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

FORM 10-Q

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

For the quarterly period ended September 30, 2006

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)

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

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

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 a large accelerated filer, an accelerated filer, or a non-accelerated filer. (Check one):
Large accelerated filer ☐ Accelerated filer ☒ Non-accelerated filer ☐

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 10, 2006: 5,257,657

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MAXXAM INC. AND SUBSIDIARIES

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

	September 30, 2006	December 31, 2005
	(Unaudited)	
Assets		
Current assets:		
Cash and cash equivalents	\$ 30.5	\$ 72.9
Marketable securities and other short-term investments	135.2	134.6
Receivables:		
Trade, net of allowance for doubtful accounts of \$0.7 and \$0.8, respectively	12.1	11.1
Other	4.4	5.4
Inventories:		
Lumber	12.2	7.6
Logs	23.5	18.9
Real estate and other assets held for sale	8.2	12.6
Prepaid expenses and other current assets	17.2	16.4
Restricted cash and marketable securities	28.3	29.1
Total current assets	271.6	308.6
Property, plant and equipment, net of accumulated depreciation of \$228.4 and \$207.9, respectively	338.6	355.0
Timber and timberlands, net of accumulated depletion of \$230.6 and \$226.3, respectively	201.5	208.7
Real estate	45.3	43.2
Deferred income taxes	94.8	95.1
Intangible assets	2.2	2.9
Long-term receivables and other assets	29.9	26.9
Restricted cash and marketable securities	8.2	7.9
	<u>\$ 992.1</u>	<u>\$ 1,048.3</u>
Liabilities and Stockholders' Deficit		
Current liabilities:		
Accounts payable	\$ 14.5	\$ 11.2
Accrued interest	14.7	25.9
Accrued compensation and related benefits	11.6	20.7
Other accrued liabilities	30.7	37.0
Short-term borrowings and current maturities of long-term debt	174.1	112.5
Total current liabilities	245.6	207.3
Long-term debt, less current maturities	860.3	889.6
Accrued pension and other postretirement benefits	32.9	34.1
Losses in excess of investment in Kaiser	—	516.2
Other noncurrent liabilities	54.0	62.4
Total liabilities	1,192.8	1,709.6
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 shares issued and 668,119 shares outstanding	0.3	0.3
Common stock, \$0.50 par value; 13,000,000 shares authorized; 10,063,359 shares issued; 5,257,657 and 5,967,942 shares outstanding	5.0	5.0
Additional capital	225.3	225.3
Accumulated deficit	(273.1)	(670.4)
Accumulated other comprehensive loss	(10.8)	(96.6)
Treasury stock, at cost (shares held: preferred – 845; common – 4,805,702 and 4,095,417, respectively)	(147.4)	(124.9)
Total stockholders' deficit	(200.7)	(661.3)
	<u>\$ 992.1</u>	<u>\$ 1,048.3</u>

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

MAXXAM INC. AND SUBSIDIARIES

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
	(Unaudited)			
Net sales:				
Forest products	\$ 37.9	\$ 42.6	\$ 109.5	\$ 136.8
Real estate	28.9	52.3	77.1	105.2
Racing	11.0	10.9	34.9	34.0
	<u>77.8</u>	<u>105.8</u>	<u>221.5</u>	<u>276.0</u>
Costs and expenses:				
Cost of sales and operations:				
Forest products	28.0	33.0	90.2	111.9
Real estate	9.2	12.9	25.6	29.3
Racing	9.9	9.7	30.6	29.3
Selling, general and administrative expenses	14.7	22.2	39.3	50.5
Depreciation, depletion and amortization	8.7	8.3	26.1	26.1
Gain on sales of timberlands and other assets	(5.3)	—	(11.2)	(0.1)
Reversal of net investment in Kaiser	(430.9)	—	(430.9)	—
	<u>(365.7)</u>	<u>86.1</u>	<u>(230.3)</u>	<u>247.0</u>
Operating income (loss):				
Forest products	5.0	(2.1)	(0.4)	(8.0)
Real estate	10.4	30.7	26.8	48.4
Racing	(1.4)	(1.8)	(3.1)	(2.9)
Corporate, including reversal of net investment in Kaiser ...	429.5	(7.1)	428.5	(8.5)
	<u>443.5</u>	<u>19.7</u>	<u>451.8</u>	<u>29.0</u>
Other income (expense):				
Investment and interest income	(0.3)	4.3	5.6	9.6
Other income (expense)	0.2	(0.2)	1.0	—
Interest expense, net	(20.2)	(18.9)	(58.9)	(55.0)
Amortization of deferred financing costs	(4.5)	(0.6)	(5.7)	(3.1)
Income (loss) before income taxes and cumulative effect of accounting change	418.7	4.3	393.8	(19.5)
Benefit (provision) for income taxes	—	—	4.2	—
Income (loss) before cumulative effect of accounting change ..	418.7	4.3	398.0	(19.5)
Cumulative effect of accounting change, net of tax	—	—	(0.7)	—
Net income (loss)	<u>\$ 418.7</u>	<u>\$ 4.3</u>	<u>\$ 397.3</u>	<u>\$ (19.5)</u>
Basic income (loss) per common and common equivalent share before cumulative effect of accounting change	\$ 79.61	\$ 0.72	\$ 70.71	\$ (3.26)
Cumulative effect of accounting change	—	—	(0.12)	—
Basic income (loss) per common and common equivalent shares after cumulative effect of accounting change	<u>\$ 79.61</u>	<u>\$ 0.72</u>	<u>\$ 70.59</u>	<u>\$ (3.26)</u>
Diluted income (loss) per common and common equivalent share before cumulative effect of accounting change	\$ 69.32	\$ 0.62	\$ 62.20	\$ (3.26)
Cumulative effect of accounting change	—	—	(0.11)	—
Diluted income (loss) per common and common equivalent share after cumulative effect of accounting change	<u>\$ 69.32</u>	<u>\$ 0.62</u>	<u>\$ 62.09</u>	<u>\$ (3.26)</u>

