal and state income tax purposes and could require tax payments in future periods.

In the event of a failure to pay interest on the Timber Notes in full when due, the Trustee under the Timber Notes Indenture or the holders of at least 25% of the aggregate outstanding principal amount of the Timber Notes may cause all principal, interest and other amounts related to the Timber Notes to become immediately due and payable. Also, in the event of a failure by Palco to perform its covenants or agreements under the Master Purchase Agreement or the Services Agreement, which failure continues for 30 days after notice from the Trustee or the holders of 25% or more of the outstanding principal amount of the Timber Notes, the holders of a majority of the aggregate outstanding principal amount of the Timber Notes may cause all principal, interest and other amounts related to the Timber Notes to become immediately due and payable. In the event of any such acceleration, the agent under the Scotia LLC Line of Credit may also accelerate the advances then outstanding thereunder. If such accelerations of the Timber Notes and/or advances under the Scotia LLC Line of Credit occur, the Trustee may exercise all rights under the Timber Notes Indenture and related security documents, including applying funds to pay accelerated amounts, and selling the Scotia LLC Timberlands and other assets and using the proceeds thereof to pay accelerated amounts. In the event that Scotia LLC were to seek protection by filing under the Bankruptcy Code, all amounts related to the Timber Notes would become immediately due and payable under the Timber Notes Indenture and all advances under the Scotia LLC Line of Credit could be accelerated. If Palco were to seek protection by filing under the Bankruptcy Code, all amounts related to Palco's Term Loan and Revolving Credit Facility would become immediately due and payable. The foregoing rights of the Trustee, Noteholders, and Palco's lenders, are subject to the rights of Scotia LLC and Palco, respectively, under the Bankruptcy Code.

In addition, there can be no assurance that certain other pending legal, regulatory and environmental matters or future governmental regulations, legislation or judicial or administrative decisions, adverse weather conditions, or low lumber or log prices, will not have a material adverse effect on the financial condition, results of operations or liquidity of the Company's forest products operations. See Note 8 for further discussion regarding regulatory and legislative matters and legal proceedings relating to the Company's forest products operations.

Under generally accepted accounting principles, consolidation is generally required for investments of more than 50% of the outstanding voting stock of an investee, except when control is not held by the majority owner. Under these rules, legal reorganization or bankruptcy represent conditions which can preclude consolidation in instances where control rests with the bankruptcy court, rather than the majority owner. As discussed above, Palco and Scotia LLC's cash flows have been adversely impacted by difficulties in obtaining approval of Scotia LLC's THPs. If Scotia LLC is unable to make its future debt payments or were Palco's liquidity problems worsen, one of the actions that would be considered is seeking protection by filing for bankruptcy. Were this to occur, the financial results of the subsidiaries which file for bankruptcy would likely be deconsolidated on the date of such filing, and the Company would likely begin reporting its investments in such subsidiaries using the cost method. If Palco and/or Scotia LLC were among the subsidiaries that filed for bankruptcy, the resulting impact on the Company's financial statements would be significant.

The following condensed pro forma financial information reflects the Company's results as if MGI and its subsidiaries were not consolidated, and the impact of reporting the Company's investment in MGI and its subsidiaries on the cost method (in millions). This information is on a pro forma basis only and the actual impact of any future deconsolidation would differ. Furthermore, this pro forma information assumes that MGI and all of its subsidiaries file for bankruptcy, rather than the impact of only one or more subsidiaries filing.

	<b>Three Months Ended September 30, 2005</b>	<b>Nine Months Ended September 30, 2005</b>
Revenues .....	\$ 63.1	\$ 139.2
Costs and expenses .....	(41.3)	(102.1)
Operating income .....	21.8	37.1
MAXXAM's equity in MGI's losses .....	(16.0)	(50.4)
Other expenses - net .....	(1.5)	(6.2)
Income tax benefit .....	-	-
Net income (loss) .....	<u>\$ 4.3</u>	<u>\$ (19.5)</u>

	<b>As of September 30,</b>
Current assets .....	199.0
Property, plant and equipment (net) .....	246.6
Other assets .....	166.5
Total assets .....	<u>\$ 612.1</u>
Current liabilities .....	59.4
Long-term debt, less current maturities .....	221.5
Other liabilities .....	68.8
Losses recognized in excess of investment in MGI and certain intercompany items .....	423.1
Losses recognized in excess of investment in Kaiser .....	516.2
Total liabilities .....	1,289.0
Stockholders' deficit .....	(676.9)
Total liabilities and stockholders' deficit .....	<u>\$ 612.1</u>

In the event that MGI and /or any of its subsidiaries file for bankruptcy, the Company believes that it is not probable that it would be obligated to fund losses related to its investment in such subsidiaries, except as it relates to certain pension funding obligations and potential future tax payments, as noted above.

#### *Deconsolidation of Kaiser*

On February 12, 2002, Kaiser and certain of its subsidiaries filed for reorganization under Chapter 11 of the Bankruptcy Code. As a result, the Company discontinued consolidating Kaiser's financial results beginning February 12, 2002, and began reporting its investment in Kaiser using the cost method, under which the investment is reflected as a single amount on the Company's balance sheet of \$(516.2) million and the recording of earnings or losses from Kaiser was discontinued after February 11, 2002.

Through February 11, 2002, under generally accepted principles of consolidation, the Company had recognized losses in excess of its investment in Kaiser of \$516.2 million. Since Kaiser's results are no longer consolidated and the Company believes that it is not probable that it will be obligated to fund losses related to its investment in Kaiser, any adjustments reflected in Kaiser's financial statements subsequent to February 12, 2002 (relating to the recoverability and classification of recorded asset amounts and classification of liabilities or the effects on existing stockholders' deficit, as well as adjustments made to Kaiser's financial information for loss contingencies and other matters), are not expected to affect the Company's financial results.

The Company expects it will consider reversal of its losses in excess of its investment in Kaiser when either: (i) Kaiser's bankruptcy is resolved (which is expected to occur in the first quarter of 2006) and the amount of the Company's remaining investment in Kaiser is determined, or (ii) the Company disposes of its shares of Kaiser common stock. Accordingly, these consolidated financial statements do not reflect any adjustments related to the deconsolidation of Kaiser other than presenting the Company's investment in Kaiser using the cost method. When either of the events described above occurs, the Company will re-evaluate the appropriate accounting treatment of its investment in Kaiser based upon the facts and circumstances at such time. It is likely that the Company's ownership interest in Kaiser will be cancelled. In this regard, see Note 7 for information regarding the filing by Kaiser of its plan of reorganization, which provides for the cancellation of Kaiser's equity interests without consideration. In the event of such cancellation, the Company expects that it will reverse the \$516.2 million of losses in excess of its investment in Kaiser, net of accumulated other comprehensive losses related to Kaiser, and recognize the entire amount, including the related tax effects, in income for the period. Although the Company does not expect that it will be obligated to fund losses in Kaiser, the amount of the reversal would be reduced by any losses which the Company estimates it would be obligated to fund

### *Use of Estimates and Assumptions*

The preparation of financial statements in accordance with accounting principles generally accepted in the United States of America requires the use of estimates and assumptions that affect (i) the reported amounts of assets and liabilities, (ii) the disclosure of contingent assets and liabilities known to exist as of the date the financial statements are published, and (iii) the reported amount of revenues and expenses recognized during each period presented. The Company reviews all significant estimates and assumptions affecting its consolidated financial statements on a recurring basis and records the effect of any necessary adjustments prior to filing the consolidated financial statements with the SEC. Adjustments made to estimates often relate to improved information not previously available. Uncertainties regarding such estimates and the related assumptions are inherent in the preparation of the Company's consolidated financial statements; accordingly, actual results could differ from these estimates.

Risks and uncertainties are inherent with respect to the ultimate outcome of the matters discussed in Note 8. The results of a resolution of such uncertainties could have a material effect on the Company's consolidated financial position, results of operations or liquidity. In addition, uncertainties related to the projection of future taxable income could affect the realization of the Company's deferred tax assets. Estimates of future benefit payments used to measure the Company's pension and other postretirement benefit obligations are subject to a number of assumptions about future experience, as are the estimated future cash flows projected in the evaluation of long-lived assets for possible impairment. To the extent there are material differences between these estimates and assumptions and actual results, the Company's financial statements or liquidity could be materially affected.

### *Reclassifications*

Certain reclassifications have been made to prior periods' consolidated financial statements to be consistent with the current period's presentation. This includes the reclassification of: (i) auction rate securities from cash and cash equivalents to marketable securities in the Consolidated Balance Sheet and Consolidated Statement of Cash Flows, (ii) restricted cash from financing activities to investing activities in the Consolidated Statement of Cash Flows, and (iii) restricted cash from ending cash and cash equivalents into investing activities in the Consolidated Statement of Cash Flows.

## **2. New Accounting Standards**

### *Postretirement Medical Costs*

In May 2004, the FASB issued FSP FAS 106-2 related to the Prescription Drug Act. FSP FAS 106-2 applies only to sponsors of single-employer defined benefit postretirement health care plans in instances where (i) the employer has concluded that prescription drug benefits available under the plan to some or all participants, for some or all future years, are "actuarially equivalent" to Medicare Part D and thus qualify for the subsidy provided by the Prescription Drug Act, and (ii) the expected subsidy will offset or reduce the employer's share of the cost of the underlying postretirement prescription drug coverage on which the subsidy is based. FSP FAS 106-2 provides guidance on the accounting for the effects of the Prescription Drug Act on a company's accumulated postretirement benefit obligation. In addition, FSP FAS 106-2 addresses accounting for plan amendments and requires certain financial statement disclosures regarding the Prescription Drug Act and its effects.

FSP FAS 106-2 was effective for the first interim period beginning after June 15, 2004. The Company believes that the benefits provided by the Company's postretirement medical plan are actuarially equivalent to Medicare Part D; however, based on the proposed regulations issued to date and the Company's understanding of the Prescription Drug Act, the Company is uncertain as to the potential future subsidies which may be realized under the Prescription Drug Act. Therefore, measures of the accumulated postretirement benefit obligation and net periodic benefit cost included herein do not reflect any amount associated with potential subsidies under the Prescription Drug Act. While the Company continues to evaluate the impact of FSP FAS 106-2, the Company does not believe that it will have a material impact on the Company's financial condition, results of operations, or liquidity.

### *Accounting for Stock Options*

In December 2004, the FASB issued SFAS No. 123(r), *Share Based Payments*. SFAS No. 123(r) will require compensation costs related to share-based payments to be determined by the fair value of the equity or liability instruments issued on the grant date. In addition, such awards will be remeasured each reporting period. Compensation cost will be recognized over the period that an employee provides service in exchange for the award. SFAS No. 123(r) also requires that for the portion of outstanding awards for which the requisite service has not yet been rendered, compensation cost will be recognized as of the required effective date, January 1, 2006, based on the grant-date fair value of those awards. SFAS No. 123(r) applies to all awards granted after the required effective date. The Company continues to evaluate the effects of this Statement on its financial condition, results of operations, or liquidity.

### *Inventory Costs*

In November 2004, the FASB issued SFAS No. 151, *Inventory Costs, an amendment of ARB No. 43, Chapter 4*. SFAS No. 151 clarifies that abnormal amounts of idle facility expense, freight, handling cost and wasted materials (spoilage) should be recognized as current-period charges, and requires the allocation of fixed production overhead to inventory based on the normal capacity of the production facilities. The effective date of the new Statement for the Company is January 1, 2006. Management does not expect the adoption of this Statement to have a material impact on the Company's financial condition, results of operations, or liquidity.

### *Exchanges of Nonmonetary Assets*

In December 2004, the FASB issued SFAS No. 153, *Exchanges of Nonmonetary Assets, an amendment of APB Opinion No. 29*. SFAS No. 153 is based on the principle that exchanges of nonmonetary assets should be measured based on the fair value of the assets exchanged. APB Opinion No. 29 provided an exception to this principle for exchanges of similar productive assets. Under APB Opinion No. 29, an exchange of a productive asset was based on the recorded amount of the asset relinquished. SFAS No. 153 eliminated this exception and replaced it with an exception for exchanges of nonmonetary assets that do not have commercial substance. The effective date of the new Statement for the Company is January 1, 2006. Management does not expect that adoption of this Statement will have a material impact on the Company's financial condition, results of operations, or liquidity.

## **3. Segment Information and Other Items**

Net sales and operating income (loss) for each reportable segment are presented in the Consolidated Statement of Operations. Operating income (loss) for "Corporate" represents general and administrative expenses not directly attributable to the reportable segments. The amounts reflected in the "Corporate" column also serve to reconcile the total of the reportable segments' amounts to totals in the Company's consolidated financial statements.

The following table presents certain other unaudited financial information by reportable segment (in millions).

	Reportable Segments			Corporate	Consolidated Total
	Forest Products	Real Estate	Racing		
Depreciation, depletion and amortization for the three months ended:					
September 30, 2005	\$ 4.3	\$ 3.6	\$ 0.4	\$ -	\$ 8.3
September 30, 2004	4.8	3.5	0.4	-	8.7
Depreciation, depletion and amortization for the nine months ended:					
September 30, 2005	14.1	10.7	1.2	0.1	26.1
September 30, 2004	14.8	10.5	1.3	-	26.6
Total assets as of:					
September 30, 2005	432.1	372.7	33.7	205.7	1,044.2
December 31, 2004	440.0	338.2	33.2	203.8	1,015.2

### *Forest Products*

In March 2005, Palco reached a \$3.1 million settlement of a lawsuit filed by Palco against several insurance companies for reimbursement of settlement payments and defense costs related to a legal matter which was concluded in 2002. This settlement was fully recognized in operating income, as a reduction of selling, general and administrative expenses, in the first quarter of 2005.

Palco has closed its Carlotta and Fortuna mills. In connection therewith, certain equipment from these mills is being moved to Palco's new mill in Scotia. Management is considering alternative uses for the properties and remaining equipment, including sales to third parties, and future write-downs of certain assets may be required if the net book value (less sales costs) of the remaining assets exceeds their estimated realizable values. As a result of closure of these mills, Palco incurred and recognized \$1.4 million of severance costs during the nine months ended September 30, 2004 and \$0.7 million of severance costs during the nine months ended September 2005.

In April 2005, deferred loan costs of \$1.3 million related to the Palco Credit Agreement were written off and loan costs of \$2.3 million related to the Revolving Credit Facility and the Term Loan were capitalized.