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

MAXXAM INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS
(In millions of dollars)

	Nine Months Ended September 30,	
	2006	2005
	(Unaudited)	
Cash flows from operating activities:		
Net income (loss)	\$ 397.3	\$ (19.5)
Adjustments to reconcile net income (loss) to net cash provided by (used for) operating activities:		
Reversal of net investment in Kaiser	(430.9)	—
Depreciation, depletion and amortization	26.1	26.1
Non-cash stock-based compensation benefit	(3.7)	0.3
Gains on sales of timberlands and other assets	(11.2)	(0.1)
Net gains from marketable securities	(1.2)	(4.6)
Amortization of deferred financing costs	5.7	3.1
Equity in loss of unconsolidated affiliates, net of dividends received	0.7	0.7
Increase (decrease) in cash resulting from changes in:		
Receivables	0.1	3.0
Inventories	(8.8)	(3.3)
Prepaid expenses and other assets	(1.5)	(0.1)
Accounts payable	3.4	—
Accrued and deferred income taxes	(3.9)	(0.3)
Other accrued liabilities	(11.8)	15.9
Accrued interest	(11.2)	(12.2)
Long-term assets and long-term liabilities	(2.9)	6.4
Other	1.1	(0.6)
Net cash provided by (used for) operating activities	<u>(52.7)</u>	<u>14.8</u>
Cash flows from investing activities:		
Net proceeds from the disposition of property and investments	15.9	0.1
Sales and maturities of marketable securities and other investments	420.2	497.0
Purchases of marketable securities and other investments	(419.0)	(469.9)
Net proceeds from restricted cash	0.4	8.4
Capital expenditures	(8.4)	(16.2)
Return of investment in joint venture	—	0.5
Other, net	0.3	0.1
Net cash provided by investing activities	<u>9.4</u>	<u>20.0</u>
Cash flows from financing activities:		
Proceeds from issuances of long-term debt	0.2	38.0
Principal payments on long-term debt	(67.4)	(31.0)
Principal payments on Timber Notes deposited in the SAR Account	11.1	9.5
Borrowings (repayments) under revolving and short-term credit facilities	88.3	25.5
Incurrence of deferred financing costs	(8.8)	(3.1)
Treasury stock purchases	(22.5)	(0.2)
Net cash provided by financing activities	<u>0.9</u>	<u>38.7</u>
Net increase (decrease) in cash and cash equivalents	(42.4)	73.5
Cash and cash equivalents at beginning of the period	72.9	18.5
Cash and cash equivalents at end of the period	<u>\$ 30.5</u>	<u>\$ 92.0</u>
Supplemental disclosure of cash flow information:		
Interest paid, net of capitalized interest and interest paid in respect of the		
Timber Notes held in the SAR Account	\$ 70.2	\$ 67.2

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 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, 2006, the consolidated results of operations for the three months and nine months ended September 30, 2006 and 2005, and the consolidated cash flows for the nine months ended September 30, 2006 and 2005.