#### *Real Estate*

During the third quarter of 2005, PDMPI completed a significant parcel sale; this transaction represented more than 50% of the real estate segment's revenues for the third quarter of 2005.

#### *Other Items not Directly Related to Industry Segments*

In the three months ended September 30, 2005, the Company recognized a \$4.1 million charge related to changes in stock-based compensation expense. For the nine months ended September 30, 2005, this charge was largely offset by a benefit of \$3.8 million recognized during the first six months of 2005. Stock based compensation expense is adjusted as the market value of the Company's Common Stock changes.

## **4. Debt**

#### *Palco*

As of December 31, 2004 and March 31, 2005, Palco was in default under the Palco Credit Agreement and obtained limited waivers of the default through April 22, 2005. On April 19, 2005, Palco and Britt, as Borrowers, closed the Revolving Credit Facility and the Term Loan. The Term Loan was fully funded at closing and the Borrowers used approximately \$10.8 million of the funds from the Term Loan to pay off amounts previously borrowed under the Palco Credit Agreement and terminated that facility. Deferred loan costs of \$1.3 million related to the Palco Credit Agreement were written off in April 2005 and loan costs of \$2.3 million related to the Revolving Credit Facility and the Term Loan were capitalized and, beginning in April 2005, are being amortized using the effective interest rate method. As of September 30, 2005, \$34.8 million was outstanding under the Term Loan and \$12.1 million was outstanding under the Revolving Credit Facility. Palco estimates that its cash flow from operations will not provide sufficient liquidity to fund its operations until the fourth quarter of 2006. Accordingly, Palco expects to be dependent on the funds available under the Revolving Credit Facility, and expects additional liquidity will be needed, to fund its working capital and other cash requirements in 2005 and 2006.

As of September 30, 2005, borrowings under the Revolving Credit Facility were limited to the sum of 85% of Palco and Britt's eligible accounts receivable plus 75% of their eligible inventories (up to a maximum of \$30.0 million, subject to limitations such as the ability of the lender to establish reasonable reserves). Loans under the Revolving Credit Facility bear interest, at the Borrowers' option, at the rate of LIBOR plus 2.25% or prime plus 0.50%. The Revolving Credit Facility matures on April 19, 2010. The Term Loan bears interest, at the Borrowers' option, at the rate of LIBOR plus 6% or prime plus 5%. The Term Loan is repayable in quarterly installments of \$87,500 each, which began on June 1, 2005. A balloon payment of the remaining principal balance is due on April 19, 2010. Both the Term Loan and the Revolving Credit Facility contain EBITDA maintenance covenants that, if not met, could trigger a mandatory prepayment of outstanding borrowings. The operating cash flow estimates used to establish the EBITDA maintenance covenants are subject to a number of assumptions about future operating cash flow and actual results could differ from these estimates. Accordingly, the availability of these funds is largely dependent on Palco's ability to harvest adequate timber from the Scotia LLC Timberlands and reduce operating costs. Available resources to fund Palco's and Britt's operating needs at September 30, 2005, were \$8.0 million, comprised of the maximum availability under the Revolving Credit Facility of \$7.7 million and unrestricted cash and marketable securities of \$0.3 million.

Subsequent to September 30, 2005, Palco borrowed the maximum available under the Revolving Credit Facility and on October 26, 2005, Palco, Britt and certain of their affiliates entered into the Omnibus Amendment, which amended the Term Loan and the Revolving Credit Facility to, among other things, temporarily increase the amount of the Revolving Credit Facility from \$30.0 million to \$35.0 million and temporarily increase the advance rate applicable to the Borrowers' inventory from 75% to 80%. The increase in the inventory advance rate is subject to satisfactory inventory appraisals and the amount of the increase in such advances is capped at \$1.5 million. The increase in the amount of the Revolving Credit Facility and the increase in the inventory advance rate will be gradually phased out in January through March 2006. The Omnibus Amendment also revises financial covenants applicable to the Revolving Credit Facility and the Term Loan. MGI furnished cash collateral of \$2.0 million as additional security for the Borrowers' obligations under the Revolving Credit Facility and the Term Loan Facility. This cash collateral will be released on April 1, 2006, so long as the Borrowers have achieved earnings and borrowing availability targets to be determined by the Lenders.

The Revolving Credit Facility and Term Loan are each secured by a security interest in the stock of Palco held by its immediate parent, MGI, and substantially all of the assets of the Borrowers (other than Palco's equity interest in Scotia LLC). Both the Term Loan and the Revolving Credit Facility have provisions requiring that the net cash proceeds of the specified asset sales be used to prepay amounts outstanding under the loans. The Revolving Credit Facility and the Term Loan contain substantially identical restrictive covenants that limit the Borrowers' ability to incur debt, grant

liens, make investments, pay dividends, make capital expenditures in excess of stated amounts, or merge or consolidate, and require the Borrowers to maintain minimum levels of EBITDA throughout the life of the loans. The Revolving Credit Facility and the Term Loan contain customary events of default and customary remedies with respect to the occurrence of an event of default.

The Revolving Credit Facility includes a prepayment premium of 1% payable in connection with any prepayment or reduction in the commitment occurring within the first two years. The Term Loan includes prepayment premiums of 4%, 3%, 2% and 1% payable in connection with any prepayment of the Term Loan that occurs during the first, second, third and fourth years, respectively. No prepayment premium will be payable under either credit facility to a lender who is also a lender under any refinancing used to prepay such credit facility. The Term Loan also requires certain mandatory prepayments in connection with asset sales by Borrowers.

Under the Revolving Credit Facility and Term Loan, Palco is permitted to invest up to \$5.0 million in Scotia LLC. No such investment had been made or committed to be made by Palco, and there can be no assurance that Palco will determine or be able to make any such investment in whole or part in the future.

On April 21, 2005, Moody's lowered its ratings on the Class A-1 Timber Notes from Baa2 to Ba3; the Class A-2 Timber Notes from Baa3 to B1; and the Class A-3 Timber Notes from Bal to B1. On June 20, 2005, Moody's further lowered its ratings on all classes of the Timber Notes to Caal. S&P announced on April 7, 2005, that it had lowered Palco's credit rating to CCC- (which rating it affirmed on April 28, 2005). As a result of the S&P credit rating actions related to Palco, Palco was required to post a \$9.9 million letter of credit with the State of California to secure its workers compensation liabilities, which reduced Palco's availability under the Revolving Credit Facility by a corresponding amount.

#### *Scotia LLC*

The Scotia LLC Line of Credit allows Scotia LLC to borrow up to one year's interest due on the Timber Notes. On June 20, 2003, the Scotia LLC Line of Credit was extended to July 7, 2006. At or near the completion of such extension, Scotia LLC would request that the Scotia LLC Line of Credit be extended for an additional period of not less than 364 days. If not extended, Scotia LLC may draw upon the full amount available. The amount drawn would be repayable in 12 semiannual installments on each note payment date (after the payment of certain other items, including the Aggregate Minimum Principal Amortization Amount, as defined, then due), commencing approximately two and one-half years following the date of the draw. At September 30, 2005, the maximum availability under the Scotia LLC Line of Credit was \$55.4 million, and outstanding borrowings were \$49.5 million.

On the note payment date in January 2005, Scotia LLC used the funds available under the Scotia LLC Line of Credit to pay all of the \$28.5 million of interest due (\$26.3 million net of interest due in respect of Timber Notes held by Scotia LLC). Scotia LLC also repaid \$17.1 million of principal on the Timber Notes (an amount equal to Scheduled Amortization) using funds held in the SAR Account.

On the note payment date in July 2005, Scotia LLC used its existing cash resources, all of the remaining funds available under the Scotia LLC Line of Credit, and the additional funds made available from the \$2.2 million early log payment by Palco (see Note 1), to pay all of the \$27.9 million of interest due (\$25.9 million net of interest due in respect of Timber Notes held by Scotia LLC). Scotia LLC also repaid \$8.0 million of principal on the Timber Notes (an amount equal to Scheduled Amortization) using funds held in the SAR Account.

## **5. Income Taxes**

The Company generated income (loss) before income taxes of \$4.3 million and \$(19.5) million for the third quarter and the first nine months of 2005, respectively; however, the Company has not recorded any tax provision or benefit during these periods as the Company anticipates an effective tax rate of zero for the year ended December 31, 2005. Each period, the Company evaluates appropriate factors in determining the realizability of the deferred tax assets attributable to losses and credits generated in that period and those being carried forward. These factors are discussed further in Note 9 to the Company's consolidated financial statements included in the Form 10-K. Based on this evaluation, the Company provided valuation allowances with respect to the deferred tax assets attributable to the losses and credits generated during the nine months ended September 30, 2005. These valuation allowances were in addition to the valuation allowances which were provided in prior years.

## 6. Employee Benefit Plans

The components of pension and other postretirement benefits expense are as follows (in millions):

	Pension Benefits		Medical/Life Benefits		Pension Benefits		Medical/Life Benefits	
	Three Months Ended September 30,				Nine Months Ended September 30,			
	2005	2004	2005	2004	2005	2004	2005	2004
Components of net periodic benefit costs:								
Service cost	\$ 0.3	\$ 0.7	\$ 0.1	\$ 0.1	\$ 2.1	\$ 2.1	\$ 0.3	\$ 0.3
Interest cost	1.4	1.4	0.2	0.2	4.2	4.2	0.6	0.6
Expected return on assets	(1.3)	(1.3)	—	—	(3.9)	(3.9)	—	—
Amortization of prior service costs	—	—	(0.1)	(0.1)	—	—	(0.3)	(0.3)
Recognized net actuarial loss	0.2	—	—	—	0.6	0.1	—	—
Curtailement	—	—	(0.1)	—	—	—	(0.1)	(0.1)
Net periodic benefit costs	<u>\$ 0.6</u>	<u>\$ 0.8</u>	<u>\$ 0.1</u>	<u>\$ 0.2</u>	<u>\$ 3.0</u>	<u>\$ 2.5</u>	<u>\$ 0.5</u>	<u>\$ 0.5</u>

The Company is evaluating its employee benefit plans and changes to such plans may be implemented in 2006.

## 7. Investment in Kaiser

As discussed further in the Form 10-K, Kaiser, its wholly owned subsidiary, KACC, and 24 of KACC's subsidiaries have filed separate voluntary petitions in the Bankruptcy Court for reorganization under Chapter 11 of the Bankruptcy Code. On June 29, 2005, Kaiser, together with KACC and 19 of KACC's subsidiaries, filed a plan of reorganization and related disclosure statement in the U.S. Bankruptcy Court for the District of Delaware. The plan provides for, among other things, the cancellation of the equity interests of current stockholders without consideration. While the disclosure statement and plan are subject to approval by the Bankruptcy Court, the Company expects Kaiser to emerge from Chapter 11 during the first quarter of 2006. However, no assurance can be given that this will occur.

Kaiser's common stock is publicly traded on the OTC Bulletin Board under the trading symbol "KLUCQ.OB." The market value for the 50,000,000 Kaiser Shares, based on the price per share quoted at the close of business on November 4, 2005 was \$1.7 million. There can be no assurance that such value could be realized.

## 8. Contingencies

### *Forest Products Operations*

Regulatory and environmental matters play a significant role in the Company's forest products business, which is subject to a variety of California and federal laws and regulations, as well as the HCP, dealing with timber harvesting practices, threatened and endangered species and habitat for such species, and air and water quality.

### *Environmental Plans*

From March 1999 until October 2002, Scotia LLC prepared THPs in accordance with the SYP. The SYP was intended to comply with CDF regulations requiring timber companies to demonstrate sustained yield, i.e. that their projected average annual harvest for any decade within a 100-year planning period will not exceed the average annual growth level at the end of the 100-year planning period. The forest practice rules allow companies which do not have a sustained yield plan to follow alternative procedures to document compliance with the sustained yield requirements. As discussed below, on October 31, 2003, the Court hearing the *EPIC-SYP/Permits lawsuit* entered a judgment invalidating the SYP and the California Permits, and that decision is now on appeal. As a result of an earlier stay order issued in this case, Scotia LLC has since October 2002 been obtaining review and approval of THPs under alternative procedures pending approval of the Option A Plan, which is an alternative to a sustained yield plan. The Option A Plan was approved by the CDF in March 2005.

The HCP and related Federal Permits allow incidental "take" of certain federally listed species located on the Scotia LLC Timberlands so long as there is no "jeopardy" to the continued existence of such species. The HCP identifies the measures to be instituted in order to minimize and mitigate the anticipated level of take to the greatest extent practicable. The HCP and Federal Permits have terms of 50 years. Since the consummation of the Headwaters Agreement in March 1999, there has been a significant amount of work and additional costs required in connection with the implementation of the HCP and SYP, and this work and the additional costs are expected to continue for the foreseeable future.

### *Water Quality*

Laws and regulations dealing with water quality are impacting Palco and Scotia LLC primarily in four areas: efforts by the EPA and the North Coast Water Board to establish TMDLs in watercourses that have been declared to be water quality impaired; actions by the North Coast Water Board to impose waste discharge reporting requirements in respect of watersheds on the Scotia LLC Timberlands and, in some cases, clean-up or preventive measures; actions by the North Coast Water Board during the THP approval process which impose certain operational requirements on individual THPs; and a directive of the North Coast Water Board to its staff to develop WWDRs for the Freshwater and Elk River watersheds.

Under the CWA, the EPA is required to establish TMDLs in watercourses that have been declared to be “water quality impaired.” The EPA and the North Coast Water Board are in the process of establishing TMDLs for many northern California rivers and certain of their tributaries, including nine watercourses that flow within the Scotia LLC Timberlands. The Company expects this process to continue into 2010. The final TMDL requirements applicable to the Scotia LLC Timberlands may require aquatic protection measures that are different from or in addition to those in the HCP or that result from the prescriptions to be developed pursuant to the watershed analysis process provided for in the HCP.

Beginning with the 2002-2003 winter operating period, Palco and Scotia LLC have been required to submit information on sediment discharges and erosion control plans to the North Coast Water Board each year in order to conduct harvesting activities. After consideration of these reports, the North Coast Water Board imposed requirements on Palco to implement additional mitigation and erosion control practices during harvest activities. Reporting and mitigation requirements imposed by the North Coast Water Board and CDF have significantly increased operating costs and will in the future further increase costs or cause delays in THP approvals or harvesting on approved THPs.

The North Coast Water Board has also issued the Elk River Order, which is a clean up and abatement order aimed at addressing existing sediment production sites in the Elk River watershed through clean up actions. The North Coast Water Board has also initiated the process which could result in similar orders for the Freshwater and Bear Creek watersheds, and is contemplating similar actions for the Jordan and Stitz Creek watersheds. The Elk River Order has resulted in increased costs to Palco that could extend over a number of years. Additional orders in other watersheds (should they be issued) may also result in further cost increases. Palco’s appeal of the Elk River Order to the State Water Board was denied. Palco has appealed the decision of the State Water Board but is holding such appeal in abeyance until resolution of the *THP 520 lawsuit* discussed below.

The North Coast Water Board in December 2003 directed its staff to formulate WWDRs for the Freshwater and Elk River watersheds on the Scotia LLC Timberlands. As harvesting activities on the Scotia LLC Timberlands cannot readily be moved between watersheds due to, among other things, historic harvest patterns, adjacency restrictions, and the age classes of trees, development of WWDRs and the other matters described in the “Forest Products Operations—Water Quality” section of Note 8 are expected to result in reduced harvest in the future. The staff of the North Coast Water Board has circulated for public review and comment draft WWDRs for the Freshwater and Elk River watersheds. If these draft WWDRs are approved in their current form, there would likely be a significant adverse impact on current and future harvest levels.

As WWDRs had not been formulated, the North Coast Water Board for some time failed to release for harvest a number of Scotia LLC’s THPs that had already been approved by the other governmental agencies which approve Scotia LLC’s THPs. In February 2005, the Executive Officer of the staff of the North Coast Water Board released sufficient THPs to allow the harvest of up to 50% of the CDF Harvest Limit for these two watersheds. On March 16, 2005, the North Coast Water Board ordered the enrollment of additional THPs that would allow the harvest of up to 75% of the CDF Harvest Limit for these two watersheds. Third parties subsequently appealed this decision to the State Water Board. On June 16, 2005, the State Water Board heard this appeal and rendered a decision, which had the effect of disallowing further harvesting on the additional 25% of the CDF Harvest Limit approved by the North Coast Water Board on March 16, 2005. The State Water Board’s decision also has the effect of disallowing further harvesting in the Freshwater and Elk River watersheds until WWDRs for these watersheds are adopted by the North Coast Water Board. Palco has appealed the State Water Board’s June 16, 2005, decision in a California state court. A hearing on the appeal has not yet been scheduled.

On September 2, 2005, the North Coast Water Board set hearings on the draft WWDRs for September 14 and 15, 2005. On September 9, 2005, Palco and Scotia LLC filed a petition in California state court seeking an order mandating that the North Coast Water Board not take any further action on the proposed WWDRs. The petition alleges defects in the proposed WWDRs and the North Coast Water Board’s hearing procedures. Palco and Scotia LLC also requested



a temporary restraining order and preliminary injunction to prevent the North Coast Water Board from taking any further action until their petition is heard. The temporary restraining order was granted and the preliminary injunction hearing is scheduled for November 9, 2005.

Effective January 1, 2004, California Senate Bill 810 provides regional water quality control boards with additional authority related to the approval of THPs on land within impaired watersheds. The Company is uncertain of the operational and financial effects which will ultimately result from Senate Bill 810; however, because substantially all rivers and waterbodies on the Scotia LLC Timberlands are classified as sediment-impaired, implementation of this law could result in delays in obtaining approvals of THPs, lower harvest levels and increased costs and additional protection measures beyond those contained in the HCP. Also see the description of the *THP No. 520 lawsuit* below.

#### *Timber Harvest Litigation*

A California state court has invalidated the SYP in connection with two lawsuits filed against Palco, as described below, which decision has been appealed. Other pending judicial and administrative proceedings, as described below, could affect Palco's and Scotia LLC's ability to implement the HCP, implement certain approved THPs, or carry out other operations.

In March 1999, the *EPIC-SYP/Permits lawsuit* was filed. This action alleged, among other things, various violations of the CESA and the California Environmental Quality Act, and challenged, among other things, the validity and legality of the SYP and the California Permits. The plaintiffs sought, among other things, to set aside California's approval of the SYP and the California Permits and injunctive relief to prevent implementation of THPs approved in reliance upon these documents. In March 1999, a similar action, the *USWA lawsuit*, was filed challenging the validity and legality of the SYP. The *EPIC-SYP/Permits* and *USWA lawsuits* were consolidated for trial. Following trial, the Court on October 31, 2003, entered a judgment invalidating the SYP and the California Permits due to several deficiencies in agency procedures and the failure of the Palco Companies to submit a complete and comprehensible SYP. As a result of this case, Scotia LLC has, since October 2002, when the Court issued a stay order preventing future reliance upon the SYP, been obtaining review and approval of new THPs under alternative procedures pending approval of the Option A Plan. As noted above, the Option A Plan was approved by the CDF in March 2005. The Palco Companies and the State of California have appealed the October 31, 2003 decision. The appeal was heard by the Court of Appeal on September 16, 2005, and its decision is pending. In September 2004, the Court granted the plaintiffs' request for reimbursement of an aggregate of \$5.8 million in attorneys' fees and other expenses incurred in connection with these matters. The Palco Companies and the State of California have also appealed this decision.

In July 2001, the *Bear Creek lawsuit* was filed and later amended to add the EPA as a defendant. The lawsuit alleges that harvesting and other forestry activities under certain of Scotia LLC's approved THPs will result in discharges of pollutants in violation of the CWA. The plaintiff asserts that the CWA requires the defendants to obtain a permit from the North Coast Water Board before beginning timber harvesting and road construction activities and is seeking to enjoin these activities until such permit has been obtained. The plaintiff also seeks civil penalties of up to \$27,500 per day for the alleged continued violation of the CWA. On October 14, 2003, in connection with certain motions that had been filed, the Court upheld the validity of an EPA regulation which exempts harvesting and other forestry activities from certain discharge requirements. Both state and federal agencies, along with Palco and other timber companies, have relied upon this regulation for more than 25 years. However, the Court interpreted the regulation in such a way as to narrow the forestry operations which are exempted, thereby limiting the regulation's applicability and subjecting culverts and ditches to permit requirements. This ruling has widespread implications for the timber industry in the United States. The case is not yet final as the trial has not yet been held, and there are many unresolved issues involving interpretation of the Court's decision and its application to actual operations. The Company has recently filed a motion for summary judgment on the ground that it has met the requirements for a storm water pollution prevention permit under a general permit issued by the state of California.

Should the decision ultimately become final and be held to apply to all of Palco's timber operations, it may have some or all of the following effects: imposing additional permitting requirements, delaying approvals of THPs, increasing harvesting costs, and adding water protection measures beyond those contained in the HCP. Nonetheless, the Company believes that it is not likely that civil penalties will be awarded for operations that occurred prior to the Court's decision due to the historical reliance by timber companies on the regulation and Palco's belief that the requirements under the HCP are adequate to ensure that sediment and pollutants from harvesting activities on the Scotia LLC Timberlands will not reach levels harmful to the environment. While the impact of a conclusion to this case that upholds the October 14, 2003 ruling may be adverse, the Company does not believe that such an outcome would have a material adverse impact on the Company's consolidated financial condition, results of operations or liquidity. Nevertheless, due to the numerous ways in which the Court's interpretation of the regulation could be applied to actual operations, there can be no assurance

that this will be the case.

On November 20, 2002, the *Cook action* and the *Cave action* were filed, which name Palco, Scotia LLC and certain affiliates as defendants. On April 4, 2003, the plaintiffs in these actions filed amended complaints and served the defendants with notice of the actions. The *Cook action* alleges, among other things, that defendants' logging practices have contributed to an increase in flooding along Freshwater Creek (which runs through the Scotia LLC Timberlands), resulting in personal injury and damage to the plaintiffs' properties. Plaintiffs further allege that in order to have THPs approved in the affected areas, the defendants engaged in certain unfair business practices. The plaintiffs seek, among other things, compensatory and exemplary damages, injunctive relief, and appointment of a receiver to ensure that the watershed is restored. The *Cave action* contains similar allegations and requests similar relief with respect to the Elk River watershed (a portion of which is contained on the Scotia LLC Timberlands). The Company does not believe the resolution of these actions should result in a material adverse effect on its consolidated financial condition, results of operations or liquidity.

On February 25, 2003, the District Attorney of Humboldt County filed the *Humboldt DA action*. The suit was filed under California's unfair competition law and alleges that the Palco Companies used certain unfair business practices in connection with completion of the Headwaters Agreement, and that this resulted in these companies being able to harvest significantly more trees under the Environmental Plans than would have otherwise been the case. The suit sought a variety of remedies including a civil penalty of \$2,500 for each additional tree that has been or will be harvested due to this alleged increase in harvest, as well as restitution and an injunction in respect of the additional timber harvesting allegedly being conducted. On June 14, 2005, the Court dismissed this matter in its entirety. On September 19, 2005, the District Attorney appealed this decision, however, the Company believes that the dismissal ruling has substantially diminished its exposure with respect to this matter.

On November 2, 2004, the *EPIC-USFWS/NOAA lawsuit* was filed. This lawsuit alleges that two federal agencies have violated certain federal laws and related regulations in connection with their oversight of the HCP and Federal Permits. The plaintiff also alleges that the Federal Permit for the northern spotted owl was unlawfully issued and asserts several claims, including that the Palco Companies violated California's unfair competition law by using false advertising and making misleading environmental claims. The plaintiff seeks a variety of remedies including requiring additional actions by the federal agencies and precluding them from authorizing take of the northern spotted owl, an injunction requiring the Palco Companies to cease certain alleged unlawful activities, as well as restitution and remediation by Palco. On April 22, 2005, pursuant to motions to dismiss filed by the Palco Companies and the federal defendants, the Court dismissed several of the claims, significantly reducing the scope of the case. On September 30, 2005, EPIC filed a motion to prevent the Palco Companies from taking any further action under the HCP and California Permits, including all timber harvesting or related activities. On October 5, 2005, Palco agreed to defer harvesting on one THP pending the resolution of EPIC's motion, while EPIC agreed not to pursue additional legal action. A hearing on plaintiff's motion for a preliminary injunction was held November 1, 2005, and the parties are awaiting a decision. The Company does not believe the resolution of this action should result in a material adverse effect on its consolidated financial condition, results of operations or liquidity.

On November 16, 2001, Palco and Scotia LLC filed the *THP No. 520 lawsuit* alleging that the State Water Board had no legal authority to impose mitigation measures that were requested by the staff of the North Coast Water Board during the THP review process and rejected by the CDF prior to approving the THP. When the staff of the North Coast Water Board attempted to impose these mitigation measures in spite of the CDF's decision, Palco and Scotia LLC appealed to the State Water Board, which imposed certain of the requested mitigation measures and rejected others. Palco and Scotia LLC filed the *THP No. 520 lawsuit* challenging the State Water Board's decision, and in January 2003, a California state court granted their request for an order invalidating the imposition of these additional measures. The State Water Board appealed this decision, and on March 18, 2004, the appellate court reversed the decision of the state court. The appellate court's decision could result in increased demands by the regional and state water boards and their staffs to impose controls and limitations upon Palco's timber harvesting beyond those provided for by the Environmental Plans or could provide additional regulatory powers to the regional and state water boards and their staffs beyond those provided in Senate Bill 810. Palco and Scotia LLC filed a petition for review of the appellate court's decision by the California Supreme Court, which in June 2004 agreed to review the decision. Briefing was completed on April 26, 2005, and a hearing has been set for November 10, 2005.

On August 8, 2005, the CBD filed an action against CDF, Palco, Scotia Pacific and Salmon Creek seeking to overturn and prevent CDFG and Palco from taking any action to implement or rely upon Consistency Determinations issued by CDFG in February 2005. The Consistency Determinations were issued as a result of the *EPIC SYP Permits lawsuit*, which overturned the California Permits issued to Palco, resulting in Palco having no coverage from the State

for the incidental take of coho salmon or the marbled murrelet. CBD alleges that the process followed by CDFG in issuing the Consistency Determinations did not comply with CEQA and that the Federal Permits are out of date because of new information and reliance upon them is therefore improper. A hearing was held in California state court on October 28, 2005, and the Court denied CBD's request for a preliminary injunction.

#### *OTS Contingency and Related Matters*

On December 26, 1995, the OTS initiated the *OTS action* against the Company and others alleging, among other things, misconduct by the Respondents and others with respect to the failure of USAT. The OTS sought damages ranging from \$326.6 million to \$821.3 million under various theories. Following a lengthy administrative hearing during portions of 1997-1999, the administrative law judge on September 12, 2001, issued a recommended decision in favor of the Respondents on each claim made by the OTS. On October 17, 2002, the *OTS action* was settled for \$0.2 million with no admission of wrongdoing on the part of the Respondents.

As a result of the dismissal of *OTS action*, a related civil action, the *FDIC action*, alleging damages in excess of \$250.0 million, was subsequently dismissed. The *FDIC action* was originally filed by the FDIC in August 1995 against Mr. Charles E. Hurwitz (Chairman and Chief Executive Officer of the Company).

On November 8, 2002, the Respondents filed the Sanctions Motion. The Sanctions Motion states that the FDIC illegally paid the OTS to bring the *OTS action* against the Respondents and that the FDIC illegally sued for an improper purpose (i.e., in order to acquire timberlands held by a subsidiary of the Company). The Respondents are seeking a sanction to be made whole for a portion of the attorneys' fees they have paid (plus interest) in connection with the *OTS* and *FDIC actions*. As of September 30, 2005, such fees were in excess of \$40.6 million. On August 23, 2005, a U.S. District Court ruled on the Sanctions Motion, ordering the FDIC to pay the Company \$72.3 million. The FDIC has appealed the District Court decision to the U.S. Fifth Circuit Court of Appeals.

The Company's bylaws provide for indemnification of its officers and directors to the fullest extent permitted by Delaware law. The Company is obligated to advance defense costs to its officers and directors, subject to the individual's obligation to repay such amount if it is ultimately determined that the individual was not entitled to indemnification. In addition, the Company's indemnity obligation can, under certain circumstances, include amounts other than defense costs, including judgments and settlements.

On January 16, 2001, the *Kahn lawsuit* was filed. The plaintiff purports to bring this action as a stockholder of the Company derivatively on behalf of the Company. The lawsuit concerns the *OTS* and *FDIC actions*, and the Company's advancement of fees and expenses on behalf of Federated and certain of the Company's directors in connection with these actions. It alleges that the defendants have breached their fiduciary duties to the Company, and wasted corporate assets, by allowing the Company to bear all of the costs and expenses of Federated and certain of the Company's directors related to the *OTS* and *FDIC actions*. The plaintiff seeks to require Federated and certain of the Company's directors to reimburse the Company for all costs and expenses incurred by the Company in connection with the *OTS* and *FDIC actions*, and to enjoin the Company from advancing to Federated or certain of the Company's directors any further funds for costs or expenses associated with these actions. The parties to the *Kahn lawsuit* have agreed to an indefinite extension of the defendants' obligations to respond to the plaintiffs' claims. Although it is impossible to assess the ultimate outcome of the *Kahn lawsuit*, the Company believes that the resolution of this matter should not result in a material adverse effect on its consolidated financial condition, results of operations or liquidity.

#### *Other Matters*

On September 2, 2004, the Company was advised that one of its former subsidiaries is a successor to a company which manufactured munitions for the U.S. Navy during World War II. The current owner of the underlying property, which is located in Cranbury, New Jersey, is seeking the Company's participation in efforts to address contamination of the site which resulted from such operations. The current owner estimates that the costs to determine what remedial actions are needed, and to perform any remedial actions determined necessary, could range from \$3.0 million to \$8.0 million. Costs for the investigation and remediation could, however, exceed \$8.0 million as the result of information learned during the investigation. The Company is currently in the process of determining the extent of its liability, which could require payment of a substantial portion of the costs, as well as the availability of funding from the U.S. Navy and insurance coverage for these activities. On December 29, 2004, the NJDEP issued a directive against the current owner of the property, MGI, and the U.S. Navy requiring these parties to conduct a RI/RA in respect of the property. As further required by the directive, MGI and the current owner on January 28, 2005, entered into an Administrative Consent Order providing, among other things, that MGI and the current owner begin implementing the RI/RA within 120 days of execution of the Order. MGI and the current owner of the property have also entered into a Participation Agreement providing for, among other things, MGI and the current owner to jointly fund the RI/RA and for a mediation process to

assist in equitably allocating the costs of the RI/RA. In April, 2005, MGI and the current owner submitted a Scope of Work for the site to the NJDEP. On April 6, 2005, MGI filed a Complaint against the United States of America, the U.S. Navy, and the U.S. Army for costs recovery and contribution; the parties subsequently denied all of the claims. The first mediation session with the current owner of the property is scheduled for November 9, 2005. The Company accrued its expected share of the estimated costs of the RI/RA in 2004. While the Company believes its estimates are reasonable, future charges may be required as additional information is obtained.

The Company is involved in other claims, lawsuits and proceedings. While uncertainties are inherent in the final outcome of such matters and it is presently impossible to determine the actual costs that ultimately may be incurred or their effect on the Company, management believes that the resolution of such uncertainties and the incurrence of such costs should not result in a material adverse effect on the Company's consolidated financial condition, results of operations or liquidity.

## 9. Stock-Based Compensation Plans

Stock options issued to employees and outside directors are accounted for under the intrinsic value method of accounting as defined by APB Opinion No. 25 and related interpretations. The Company has not yet changed to the fair value based method of accounting for stock-based employee compensation as prescribed by SFAS No. 123(r). The following table illustrates the pro forma effect on net income and earnings per share had the Company accounted for its stock options under the fair value method of accounting (in millions, except per share information):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
Net income (loss), as reported	\$ 4.3	\$ (20.2)	\$ (19.5)	\$ (45.8)
Add: Non-cash stock-based employee compensation expenses included in reported net loss, net of related tax effects	4.1	0.4	0.3	2.3
Deduct: Total stock-based employee compensation expense determined under the fair value method for all awards, net of related tax effects	<u>(4.5)</u>	<u>(0.9)</u>	<u>(1.5)</u>	<u>(3.7)</u>
Pro forma net income (loss)	<u>\$ 3.9</u>	<u>\$ (20.7)</u>	<u>\$ (20.7)</u>	<u>\$ (47.2)</u>
Basic income (loss) per share:				
As reported	\$ 0.72	\$ (3.37)	\$ (3.26)	\$ (7.66)
Pro forma	0.65	(3.45)	(3.47)	(7.88)
Diluted income (loss) per share:				
As reported	\$ 0.62	\$ (3.37)	\$ (3.26)	\$ (7.66)
Pro forma	0.56	(3.45)	(3.47)	(7.88)

## 10. Per Share Information

The weighted average number of shares used to determine basic and diluted earnings per share was:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
Weighted average shares outstanding:				
Common Stock	5,967,942	5,976,466	5,973,608	5,976,466
Effect of dilution:				
Class A Preferred Stock <sup>(1)</sup>	668,119	—	—	—
Weighted average number of common and common equivalent shares - Basic	6,636,061	5,976,466	5,973,608	5,976,466
Effect of dilution:				
Stock options <sup>(1)</sup>	311,886	—	—	—
Weighted average number of common and common equivalent shares - Diluted	6,947,947	5,976,466	5,973,608	5,976,466

<sup>(1)</sup> The Class A Preferred Stock and options were not included, except for the three months ended September 30, 2005, in the computation of basic or diluted earnings per share because the Company had a loss for the nine months ended September 30, 2005 and 2004, respectively.

## 11. Comprehensive Income (Loss)

The following table sets forth comprehensive income (loss) (in millions).

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
Net income (loss):	\$ 4.3	\$ (20.2)	\$ (19.5)	\$ (45.8)
Other comprehensive income (loss):				
Unrealized income (loss) on available-for-sale investments	—	0.3	(0.1)	(1.5)
Total comprehensive income (loss)	\$ 4.3	\$ (19.9)	\$ (19.6)	\$ (47.3)

## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following should be read in conjunction with the financial statements in Part I, Item 1. of this Report and Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations" and Item 8. "Financial Statements and Supplementary Data" of the Form 10-K. Any capitalized terms used but not defined in this Item are defined in the "Glossary of Defined Terms" contained in Appendix A. Except as otherwise noted, all references to Notes represent the Condensed Notes to Consolidated Financial Statements included herein.

*This Quarterly Report on Form 10-Q contains statements which constitute "forward-looking statements" within the meaning of the PSLRA. These statements appear in a number of places in this section and in Part II, Item 1. "Legal Proceedings." Such statements can be identified by the use of forward-looking terminology such as "believes," "expects," "may," "estimates," "will," "should," "could," "plans," "intends," "projects," "seeks," or "anticipates" or the negative thereof or other variations thereon or comparable terminology, or by discussions of strategy. Readers are cautioned that any such forward-looking statements are not guarantees of future performance and involve significant risks and uncertainties, and that actual results may vary materially from the forward-looking statements as a result of various factors. These factors include the effectiveness of management's strategies and decisions, general economic and business conditions, developments in technology, new or modified statutory, environmental or regulatory requirements, litigation developments, and changing prices and market conditions. This Form 10-Q and the Form 10-K identify other factors which could cause differences between such forward-looking statements and actual results. No assurance can be given that these are all of the factors that could cause actual results to vary materially from the forward-looking statements.*

### Results of Operations

*This section contains statements which constitute "forward-looking statements" within the meaning of the PSLRA. See the statement in Item 2. above for cautionary information with respect to such forward-looking statements.*

The Company conducts the substantial portion of its operations through its subsidiaries, which operate in three principal industries: forest products, through MGI and its wholly owned subsidiaries, principally Palco and its subsidiaries; real estate investment and development, through MPC and other wholly owned subsidiaries as well as joint ventures; and racing operations through SHRP, Ltd. MGHI owns 100% of MGI and is a wholly owned subsidiary of the Company. In addition, the Company owns approximately 63% of Kaiser, a producer of fabricated aluminum products currently in Chapter 11. All references to the "Company" include MAXXAM Inc. and its majority and wholly owned subsidiaries (but exclusive of Kaiser and its subsidiaries), unless otherwise indicated or the context indicates otherwise. All references to specific entities refer to the respective companies and their subsidiaries, unless otherwise indicated or the context indicates otherwise.

### Consolidated Operations

#### Selected Operational Data

The following table presents selected financial information for the three and nine month periods ended September 30, 2005 and 2004 for the Company's consolidated operations.

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2005	2004	2005	2004
Net sales	\$ 105.8	\$ 81.5	\$ 276.0	\$ 242.9
Costs and expenses	(86.1)	(83.2)	(247.1)	(242.1)
Gains on sales of timberlands and other assets	—	0.2	0.1	0.2
Operating income (loss)	19.7	(1.5)	29.0	1.0
Other income, net	4.1	—	9.6	9.0
Interest expense	(19.5)	(18.6)	(58.1)	(55.7)
Income (loss) before income taxes	<u>\$ 4.3</u>	<u>\$ (20.1)</u>	<u>\$ (19.5)</u>	<u>\$ (45.7)</u>

### *Deconsolidation of Kaiser*

See Notes 1 and 7 for information regarding the deconsolidation of Kaiser's financial results and the Company's investment in Kaiser.

## ***Overview of Consolidated Results of Operations***

### *Net Sales*

Consolidated net sales for the three months ended September 30, 2005, increased \$24.3 million, as compared to the comparable period in the prior year. Real estate sales more than doubled during the quarter due to a significant acreage sale at Palmas as well as increased sales activity at Fountain Hills. This increase was offset by a \$7.0 million decline in sales at the Company's forest products segment primarily as a result of decline in lumber shipments during the quarter, compounded by an unfavorable shift in lumber sold from redwood lumber to lower-priced, common grade Douglas-fir lumber, as well as a \$0.7 million decline in racing segment net sales, due primarily to fewer live racing days during the quarter.

Consolidated net sales for the nine months ended September, 2005, increased \$33.1 million, compared to the same period in 2004. The Company's real estate segment realized a 91% increase in net sales for the first nine months of 2005, reflecting the acreage sale at Palmas as well as strong sales at Fountain Hills. This increase was offset by a \$12.4 million decline in net sales at the Company's forest products segment and a \$4.6 million decline in racing segment net sales.

### *Operating Income*

Consolidated operating income for the third quarter of 2005, totaled \$19.7 million compared to operating loss of \$1.5 million for the same quarter in 2004. Operating results for the real estate segment increased \$27.5 million, primarily as a result of increased real estate sales, as discussed above. Operating results for the forest products segment declined \$3.1 million, primarily as a result of a decline in lumber shipments during the quarter, compounded by an unfavorable shift in lumber sold from redwood lumber to lower-priced, common grade Douglas-fir lumber, exacerbated by higher harvesting, hauling, and production costs and substantial legal and professional fees relating to Scotia LLC's efforts to pursue a negotiated restructuring of the Timber Notes.

Consolidated operating income for the nine months ended September 30, 2005, increased \$28.0 million, as compared to same period in the prior year. The Company's real estate segment realized a \$38.1 million increase in operating income during the first nine months of 2005, as compared to the comparable period in the prior year. Operating results for the forest products segment declined by \$11.2 million due to a decline in lumber shipments during the quarter, compounded by an unfavorable shift in lumber sold from upper grade to common grade redwood and from redwood lumber to lower-priced, common grade Douglas-fir lumber and a substantial increase in costs, partially offset by a \$3.1 million insurance settlement received in the first quarter 2005. The corporate segment's operating loss decreased by \$2.3 million, primarily as a result of lower stock-based compensation expense in 2005, reflecting changes in the market value of the Company's stock since December 31, 2004.

### *Other Income, net*

Consolidated other income, net for the third quarter of 2005 was impacted favorably by a \$4.6 million increase in investment income, offset by a reduction in equity earnings from the Company's investment in FireRock LLC due to the sell-out of lots at the development in 2004.

Consolidated other income, net for the first nine months of 2005 was impacted favorably by a \$4.3 million increase in investment income, offset by a reduction in equity earnings from the Company's investment in FireRock LLC due to the sell-out of lots in 2004.

## ***Forest Products Operations***

### *Industry Overview and Selected Operational Data*

The Company's forest products operations are conducted through MGI and its wholly owned subsidiaries, principally Palco and its subsidiaries. The segment's business is somewhat seasonal, and its net sales have been historically higher in the months of April through November than in the months of December through March. Management expects that MGI's revenues and cash flows will continue to be seasonal because of the harvesting, road use, wet weather and other restrictions imposed by the HCP and regulation. Accordingly, MGI's results for any one quarter are not necessarily indicative of results to be expected for the full year.

Regulatory and environmental matters as well as legal actions have played and are expected to continue to play a significant role in the Company's forest products operations. Scotia LLC has previously experienced delays in the approval of its THPs as the result of regulatory compliance and litigation challenges, and expects these difficulties to persist. Moreover, the Company expects a recurrence of the additional delays that have recently been experienced in harvesting on previously-approved THPs due to regulatory oversight by the North Coast Water Board. The foregoing matters have in the past adversely affected timber harvest levels and timber harvesting and other costs; these effects are expected to continue. In addition, there can be no assurance that certain other pending legal, regulatory and environmental matters or future governmental regulations, legislation or judicial or administrative decisions, adverse weather conditions, or low lumber or log prices, will not have a material adverse effect on the financial condition, results of operations or liquidity of the Company's forest products operations. See Item 1. "Business—Forest Products Operations—Regulatory and Environmental Matters" of the Form 10-K, and Notes 1 and 8 in this Form 10-Q, for further discussion of these matters.

During 2001, comprehensive external and internal reviews were conducted of Palco's business operations. These reviews were conducted in an effort to identify ways in which Palco could operate on a more efficient and cost-effective basis. Based upon these reviews, Palco implemented a number of changes during the last quarter of 2001 and the first quarter of 2002, including closing two of its four sawmills, eliminating certain of its operations, including its company-staffed logging operations (now relying exclusively on contract loggers) and its soil amendment and concrete block activities, utilizing more efficient harvesting methods and adopting other cost saving measures. Palco has continued to examine ways in which to achieve cost savings. During 2004, Palco opened its new (replacement) planer facility and began construction on its new sawmill. Palco has spent \$26.7 million through September 30, 2005, on the new sawmill and planer facility (\$20.5 million of which was expended in 2004). The new sawmill construction project is substantially complete, and while production levels at the new sawmill continue to improve, it is not yet operating at planned capacity and is not expected to achieve planned production rates for the remainder of 2005. Funds for this project were provided from cash resources and borrowings under the Palco Credit Agreement and cash made available as a result of borrowings under the Term Loan and the Revolving Credit Facility. As part of the project, Palco's Carlotta mill was closed in 2004 and its Fortuna mill was closed in June 2005. As a result of these mill closures, Palco recognized severance costs of \$0.7 million in 2005. Certain equipment from these mills is being moved to the new sawmill and management is considering alternative uses for the properties and remaining equipment, including sales to third parties. Further actions may be taken in the fourth quarter of 2005 as a result of Palco's continuing evaluation process or in response to the financial difficulties described elsewhere in this Form 10-Q, and writedowns of certain assets may be required.



The following table presents selected operational and financial information for the third quarter and nine months ended September 30, 2005 and 2004, for the Company's forest products operations.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
(In millions of dollars, except shipments and prices)				
Shipments:				
Lumber: <sup>(1)</sup>				
Redwood upper grades	1.3	4.7	5.9	14.2
Redwood common grades	40.8	53.3	126.9	154.5
Douglas-fir upper grades	0.1	0.4	0.5	1.7
Douglas-fir common grades	23.5	10.6	81.2	39.1
Other	(0.1)	-	1.5	5.0
Total lumber	<u>65.6</u>	<u>69.0</u>	<u>216.0</u>	<u>214.5</u>
Cogeneration power <sup>(2)</sup>	<u>41.3</u>	<u>43.6</u>	<u>125.3</u>	<u>120.4</u>
Average sales price:				
Lumber: <sup>(3)</sup>				
Redwood upper grades	\$ 1,199.0	\$ 1,355.0	\$ 1,253.0	\$ 1,349.0
Redwood common grades	606.0	616.0	619.0	615.0
Douglas-fir upper grades	739.0	971.0	1,037.0	1,060.0
Douglas-fir common grades	379.0	501.0	374.0	453.0
Cogeneration power <sup>(4)</sup>	66.0	66.0	65.0	65.0
Net sales:				
Lumber, net of discount	\$ 36.0	\$ 44.0	\$ 117.2	\$ 133.6
Logs	2.4	1.2	6.3	3.6
Cogeneration power	2.8	3.0	8.3	8.1
Wood chips	0.6	0.6	2.7	1.9
Other	0.8	0.8	2.3	2.0
Total net sales	<u>\$ 42.6</u>	<u>\$ 49.6</u>	<u>\$ 136.8</u>	<u>\$ 149.2</u>
Operating income (loss)	<u>\$ (2.1)</u>	<u>\$ 1.0</u>	<u>\$ (8.0)</u>	<u>\$ 3.2</u>
Loss before income taxes	<u>\$ (15.9)</u>	<u>\$ (13.5)</u>	<u>\$ (50.3)</u>	<u>\$ (37.5)</u>

<sup>(1)</sup> Lumber shipments are expressed in millions of board feet.

<sup>(2)</sup> Power deliveries are expressed in thousands of megawatts.

<sup>(3)</sup> Dollars per thousand board feet.

<sup>(4)</sup> Dollars per megawatt.

#### *Net Sales*

Total net sales for forest products operations decreased to \$42.6 million for the third quarter of 2005, as compared to \$49.6 million for the third quarter of 2004. The \$7.0 million decrease in net sales was due to a decline in lumber shipments during the quarter, compounded by an unfavorable shift in lumber sold from redwood lumber to lower-priced, common grade Douglas-fir lumber. Additionally, there was an approximate 24% decline in the average sales price of common grade Douglas-fir during the third quarter, as compared to the same period in 2004.

Despite an overall increase in lumber shipments during the first nine months of 2005, total net sales for forest products operations decreased \$12.4 million, as compared to the same period in 2004. This decrease was primarily caused by an unfavorable shift in lumber sold from upper grade to common grade redwood and from redwood lumber to lower priced, common grade Douglas-fir lumber. Additionally, there was an approximate 17.3% decline in the average sales price of common grade Douglas-fir during the first nine months of 2005, as compared to the same period in 2004.

#### *Operating Income (loss)*

Operating results for forest products operations declined by \$3.1 million for the third quarter of 2005, compared to the same period in 2004, primarily due to decreased net sales, higher harvesting, hauling, and production costs, and a significant increase in legal and other professional fees relating primarily to Scotia LLC's efforts to pursue a negotiated restructuring of the Timber Notes.

Operating results for forest products operations declined by \$11.2 million for the nine months of 2005, compared to the same period in 2004, primarily due to the factors discussed in the preceding paragraph. The loss from logging and lumber operations for the first nine months was partially offset by a \$3.1 million insurance settlement received in the first quarter 2005. The first nine months of 2005 and 2004 included \$0.9 million and \$1.4 million, respectively, of severance costs related to a reduction in workforce.

#### *Loss Before Income Taxes*

Forest products operations' loss before income taxes increased by \$2.4 million and \$12.8 million for the third quarter and first nine months of 2005, respectively, compared to the prior year periods, primarily due to the decline in operating results discussed above and the write-off of \$1.3 million of deferred financing costs related to the Palco Credit Agreement that was paid in full and terminated in April 2005, and additional interest expense, partially offset by increased income from cash, cash equivalents, marketable securities and other investments due to higher levels of investment.

### **Real Estate Operations**

#### *Industry Overview and Selected Operational Data*

The Company, principally through its wholly owned subsidiaries and joint ventures, invests in and develops residential and commercial real estate primarily in Puerto Rico, Arizona, California, and Texas. Results of operations between quarterly periods for the Company's real estate operations are generally not comparable due to the timing of individual real estate sales transactions and cash collections. Accordingly, results for any one quarter are not necessarily indicative of results to be expected for the full year. The following table presents selected operational and financial information for the three and nine months ended September 30, 2005 and 2004, for the Company's real estate operations.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
(In millions of dollars)				
Net sales:				
Real estate:				
Fountain Hills .....	\$ 10.4	\$ 5.1	\$ 33.3	\$ 8.5
Mirada .....	4.3	3.8	8.6	9.5
Palmas .....	28.4	2.3	35.5	10.4
Other .....	—	—	0.1	—
Total .....	<u>43.1</u>	<u>11.2</u>	<u>77.5</u>	<u>28.4</u>
Resort, commercial and other:				
Fountain Hills .....	1.4	1.7	4.4	5.0
Palmas .....	3.0	2.8	9.4	8.6
Commercial lease properties .....	4.6	4.4	13.7	12.8
Other .....	0.2	0.2	0.2	0.3
Total .....	<u>9.2</u>	<u>9.1</u>	<u>27.7</u>	<u>26.7</u>
Total net sales .....	<u>\$ 52.3</u>	<u>\$ 20.3</u>	<u>\$ 105.2</u>	<u>\$ 55.1</u>
Operating income (loss):				
Fountain Hills .....	\$ 5.9	\$ 2.2	\$ 17.9	\$ 3.1
Mirada .....	2.0	1.6	3.4	3.3
Palmas .....	20.9	(2.3)	21.8	(0.5)
Commercial lease properties .....	2.8	1.9	6.2	5.3
Other .....	(0.9)	(0.2)	(0.9)	(0.9)
Total operating income .....	<u>\$ 30.7</u>	<u>\$ 3.2</u>	<u>\$ 48.4</u>	<u>\$ 10.3</u>
Investment, interest and other income (expense), net:				
Equity in earnings (losses) from real estate joint ventures .....	\$ (0.3)	\$ —	\$ (0.7)	\$ 2.9
Other .....	0.7	0.6	2.2	3.7
	<u>\$ 0.4</u>	<u>\$ 0.6</u>	<u>\$ 1.5</u>	<u>\$ 6.6</u>
Income (loss) before income taxes .....	<u>\$ 26.8</u>	<u>\$ (0.7)</u>	<u>\$ 36.9</u>	<u>\$ 3.1</u>

### *Net Sales*

Total net sales for the real estate operations for the third quarter and first nine months of 2005 increased by \$32.0 million, and \$50.1 million, respectively, as compared to the same periods in 2004, primarily due to increased lot sales and favorable pricing at Fountain Hills and acreage sales and profit participation payments, offset by lower timeshare sales at Palmas. During the third quarter of 2005, PDMPI completed a significant parcel sale; this transaction represented more than 50% of the real estate segment's revenues for the third quarter of 2005.

### *Operating Income and Income Before Income Taxes*

Operating income and income before income taxes increased by \$27.5 million for the third quarter of 2005 as compared to the same period of 2004, primarily due to the increased lot sales at the Fountain Hills development and acreage sales and profit participation payments at Palmas. Operating income increased by \$38.1 million for the nine months of 2005 as compared to the same period of 2004 primarily as a result of the higher volume of real estate sales discussed above. The segment's income before income taxes increased by \$33.8 million for the nine months of 2005 as compared to the same period in 2004, primarily due to improved operating results as discussed above, partially offset by \$3.5 million of lower equity in earnings from the Company's investment in FireRock LLC due to the sell out of lots in 2004.

### ***Racing Operations***

#### *Industry Overview and Selected Operational Data*

The Company owns SHRP, Ltd., which owns and operates Sam Houston Race Park, a Class 1 horse racing facility in Houston, Texas, and Valley Race Park, a greyhound racing facility located in Harlingen, Texas. Results of operations between quarterly periods are generally not comparable for these facilities due to the timing, varying lengths and types of racing meets held. Accordingly, results for any one quarter are not necessarily indicative of results to be expected for the full year. Historically, Sam Houston Race Park and Valley Race Park have derived a significant amount of their annual pari-mutuel commissions from live racing and simulcasting. Pari-mutuel commissions have typically been highest during the first and fourth quarters of the year, the time during which Sam Houston Race Park and Valley Race Park have historically conducted live thoroughbred and greyhound racing, respectively.

The following table presents selected operational and financial information for the third quarter and nine months ended September 30, 2005 and 2004, for the Company's racing operations.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
(In millions of dollars)				
Number of live race days:				
Sam Houston Race Park .....	35	46	88	130
Valley Race Park .....	—	—	68	81
Handle:				
Sam Houston Race Park:				
On-track handle .....	\$ 30.2	\$ 33.1	\$ 94.1	\$ 105.3
Off-track handle .....	9.7	19.0	96.0	137.1
Total .....	<u>\$ 39.9</u>	<u>\$ 52.1</u>	<u>\$ 190.1</u>	<u>\$ 242.4</u>
Valley Race Park:				
On-track handle .....	\$ 3.9	\$ 3.9	\$ 14.3	\$ 15.2
Off-track handle .....	—	—	1.7	3.0
Total .....	<u>\$ 3.9</u>	<u>\$ 3.9</u>	<u>\$ 16.0</u>	<u>\$ 18.2</u>
Net sales:				
Sam Houston Race Park:				
Gross pari-mutuel commissions .....	\$ 7.0	\$ 7.8	\$ 23.6	\$ 26.9
Other revenues .....	2.9	2.8	6.4	7.3
Total .....	<u>9.9</u>	<u>10.6</u>	<u>30.0</u>	<u>34.2</u>
Valley Race Park:				
Gross pari-mutuel commissions .....	0.9	0.9	3.3	3.6
Other revenues .....	0.1	0.1	0.7	0.8
Total .....	<u>1.0</u>	<u>1.0</u>	<u>4.0</u>	<u>4.4</u>
Total net sales .....	<u>\$ 10.9</u>	<u>\$ 11.6</u>	<u>\$ 34.0</u>	<u>\$ 38.6</u>
Operating income (loss):				
Sam Houston Race Park .....	\$ (1.7)	\$ (1.2)	\$ (2.6)	\$ (1.2)
Valley Race Park .....	(0.1)	(0.3)	(0.3)	(0.5)
Total operating loss .....	<u>\$ (1.8)</u>	<u>\$ (1.5)</u>	<u>\$ (2.9)</u>	<u>\$ (1.7)</u>
Loss before income taxes .....	<u>\$ (1.9)</u>	<u>\$ (1.5)</u>	<u>\$ (3.0)</u>	<u>\$ (1.7)</u>

#### *Net Sales*

Total net sales for racing operations declined \$0.7 and \$4.6 million for the third quarter and first nine months of 2005 compared to the prior year periods, principally due to fewer live race days at Sam Houston Race Park in the 2005 periods.

#### *Operating Loss and Loss Before Taxes*

Racing operations' operating loss and loss before taxes for the third quarter and first nine months of 2005 increased from the comparable periods in 2004, principally due to lower net sales partially offset by lower operating costs associated with the reduced number of live racing days at Sam Houston Race Park.

#### *Other Items Not Directly Related to Industry Segments*

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
(In millions of dollars)				
Operating loss .....	\$ (7.1)	\$ (4.2)	\$ (8.5)	\$ (10.8)
Loss before income taxes .....	(4.7)	(4.4)	(3.1)	(9.6)

### *Operating Loss*

The operating losses represent corporate general and administrative expenses that are not attributable to the Company's industry segments. The operating loss increased \$2.9 million and declined \$2.3 million for the third quarter and first nine months of 2005, respectively, as compared to the prior year periods, primarily due to changes in stock compensation expense and additional legal and advisor fees. Stock-based compensation expense is adjusted as the market value of the Company's Common Stock changes. For the third quarter and first nine months of 2005, there was a \$4.1 million expense and \$0.3 million benefit, respectively, recognized for stock-based compensation, reflecting changes in the market value of the Company's Common Stock since December 31, 2004. The quarter ended September 30, 2004 included \$1.9 million related to an accrual for an environmental matter discussed under "Other Matters" in Note 8.

### *Loss Before Income Taxes*

The loss before income taxes increased in the third quarter of 2005 from the third quarter of 2004 due to higher stock compensation expense, partially offset by higher returns on marketable securities and other short-term investments. The decrease in the loss before income taxes for the nine months of 2005 from the comparable period in 2004 was due to lower corporate general and administrative expenses as discussed above and higher returns on marketable securities and other short-term investments.

## **Financial Condition and Investing and Financing Activities**

*This section contains statements which constitute "forward-looking statements" within the meaning of the PSLRA. See the statement in Item 2. above for cautionary information with respect to such forward-looking statements.*

### *Overview*

The Company conducts its operations primarily through its subsidiaries. Creditors of subsidiaries of the Company have priority with respect to the assets and earnings of such subsidiaries over the claims of the creditors of the Company. Certain of the Company's subsidiaries, principally Palco and Scotia LLC, are restricted by their various debt instruments as to the amount of funds that can be paid in the form of dividends or loaned to affiliates. Scotia LLC is highly leveraged, has significant debt service requirements and is experiencing liquidity difficulties. Additionally, Palco expects to be dependent on the funds available under the Revolving Credit Facility and existing unrestricted cash and marketable securities, and will need additional liquidity, to fund its working capital requirements in 2005 and 2006. See Notes 1 and 4 and 8 and "Cash Flow—Forest Products Operations" for a description of the liquidity difficulties of both Scotia LLC and Palco. "MAXXAM Parent" is used in this section to refer to the Company on a stand-alone basis without its subsidiaries.

### *Cash Flow*

#### *Operating Activities*

Net cash provided by operating activities of \$14.8 million for the nine months ended September 30, 2005, improved by \$29.4 million as compared to the nine months ended September 30, 2004. This increase resulted primarily from higher cash collections related to real estate sales, partially offset by operating cash flow shortfalls at the Company's forest products operations.

#### *Investing Activities*

Net cash provided by investing activities of \$19.8 million for the nine months ended September 30, 2005, reflects the liquidation of certain short-term investments and the use of restricted cash for debt service payments offset by capital expenditures of \$16.2 million related to Palco's sawmill project, infrastructure requirements at Scotia LLC and Fountain Hills and capital expenditures at the Company's horse racing facility. Net cash provided by investing activities of \$7.7 million for the nine months ended September 30, 2004, reflected capital expenditures of \$27.3 million, of which \$18.6 million was related to Palco's sawmill project.

#### *Financing Activities*

The \$38.7 million of net cash provided by financing activities for the nine months ended September 30, 2005, principally reflects the net proceeds from the Palco refinancing that occurred in April 2005. Net cash provided by financing activities of \$7.7 million for the nine months ended September 30, 2004, principally reflects additional borrowings to fund the Company's forest products operations.

## ***MAXXAM Parent***

MAXXAM Parent believes that its existing resources will be sufficient to fund its working capital requirements for the next year. With respect to long-term liquidity, MAXXAM Parent believes that its existing cash and cash resources, together with distributions from the real estate operations, should be sufficient to meet its working capital requirements. However, there can be no assurance that this will be the case. See “—Forest Products Operations” below and Note 1 regarding potential adverse impacts upon MAXXAM Parent as a result of liquidity issues in respect of Palco and Scotia LLC. Additionally, see “—Racing Operations” below regarding the cash flow needs of SHRP, Ltd., which were provided by MAXXAM Parent in the first quarter of 2005.

## ***Forest Products Operations***

Substantially all of MGI’s consolidated assets are owned by Palco, and a significant portion of Palco’s consolidated assets are owned by Scotia LLC. The lenders under the Scotia LLC Line of Credit and the holders of the Timber Notes have priority over the claims of creditors of Palco with respect to the assets and cash flows of Scotia LLC. The Revolving Credit Facility and Term Loan contain certain restrictive covenants which effectively preclude the distribution of funds from Palco to MGI.

Due to its highly leveraged condition, Scotia LLC is more sensitive than less leveraged companies to factors affecting its operations and financial results, including adverse weather conditions, low log prices, governmental regulation, environmental litigation and general economic conditions. Scotia LLC’s cash flows from operations are significantly impacted by harvest volumes and log prices. As discussed in more detail below, Scotia LLC’s harvest levels and cash flows from operations will in future years be substantially below both historical levels and the minimum levels necessary in order to allow Scotia LLC to satisfy its debt service obligations in respect of the Timber Notes.

Regulatory and environmental matters as well as legal actions have played and are expected to continue to play a significant role in the Company’s forest products operations. Scotia LLC has previously experienced delays in the approval of its THPs as the result of regulatory compliance and litigation challenges, and expects these difficulties to persist. Moreover, the Company expects a recurrence of the additional delays that have recently been experienced in harvesting on previously-approved THPs due to regulatory oversight by the North Coast Water Board. The foregoing matters have in the past adversely affected timber harvest levels and timber harvesting and other costs; these effects are expected to continue. In addition, there can be no assurance that certain other pending legal, regulatory and environmental matters or future governmental regulations, legislation or judicial or administrative decisions, adverse weather conditions, or low lumber or log prices, will not have a material adverse effect on the financial condition, results of operations or liquidity of the Company’s forest products operations. See Item 1. “Business—Forest Products Operations—Regulatory and Environmental Matters” of the Form 10-K, and Notes 1 and 8 in this Form 10-Q, for further discussion of these matters.

The North Coast Water Board is requiring Palco and Scotia LLC to apply various waste discharge reporting, mitigation and erosion control requirements in respect of timber harvesting activities in several watersheds, and is likely to impose additional measures in the future. The North Coast Water Board in December 2003 directed its staff to formulate WWDRs for the Freshwater and Elk River watersheds on the Scotia LLC Timberlands. As harvesting activities on the Scotia LLC Timberlands cannot readily be moved between watersheds due to, among other things, historic harvest patterns, adjacency restrictions, and the age classes of trees, development of WWDRs and the other matters described in the “Forest Products Operations—Water Quality” section of Note 8 are expected to result in reduced harvest in the future. The staff of the North Coast Water Board has circulated for public review and comment draft WWDRs for the Freshwater and Elk River watersheds. If these draft WWDRs are approved in their current form, there would likely be a significant adverse impact on current and future harvest levels.

As WWDRs had not been formulated, the North Coast Water Board for some time failed to release for harvest a number of Scotia LLC’s THPs that had already been approved by the other governmental agencies which approve Scotia LLC’s THPs. In February 2005, the Executive Officer of the staff of the North Coast Water Board released sufficient THPs to allow the harvest of up to 50% of the CDF Harvest Limit for these two watersheds. On March 16, 2005, the North Coast Water Board ordered the enrollment of additional THPs that would allow the harvest of up to 75% of the CDF Harvest Limit for these two watersheds. Third parties subsequently appealed this decision to the State Water Board. On June 16, 2005, the State Water Board heard this appeal and rendered a decision, which had the effect of disallowing further harvesting on the additional 25% of the CDF Harvest Limit approved by the North Coast Water Board on March 16, 2005. The State Water Board’s decision also has the effect of disallowing further harvesting in the Freshwater and Elk River watersheds until WWDRs for these watersheds are adopted by the North Coast Water Board.

Palco has appealed the State Water Board's June 16, 2005, decision in a California state court. A hearing on the appeal has not yet been scheduled.

On September 2, 2005, the North Coast Water Board set hearings on the draft WWDRs for September 14 and 15, 2005. On September 9, 2005, Palco and Scotia LLC filed a petition in California state court seeking an order mandating that the North Coast Water Board not take any further action on the proposed WWDRs. The petition alleges defects in the proposed WWDRs and the North Coast Water Board's hearing procedures. Palco and Scotia LLC also requested a temporary restraining order and preliminary injunction to prevent the North Coast Water Board from taking any further action until their petition is heard. The temporary restraining order was granted and the preliminary injunction hearing is scheduled for November 9, 2005.

The unreleased and disallowed THPs in the Freshwater and Elk River watersheds represented a significant portion of the harvest that had been planned for the first nine months of 2005. The ongoing regulatory, environmental and litigation matters faced by Palco and Scotia LLC, exacerbated by the developments described in the previous paragraph, have materially adversely impacted the cash flows of both Palco and Scotia LLC. Furthermore, it is likely that additional delays in the development of the Freshwater and Elk River WWDRs will occur. Should the Freshwater-Elk River WWDRs not be approved during 2005 or in the first few months of 2006, or be approved with additional restrictions on harvest, there could be a material adverse impact on Palco's and Scotia LLC's future cash flows from operations.

As previously announced, the estimates of Scotia LLC indicated that its cash flows from operations, together with the Scotia LLC Line of Credit and other available funds, would likely be inadequate to pay all of the interest due on the July 20, 2005, payment date for the Timber Notes. As the July 20, 2005, payment date approached, it became apparent that Scotia LLC's estimates would prove correct and that the cash shortfall as of the payment date would be approximately \$2.2 million. Based upon a review of its alternatives under the circumstances, consultation with its own legal and financial advisors, and consideration of the status of discussions with the advisors of the Noteholders Committee, Scotia LLC requested that Palco make an early payment, equal to the shortfall, in respect of certain logs that had already been delivered to and purchased by Palco from Scotia LLC. Palco approved and delivered the early log payment, which allowed Scotia LLC to fund the July 20, 2005, cash shortfall and pay all of the \$27.9 million of interest due (\$25.9 million net of interest due in respect of Timber Notes held by Scotia LLC).

Scotia LLC's ability to pay all of the \$27.7 million of interest due (\$25.8 million net of interest due in respect of Timber Notes held by Scotia LLC) on the January 20, 2006, payment date will depend upon many factors, including Scotia LLC's harvest levels for the remainder of 2005, cash flows from operations through the January 20, 2006, payment date, together with access to the Scotia LLC Line of Credit. At September 30, 2005, the maximum availability under the Scotia LLC Line of Credit was \$55.4 million, and borrowings outstanding were \$49.5 million. There can be no assurance that Scotia LLC will have sufficient liquidity to make this interest payment.

In March 2005, UBS agreed to assist Scotia LLC in seeking to restructure its obligations with respect to the outstanding Timber Notes. Scotia LLC has agreed to pay UBS an advisory fee of \$150,000 per month, creditable in full against a success fee of \$5.6 million that would be payable upon consummation of any restructuring transaction prior to July 27, 2006, in addition to agreeing to reimburse certain of UBS's expenses and to indemnify UBS and its affiliates. UBS' engagement expired by its terms on July 27, 2005, and UBS and Scotia LLC subsequently extended that engagement, which can be terminated with thirty days notice by either party. In June 2005, Scotia LLC agreed to be responsible for certain payments and other obligations of the Noteholder Committee relating to their legal counsel and financial advisors. On September 23, 2005, Scotia LLC terminated its agreement to be responsible for further payments, effective immediately in the case of the legal counsel and effective October 23, 2005, in the case of the financial advisor. Scotia LLC terminated its agreement upon the recommendation of a special committee of independent managers since it concluded that insufficient progress had been made in negotiations with the Noteholder Committee and was advised that holders of less than 15% of the Timber Notes (measured by principal amount) had agreed to confidentiality provisions necessary in order to participate in a process intended to lead to a restructuring agreement. Scotia LLC continues to evaluate its liquidity alternatives in respect of the January 20, 2006, payment date and beyond.

Scotia LLC and UBS have conducted extensive reviews and analyses of Scotia LLC's assets, operations and prospects. As a result of these extensive reviews and analyses, Scotia LLC's management has concluded that, in the absence of significant regulatory relief and accommodations, Scotia LLC's annual timber harvest levels and cash flows from operations will in future years be substantially below both historical levels and the minimum levels necessary in order to allow Scotia LLC to satisfy its debt service obligations in respect of the Timber Notes. Scotia LLC has announced that its projected average annual harvest level over the ten-year period beginning 2006 is estimated at approximately 100 million board feet per year. This harvest level reflects Scotia LLC management's most recent

estimate of the cumulative impact of ongoing regulatory limitations, prescriptions, and other actions and is based upon a number of assumptions which may or may not prove to be accurate. Scotia LLC's management also determined that reductions must be made to its cost structure in line with these anticipated reductions in harvest levels and cash flows. Accordingly, on August 30, 2005, Scotia LLC implemented a restructuring plan reducing its workforce by approximately one third. To the extent that Scotia LLC is unable to restructure its Timber Notes consistent with management's expectations as to future harvest levels and cash flows, or to secure additional liquidity from external sources, the Company expects that Scotia LLC, and, as may be required, Palco, will be forced to take extraordinary actions, which may include: further reducing expenditures by laying off employees and shutting down various operations; seeking other sources of liquidity, such as from asset sales; and seeking protection by filing under the Bankruptcy Code.

As of December 31, 2004 and March 31, 2005, Palco was in default under the Palco Credit Agreement and obtained limited waivers of the default through April 22, 2005. On April 19, 2005, Palco and Britt, as Borrowers, closed the Revolving Credit Facility and the Term Loan. The Term Loan was fully funded at closing and the Borrowers used approximately \$10.8 million of the funds from the Term Loan to pay off amounts previously borrowed under the Palco Credit Agreement and terminated that facility. As of September 30, 2005, \$34.8 million was outstanding under the Term Loan and \$12.1 million was outstanding under the Revolving Credit Facility. Palco estimates that its cash flow from operations will not provide sufficient liquidity to fund its operations until the fourth quarter of 2006. Accordingly, Palco expects to be dependent on the funds available under the Revolving Credit Facility, and expects additional liquidity will be needed, to fund its working capital and other cash requirements in 2005 and 2006. The Revolving Credit Facility and Term Loan are each secured by a security interest in the stock of Palco and substantially all of the assets of the Borrowers (other than Palco's equity interest in Scotia LLC). Both the Term Loan and the Revolving Credit Facility have provisions requiring that the net cash proceeds of specified asset sales be used to prepay amounts outstanding under the loans.

As of September 30, 2005, borrowings under the Revolving Credit Facility were limited to the sum of 85% of Palco and Britt's eligible accounts receivable plus 75% of their eligible inventories (up to a maximum of \$30.0 million, subject to limitations such as the ability of the lender to establish reasonable reserves). Both the Term Loan and the Revolving Credit Facility contain EBITDA maintenance covenants that, if not met, could trigger a mandatory prepayment of outstanding borrowings. The operating cash flow estimates used to establish the EBITDA maintenance covenants are subject to a number of assumptions about future operating cash flow and actual results could differ from these estimates. Accordingly, the availability of these funds is largely dependent on Palco's ability to harvest adequate timber from the Scotia LLC Timberlands and reduce operating costs. Available resources to fund Palco's and Britt's operating needs at September 30, 2005, were \$8.0 million, comprised of the maximum availability under the Revolving Credit Facility of \$7.7 million and unrestricted cash and marketable securities of \$0.3 million.

Subsequent to September 30, 2005, Palco borrowed the maximum available under the Revolving Credit Facility and on October 26, 2005, Palco, Britt and certain of their affiliates entered into the Omnibus Amendment, which amended the Term Loan and the Revolving Credit Facility to, among other things, temporarily increase the amount of the Revolving Credit Facility from \$30.0 million to \$35.0 million and temporarily increase the advance rate applicable to the Borrowers' inventory from 75% to 80%. The increase in the inventory advance rate is subject to satisfactory inventory appraisals and the amount of the increase in such advances is capped at \$1.5 million. The increase in the amount of the Revolving Credit Facility and the increase in the inventory advance rate will be gradually phased out in January through March 2006. The Omnibus Amendment also revises financial covenants applicable to the Revolving Credit Facility and the Term Loan. MGI furnished cash collateral of \$2.0 million as additional security for the Borrowers' obligations under the Revolving Credit Facility and the Term Loan Facility. This cash collateral will be released on April 1, 2006, so long as the Borrowers have achieved earnings and borrowing availability targets to be determined by the Lenders.

Palco's available cash resources, including proceeds from and availability under the Term Loan and Revolving Credit Facility have been primarily utilized during the first nine months of 2005 in the following areas: (i) \$10.8 million was used to pay off amounts previously borrowed under the Palco Credit Agreement; (ii) approximately \$ 6.2 million was used to fund capital expenditures related to Palco's new state-of-the-art sawmill in Scotia, California; (iii) \$9.9 million was used as collateral to secure Palco's workers compensation liabilities; (iv) \$13.5 million was used to build log inventory levels; and (v) the remainder was used to pay advisor fees and to fund working capital shortfalls. Palco's ability to generate sufficient liquidity to fund its short term liquidity needs will depend upon many factors, including Palco's ability to achieve planned production rates at the new sawmill. While production levels at the new sawmill continue to improve, the new sawmill is not yet operating at planned capacity and is not expected to achieve planned production rates for the remainder of 2005. Accordingly, additional liquidity will be needed at Palco to fund working capital requirements in 2005 and 2006, but there can be no assurance that Palco will be able to secure additional liquidity.



In the event that Palco were unable to secure the necessary liquidity, it would be forced to take extraordinary actions, which may include: further reducing expenditures by laying off employees and shutting down various operations and seeking protection by filing under the Bankruptcy Code.

On April 21, 2005, Moody's lowered its ratings on the Class A-1 Timber Notes from Baa2 to Ba3; the Class A-2 Timber Notes from Baa3 to B1; and the Class A-3 Timber Notes from Bal to B1. On June 20, 2005, Moody's further lowered its ratings on all classes of the Timber Notes to Caal. S&P announced on April 7, 2005, that it had lowered Palco's credit rating to CCC- (which rating it affirmed on April 28, 2005). As a result of the S&P credit rating actions related to Palco, Palco was required to post a \$9.9 million letter of credit with the State of California to secure its workers compensation liabilities, which reduced Palco's availability under the Revolving Credit Facility by a corresponding amount. See Note 4 for further discussion of availability under Palco's debt facilities.

The liquidity issues being experienced by Scotia LLC and Palco could result in claims against and have adverse impacts on MAXXAM Parent, MGHI and/or MGI. For example, under ERISA law, were Palco to terminate its pension plan, MAXXAM Parent and its wholly owned subsidiaries would be jointly and severally liable for any unfunded pension plan obligations. The unfunded obligation attributable to Palco's pension plan as of December 31, 2004, is estimated to have been in the range of approximately \$35 million based upon annuity placement interest rate assumptions at that time. In addition, it is possible that certain transactions could be entered into in connection with a potential restructuring or reorganization of Palco or Scotia LLC, such as a sale or other transfer of all or a portion of the equity ownership in Palco and/or Scotia LLC, a sale or other transfer of a substantial portion of Palco's and/or Scotia LLC's assets and/or a cancellation of some or all of Palco's and/or Scotia LLC's indebtedness, which could require the utilization of all or a substantial portion of, or the loss of a significant portion of, the Company's net operating losses for federal and state income tax purposes and could require tax payments in future periods.

The Scotia LLC Line of Credit allows Scotia LLC to borrow up to one year's interest due on the Timber Notes. On June 20, 2003, the Scotia LLC Line of Credit was extended to July 7, 2006. At or near the completion of such extension, Scotia LLC would request that the Scotia LLC Line of Credit be extended for an additional period of not less than 364 days. If not extended, Scotia LLC may draw upon the full amount available. The amount drawn would be repayable in 12 semiannual installments on each note payment date (after the payment of certain other items, including the Aggregate Minimum Principal Amortization Amount, as defined, then due), commencing approximately two and one-half years following the date of the draw. At September 30, 2005, the maximum availability under the Scotia LLC Line of Credit was \$55.4 million, and outstanding borrowings were \$49.5 million.

On the note payment date in January 2005, Scotia LLC used the funds available under the Scotia LLC Line of Credit to pay all of the \$28.5 million of interest due (\$26.3 million net of interest due in respect of Timber Notes held by Scotia LLC). Scotia LLC also repaid \$17.1 million of principal on the Timber Notes (an amount equal to Scheduled Amortization) using funds held in the SAR Account.

On the note payment date in July 2005, Scotia LLC used its existing cash resources, all of the remaining funds available under the Scotia LLC Line of Credit, and the additional funds made available from the \$2.2 million early log payment by Palco (see Note 1), to pay all of the \$27.9 million of interest due (\$25.9 million net of interest due in respect of Timber Notes held by Scotia LLC). Scotia LLC also repaid \$8.0 million of principal on the Timber Notes (an amount equal to Scheduled Amortization) using funds held in the SAR Account.

The Master Purchase Agreement between Scotia LLC and Palco (see Item 1. "Business—Forest Products Operations—Relationships among the Palco Companies" of the Form 10-K) contemplates that all sales of logs by Scotia LLC to Palco will be at fair market value (based on stumpage prices) for each species and category of logs. The Master Purchase Agreement provides that if the purchase price equals or exceeds the SBE Price and a structuring price set forth in a schedule to the Timber Notes Indenture, the purchase price is deemed to be at fair market value. If the purchase price equals or exceeds the SBE Price, but is less than the structuring price, then Scotia LLC is required to engage an independent forestry consultant to confirm that the purchase price reflects fair market value. In December 2004, the California State Board of Equalization adopted the new Harvest Value Schedule for the first six months of 2005. The prices published in that schedule (which exceeded the applicable structuring prices) reflected a 14.3% increase in the SBE Price for small redwood logs and a 12.5% increase for small Douglas-fir logs from the prices published for the third half of 2004. In June 2005, the California State Board of Equalization adopted the new Harvest Value Schedule for the second half of 2005. The prices established in that schedule (which exceed the applicable structuring prices) reflected a 4.2% increase in the SBE Price for small redwood logs from the price published for the first half of 2005. There was no change in the small Douglas-fir log price from the price published for the first half of 2005.

Palco has continued to examine ways in which to achieve cost savings. During 2004, Palco opened its new (replacement) planer facility and began construction on its new sawmill. Palco has spent \$26.7 million through September 30, 2005, on the new sawmill and planer facility (\$20.5 million of which was expended in 2004). The new sawmill construction project is substantially complete, and while production levels at the new sawmill continue to improve, it is not yet operating at planned capacity and is not expected to achieve planned production rates for the remainder of 2005. Funds for this project were provided from cash resources and borrowings under the Palco Credit Agreement and cash made available as a result of borrowings under the Term Loan and the Revolving Credit Facility. As part of the project, Palco's Carlotta mill was closed in 2004 and its Fortuna mill was closed in June 2005. As a result of these mill closures, Palco recognized severance costs of \$0.7 million in 2005. Certain equipment from these mills is being moved to the new sawmill and management is considering alternative uses for the properties and remaining equipment, including sales to third parties. Further actions may be taken in the fourth quarter of 2005 as a result of Palco's continuing evaluation process or in response to the financial difficulties described elsewhere in this Form 10-Q, and writedowns of certain assets may be required.

As noted above, Palco will continue to require funds available under the Revolving Credit Facility and Term Loan, and expects additional liquidity will be needed, in order to meet its working capital and capital expenditure requirements for the next year. Furthermore, Palco's cash flows from operations may be adversely affected by diminished availability of logs from Scotia LLC, lower lumber prices, adverse weather conditions, pending legal, regulatory and environmental matters or increased funding requirements for its pension plan. See "Results of Operations—Forest Products Operations" above, as well as Note 8, for discussion of the regulatory, environmental and legal matters affecting harvest levels and operating costs. Capital expenditures were \$11.7 million for the first nine months of 2005 and are expected to be between \$4.5 million and \$6.1 million for the remainder of 2005, subject to available cash.

With respect to long-term liquidity, until such time as Palco and Scotia LLC have adequate cash flows from operations, there can be no assurance that they will be able to meet their working capital, capital expenditure and debt service obligations. Liquidity, capital resources and results of operations in the long-term may continue to be adversely affected by the same factors affecting short-term cash flows from operations, as discussed above.

#### ***Real Estate Operations***

Capital expenditures and real estate improvements and development costs were \$12.1 million for the first nine months of 2005 and are expected to be between approximately \$6.0 million to \$7.0 million for remainder of 2005, primarily for infrastructure construction obligations at Fountain Hills. The Company expects that these expenditures will be funded by cash flows from operations, existing cash and available credit facilities.

The Company believes that the cash flows from operations, existing cash and credit facilities of its real estate subsidiaries will be sufficient to fund the working capital and capital expenditure requirements of such subsidiaries for the next year. With respect to the long-term liquidity of such subsidiaries, the Company believes that their ability to generate cash from the sale of their existing real estate, together with their ability to obtain financing and joint venture partners, should provide sufficient funds to meet their working capital and capital expenditure requirements. PDMPI and its subsidiaries have, however, required advances from MAXXAM Parent in prior years to fund their operations, and PDMPI may require such advances in the future.

#### ***Racing Operations***

Capital expenditures and investments in new ventures were \$3.3 million for the first nine months of 2005 and an additional \$0.2 million is expected for the remainder of 2005.

In the first quarter of 2005, SHRP, Ltd. borrowed \$4.5 million from MAXXAM Parent to fund its 2005 capital expenditures and improve its working capital position. In the third quarter of 2005, SHRP, Ltd. borrowed \$1.3 million from MAXXAM Parent to make additional capital expenditures. SHRP, Ltd.'s management expects that SHRP, Ltd. may require additional advances from MAXXAM Parent to fund its operations and capital expenditures in the next year. SHRP, Ltd. is experiencing strong competition from internet wagering and "racinos" in surrounding states. These factors will also play a role in SHRP, Ltd.'s long-term liquidity. SHRP, Ltd.'s management believes that cash flows from operations may not be sufficient to fund its operations and capital expenditures on a long term basis. Therefore, additional advances from MAXXAM Parent or additional working capital sources may be required.

In January 2004, a subsidiary of the Company applied to the Texas Racing Commission for an additional license to construct and operate a Class 2 horse racing facility in Laredo, Texas. The review process is only in the preliminary

stages, and there can be no assurance that the Company will obtain this additional license as, among other things, there is a competing applicant. Additionally, the Company is considering a variety of alternatives for addressing (should the subsidiary be granted the Laredo license) a Racing Act provision that a person may not own a greater than five percent interest in more than two Texas-licensed race tracks.

### ***Kaiser's Operations***

With respect to the Company's interest in Kaiser, the Debtors have indicated that they believe that it is likely that the equity of Kaiser's stockholders will be cancelled without consideration. See Notes 1 and 7 for further information.

### **Off-Balance Sheet Arrangements**

The Company does not have any off-balance sheet financing, other than operating leases entered into in the normal course of business, or unconsolidated special purpose entities. The Company does not use derivatives for any of its treasury or risk management activities.

### **Trends**

#### ***Forest Products***

See Notes 1 and 8 and Part I, Item 2. "Management's Discussion and Analysis of Financial Conditions and Results of Operations—Financial Condition and Investing and Financing Activities—Forest Products Operations" for information regarding various regulatory, environmental, litigation and other matters which have caused and are expected to continue to cause delays in the approval of the Company's THPs and the ability to harvest on THPs once they are approved, as well as adverse impacts on timber harvest levels and timber harvesting and other costs, resulting in significant liquidity difficulties for both Palco and Scotia LLC. Both Palco and Scotia are evaluating their liquidity alternatives. There can be no assurance that Scotia LLC and/or Palco will have sufficient liquidity to satisfy their debt service obligations and fund their working capital requirements.

Scotia LLC has announced that its projected average annual harvest level over the ten-year period beginning 2006 is estimated at approximately 100 million board feet per year. This harvest level reflects Scotia LLC management's most recent estimate of the cumulative impact of ongoing regulatory limitations, prescriptions, and other actions.

#### ***Real Estate***

As previously disclosed, PDMPI had been considering various alternatives to accelerate sales of its approximately 1,100 acres of undeveloped land as well as disposition of other assets. In connection with this, PDMPI had been working with an agent to solicit developer and investor interest in acquiring such acreage and other assets. This program resulted in a large parcel sale during the third quarter of 2005. PDMPI continues to solicit developer and investor interest on the remaining undeveloped acres.

#### ***Racing***

During its regular legislative session that ended in May 2005 and two subsequent 30-day special sessions, the Texas Legislature considered a variety of alternatives to address a projected budget shortfall, including enhancing state revenues through additional forms of gaming such as video lottery terminals at existing horse and dog racing tracks, gaming on Indian reservations, and full casinos; however, the Legislature adjourned from its regular session and special sessions of 2005 without enacting any such legislation. The next regular session of the Texas Legislature will begin in January of 2007. The Company intends to continue to vigorously pursue any such legislation which is favorable to it. As any legislation expanding gaming in Texas may well require the approval of two-thirds of each legislative house and a majority of the state's voters, no assurance can be given that any such legislation will be enacted or become effective. Moreover, it is impossible to determine what the provisions of any such legislation will be or its effect on the Company.

### **Contractual Obligations**

At January 1, 2005, the Company entered into an operating lease for its Corporate offices. The lease began on January 1, 2005 and terminates on September 30, 2015. Minimum annual rental payments under the lease are \$0.1 million in 2005 and escalate to a maximum of \$0.4 million in 2014.

## **Critical Accounting Policies and Estimates**

See Item 7. “Management’s Discussion and Analysis of Financial Condition and Results of Operations—Critical Accounting Policies and Estimates” of the Form 10-K for a discussion of the Company’s critical accounting policies. There have been no material changes to the Company’s critical accounting policies and estimates provided in the Form 10-Q.

## **New Accounting Pronouncements**

See Note 2 for a discussion of new accounting pronouncements and their potential impact on the Company.

## **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

The Company is exposed to changes in interest rates primarily under the Scotia LLC Line of Credit and the Revolving Credit Facility and Term Loan, as well as certain other debt facilities used to finance real estate development activities. As of September 30, 2005, there were \$96.4 million in borrowings outstanding under all variable rate facilities. Based on the amount of borrowings outstanding under these facilities during the nine months ended September 30, 2005, a 1.0% change in interest rates effective from the beginning of the year would have resulted in an increase or decrease in interest expense for the period of \$0.6 million.

## **ITEM 4. CONTROLS AND PROCEDURES**

The Company maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in the Company’s reports under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the SEC, and that such information is accumulated and communicated to the Company’s management, including its Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Also, the Company has investments in certain unconsolidated entities. As the Company does not control or manage these entities, its disclosure controls and procedures with respect to such entities are necessarily substantially more limited than those it maintains with respect to its consolidated subsidiaries.

As of the end of the period covered by this report, our management carried out an evaluation, under the supervision and with the participation of the Company’s management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company’s disclosure controls and procedures. Based on the evaluation, our management, including our Chief Executive Officer and Chief Financial Officer, concluded that the Company’s disclosure controls and procedures were effective as of September 30, 2005.

There have been no significant changes in the Company’s internal controls or in other factors that could significantly affect the internal controls subsequent to the date the Company completed its evaluation.

## **PART II. OTHER INFORMATION**

### **ITEM 1. LEGAL PROCEEDINGS**

The information set forth in Note 8 is incorporated herein by reference.

### **ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

The Company may from time to time purchase shares of its Common Stock on national exchanges or in privately negotiated transaction. Through the nine months ended September 30, 2005, the Company purchased 8,600 shares of its Common Stock at \$22.05 per share for a total of \$0.2 million in June 2005.

**ITEM 6. EXHIBITS**

**a. Exhibits:**

10.1 Omnibus Amendment to Revolving Credit Agreement, Term Loan Agreement, Intercreditor Agreement and Guarantee and Collateral Agreements (incorporated herein by reference to Exhibit 10.1 to a Current Report on Form 8-K of the Company dated October 26, 2005)

\* 31.1 Section 302 Certification of Chief Executive Officer

\* 31.2 Section 302 Certification of Chief Financial Officer

\* 32.1 Section 906 Certification of Chief Executive Officer

\* 32.2 Section 906 Certification of Chief Financial Officer

\* Included with this filing

## SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized, who have signed this report on behalf of the Registrant and as the principal financial and accounting officers of the Registrant, respectively.

MAXXAM INC.

Date: November 9, 2005

By:           /S/          PAUL N. SCHWARTZ            
Paul N. Schwartz  
President, Chief Financial Officer and Director  
(Principal Financial Officer)

Date: November 9, 2005

By:           /S/          M. EMILY MADISON            
M. Emily Madison  
Vice President, Finance  
(Principal Accounting Officer)

### Glossary of Defined Terms

Set forth below is a list of all terms used in this Report.

*APB Opinion No. 25:* Accounting Principles Board Opinion 25, “Accounting for Stock Issued to Employees”

*APB Opinion No. 29:* Accounting Principles Board Opinion 29, “Accounting for Nonmonetary Transactions”

*Bankruptcy Code:* The United States Bankruptcy Code

*Bankruptcy Court:* The United States Bankruptcy Court for the District of Delaware

*Bear Creek lawsuit:* An action entitled *Environmental Protection Information Association v. Pacific Lumber, Scotia Pacific Company LLC* (No. C01-2821) filed in the U.S. District Court for the Northern District of California

*Borrowers:* Palco and Britt, as borrowers under the Revolving Credit Facility and Term Loan

*Britt:* Britt Lumber Co., Inc., a wholly owned subsidiary of Palco

*California Permits:* The Permits issued by California pursuant to the HCP

*California Senate Bill 810:* Bill which became effective January 1, 2004, providing regional water quality control boards with additional authority related to the approval of THPs on land within impaired watersheds

*Cave action:* An action entitled *Steve Cave, et al. v. Gary Clark, et al.* (No. DR020719) filed in the Superior Court of Humboldt County, California

*CBD:* Center for Biological Diversity

*CDF:* California Department of Forestry and Fire Protection

*CDF Harvest Limit:* Annual harvest limit established by the CDF

*CDFG:* California Department of Fish and Game

*CESA:* California Endangered Species Act

*Class A Preferred Stock:* The Company’s Class A \$.05 Non-Cumulative Participating Convertible Preferred Stock

*Common Stock:* The Company’s \$0.50 par value common stock

*Company:* MAXXAM Inc., including its subsidiaries

*Consistency Determinations:* Documents issued by CDFG in February 2005 which stated that as long as Palco continues to follow the requirements of its HCP and has Federal Permits (which were unaffected by the *EPIC SYP/Permits lawsuit*), then Palco meets all requirements under CESA for the incidental take of coho salmon or the marbled murrelet.

*Cook action:* An action entitled *Alan Cook, et al. v. Gary Clark, et al.* (No. DR020718) filed in the Superior Court of Humboldt County, California

*CWA:* Federal Clean Water Act

*Debtors:* Kaiser, KACC and the subsidiaries of KACC which have filed petitions for reorganization

*EBITDA:* As defined in Section 1.01 of the Revolving Credit Agreement and Term Loan which, among other things, excludes the results of Scotia LLC

*Elk River Order:* Clean up and abatement order issued to Palco by the North Coast Water Board for the Elk River watershed

*Environmental Plans:* The HCP and the SYP

*EPA:* Federal Environmental Protection Agency

*EPIC-SYP/Permits lawsuit:* An action entitled *Environmental Protection Information Association, Sierra Club v. California Department of Forestry and Fire Protection, California Department of Fish and Game, The Pacific Lumber Company, Scotia Pacific Company LLC, Salmon Creek Corporation, et al.* filed in the Superior Court of Humboldt County, California (No. CV990445)

*EPIC-USFWS/NOAA lawsuit:* An action entitled *Environmental Protection Information Center v. U.S. Fish & Wildlife Service, NOAA Fisheries, et al.* (No. C04-4647) filed in U.S. Court for the Northern District of California

*ERISA:* The Employee Retirement Income Security Act of 1974, as amended from time to time

*FASB:* Financial Accounting Standards Board

*FDIC:* Federal Deposit Insurance Corporation

*FDIC action:* An action entitled *Federal Deposit Insurance Corporation, as manager of the FSLIC Resolution Fund v. Charles E. Hurwitz* (No. H-95-3956) filed by the FDIC on August 2, 1995 in the U.S. District Court for the Southern District of Texas

*Federal Permits:* The Permits issued by the federal government pursuant to the HCP

*Federated:* Federated Development Company, a principal stockholder of the Company now known as Gideon Holdings, Inc.

*FireRock LLC:* A 50% owned joint venture which developed and manages a real estate project in Arizona

*Form 10-K:* Annual Report on Form 10-K of the Company for the fiscal year ended December 31, 2004

*Fountain Hills:* Fountain Hills, a master-planned residential community located in Fountain Hills, Arizona

*FSP FAS 106-2:* FASB Staff Position FAS 106-2, "Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003"

*Harvest Value Schedule:* A schedule setting forth SBE Prices which is published biannually by the California State Board of Equalization for purposes of computing yield taxes on timber sales

*HCP:* The habitat conservation plan covering multiple species approved in March 1999 in connection with the consummation of the Headwaters Agreement

*Headwaters Agreement:* The agreement among Palco, Scotia LLC, Salmon Creek, the United States and California pursuant to which the Palco Companies transferred to the United States government 5,600 acres of timberlands in exchange for \$300 million, approximately 7,700 acres of timberlands, and federal and state government-approved habitat conservation and sustained yield plans

*Humboldt DA action:* A civil suit entitled *The People of the State of California v. Pacific Lumber, Scotia Pacific Holding Company and Salmon Creek Corporation* (No. DR030070) filed in the Superior Court of Humboldt County, California, by the District Attorney of Humboldt County

*KACC:* Kaiser Aluminum & Chemical Corporation, Kaiser's principal operating subsidiary



*Kahn lawsuit:* An action entitled *Alan Russell Kahn v. Federated Development Co., MAXXAM Inc., et. al.* (Civil Action 18623NC) filed in the Delaware Court of Chancery

*Kaiser:* Kaiser Aluminum Corporation, a subsidiary of the Company engaged in aluminum operations

*Kaiser Shares:* 50,000,000 shares of the common stock of Kaiser collectively owned by the Company and MGHI

*LIBOR:* London Inter Bank Offering Rate

*Master Purchase Agreement:* The agreement between Palco and Scotia LLC that governs all purchases of logs by Palco from Scotia LLC

*MAXXAM:* MAXXAM Inc., including its subsidiaries

*MAXXAM Parent:* MAXXAM Inc., excluding its subsidiaries

*Moody's:* Moody's Investors Service

*MGHI:* MAXXAM Group Holdings Inc., a wholly owned subsidiary of the Company

*MGI:* MAXXAM Group Inc., a wholly owned subsidiary of MGHI

*MPC:* MAXXAM Property Company, a wholly owned subsidiary of the Company

*NJDEP:* New Jersey Department of Environmental Protection

*North Coast Water Board:* California North Coast Regional Water Quality Control Board

*Noteholders:* Holders of the Timber Notes

*Noteholder Committee:* An ad hoc committee of holders of the Timber Notes

*Omnibus Amendment:* Amendment to Revolving Credit Facility and Term Loan (and other loan documents) entered into on October 26, 2005

*Option A Plan:* Plan for complying with California's sustained yield requirements, which has been approved by the CDF

*OTS:* The United States Department of Treasury's Office of Thrift Supervision

*OTS action:* A formal administrative proceeding initiated by the OTS against the Company and others on December 26, 1995

*Palco:* The Pacific Lumber Company, a wholly owned subsidiary of MGI

*Palco Companies:* Palco, Scotia LLC and Salmon Creek, collectively

*Palco Credit Agreement:* January 2004 revolving credit facility between Palco and a bank which provided for borrowings up to \$30.0 million, which facility was terminated in connection with the closing of the Revolving Credit Facility and Term Loan

*Palmas:* Palmas del Mar, a master-planned residential community and resort located on the southeastern coast of Puerto Rico near Humacao

*PDMPI:* Palmas del Mar Properties, Inc., a wholly owned subsidiary of the Company

*Permits:* The incidental take permits issued by the United States and California pursuant to the HCP

*Prescription Drug Act:* Medicare Prescription Drug, Improvement, and Modernization Act of 2003

*PSLRA*: Private Securities Litigation Reform Act of 1995

*Racing Act*: The Texas Racing Act and related regulations

*Respondents*: The Company, Federated, Mr. Charles Hurwitz and the other respondents in the *OTS action*

*Revolving Credit Agreement*: The agreement evidencing the Revolving Credit Facility

*Revolving Credit Facility*: Revolving credit facility evidenced by the Revolving Credit Agreement dated as of April 19, 2005 among Palco and Britt, as Borrowers, and Credit Suisse First Boston

*RI/RA*: Remedial investigation and remedial action

*S&P*: Standard & Poor's Rating Service

*Salmon Creek*: Salmon Creek LLC, a wholly owned subsidiary of Palco

*Sam Houston Race Park*: Texas Class 1 horse racing facility in Houston, Texas and operated by SHRP, Ltd.

*Sanctions Motion*: An amended counterclaim and motion for sanctions filed by the Respondents on November 8, 2002, in connection with the *FDIC action*

*SAR Account*: Funds held in a reserve account titled the Scheduled Amortization Reserve Account and used to support principal payments on the Timber Notes

*SBE Price*: The applicable stumpage price for a particular species and size of log, as set forth in the most recent Harvest Value Schedule

*Scheduled Amortization*: The amount of principal which Scotia LLC must pay through each Timber Note payment date in order to avoid prepayment or deficiency premiums

*Scotia LLC*: Scotia Pacific Company LLC, a limited liability company wholly owned by Palco

*Scotia LLC Line of Credit*: The agreement between a group of lenders and Scotia LLC pursuant to which Scotia LLC may borrow in order to pay up to one year's interest due on the Timber Notes

*Scotia LLC Timber*: The timber in respect of the Scotia LLC Timberlands and the Scotia LLC Timber Rights

*Scotia LLC Timberlands*: Approximately 204,000 acres of timberlands owned by Scotia LLC

*Scotia LLC Timber Rights*: Scotia LLC's exclusive right to harvest on approximately 12,200 acres of timberlands owned by Palco and Salmon Creek

*SEC*: The Securities and Exchange Commission

*Services Agreement*: Agreement between Scotia LLC and Palco under which Palco provides certain operational, management and related services to the Scotia LLC with respect to the Scotia LLC Timberlands

*SFAS*: Statement of Financial Accounting Standards

*SFAS No. 123(r)*: SFAS No. 123 (revised 2004), "Share-Based Payments"

*SFAS No. 151*: SFAS No. 151, "Inventory Costs"

*SFAS No. 153*: SFAS No. 153, "Exchange of Nonmonetary Assets," an amendment of APB Opinion No. 29

*SHRP, Ltd.*: Sam Houston Race Park, Ltd., a wholly owned subsidiary of the Company

*State*: State of California

*State Water Board:* California State Water Resources Control Board

*SYP:* The sustained yield plan approved in March 1999 as part of the Headwaters Agreement, and later invalidated by a California state court

*take:* Adverse impacts on species which have been designated as endangered or threatened

*Term Loan:* \$35.0 million term loan evidenced by the Term Loan Agreement dated as of April 19, 2005 among Palco and Britt, as Borrowers, and The CIT Group/Business Credit, Inc.

*Texas Racing Commission:* The Racing Commission of the State of Texas

*THP:* Timber harvesting plan required to be filed with and approved by the CDF prior to the harvesting of timber

*THP No. 520 lawsuit:* An action entitled *The Pacific Lumber Company, et al. v. California State Water Resources Control Board* (No. DR010860) filed in the Superior Court of Humboldt County, California

*Timber Notes:* Scotia LLC's 6.55% Series B Class A-1 Timber Collateralized Notes, 7.11% Series B Class A-2 Timber Collateralized Notes and 7.71% Series B Class A-3 Timber Collateralized Notes due July 20, 2028

*Timber Notes Indenture:* The indenture governing the Timber Notes

*TMDLs:* Total maximum daily load limits

*Trustee:* The trustee under the Timber Notes Indenture

*UBS:* UBS Securities LLC

*USAT:* United Savings Association of Texas

*USWA lawsuit:* An action entitled *United Steelworkers of America, AFL-CIO, CLC, and Donald Kegley v. California Department of Forestry and Fire Protection, The Pacific Lumber Company, Scotia Pacific Company LLC and Salmon Creek Corporation* (No. CV990452) filed in the Superior Court of Humboldt County, California

*WWDRs:* Watershed-wide waste discharge requirements