Kaiser Update

In February 2002, Kaiser and certain of its subsidiaries filed for reorganization under Chapter 11 of the Bankruptcy Code. Kaiser's plan of reorganization provided for the cancellation of Kaiser's equity, including the Company's Kaiser Shares, without consideration or obligation. Kaiser's plan of reorganization became effective on July 6, 2006, and Kaiser emerged from bankruptcy. Since the Company's Kaiser Shares were cancelled without obligation, the Company reversed the \$516.2 million of losses in excess of its investment in Kaiser along with the accumulated other comprehensive losses of \$85.3 million related to Kaiser, resulting in a net gain of \$430.9 million, recognized in the third quarter of 2006. As a result of the cancellation of the Company's Kaiser Shares in 2006, the Company expects it will take a worthless stock deduction on its 2006 consolidated federal income tax return. However, due to uncertainties regarding whether the Company will ultimately realize the resulting tax asset of approximately \$135.8 million, the Company has established a full valuation allowance related to this tax asset.

Financial Difficulties of Forest Products Entities

Future Harvest Levels

ScoPac has conducted extensive reviews and analyses of its assets, operations and future prospects. As a result of these extensive reviews and analyses, ScoPac has concluded that, in the absence of significant regulatory relief and accommodations, its future annual timber harvest levels and cash flows from operations for at least the next several years will be substantially below both historical harvest levels and the minimum levels necessary in order to allow it to satisfy its debt service obligations in respect of the Timber Notes. ScoPac has previously disclosed that its estimated average annual harvest levels over the ten-year period beginning in 2006 is estimated to be approximately 100 million board feet per year. This harvest level reflects ScoPac's estimate of the cumulative impact of ongoing regulatory limitations, watershed prescriptions, the requirements of the HCP and other matters and is based on a number of assumptions that may or may not prove to be accurate. Actual harvest levels may even be lower, depending on the outcome of various assumptions.

Regulatory Matters

Regulatory and environmental matters as well as legal actions have had and are expected to continue to have a significant adverse effect on the Company's forest products operations and liquidity. The ability to harvest ScoPac Timber depends in large part upon ScoPac's ability to obtain regulatory approval of its THPs. ScoPac has experienced difficulties and delays in the approval of its THPs as the result of regulatory and litigation challenges and expects these challenges to persist. The foregoing matters have resulted in declines in actual and expected harvest levels and cash flows, significant increases in the cost of logging operations and increased costs related to timber harvest litigation, all of which have severely impacted the historical cash flows of both Palco and ScoPac. These adverse effects are expected to continue.

The North Coast Water Board is requiring Palco and ScoPac 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 Palco Timberlands. THPs in these two watersheds represent a significant portion of the harvest planned in 2006 and for the next several years.

On May 8, 2006, the North Coast Water Board adopted the Freshwater and Elk River WWDRs. The decision allows harvesting in these two watersheds, up to approximately 50% of the applicable CDF Harvest Limit, once the staff of the North Coast Water Board reviews and enrolls THPs submitted by ScoPac. The North Coast Water Board's decision also allowed the enrollment of additional THPs, bringing the total to approximately 75% of the CDF Harvest Limit for these two watersheds, upon approval of a monitoring and reporting program by the Executive Officer of the North Coast Water Board staff. The monitoring and reporting program was approved on September 29, 2006, allowing enrollment by the staff of the North Coast Water Board of the additional THPs for these two watersheds planned for harvest in 2006. This monitoring and reporting program will also govern future THPs in these two watersheds. However, there can be no assurance that additional THPs in these two watersheds will ultimately be enrolled or harvested as planned in 2006 or future years. The North Coast Water Board's adoption of these WWDRs has been appealed to the State Water Board, but the appeals are being held in abeyance in order to see how the implementation of the WWDRs proceeds. As harvesting activities on the Palco 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 various other matters described herein are expected to result in reduced harvest levels in 2006 and beyond.

ScoPac Liquidity Update

In the absence of significant regulatory relief and accommodations, ScoPac's annual timber harvest levels and cash flows from operations will, for at least the next several years, be substantially below both historical levels and the minimum levels necessary to allow ScoPac to satisfy its debt service obligations in respect of the Timber Notes.

In an effort to address the expected future interest payment shortfalls, ScoPac initiated the ScoPac Land Sale Program to sell certain timberland properties, as well as various non-timberland properties, such as ranchlands and recreational areas. ScoPac expects that all of the net proceeds from sales under the ScoPac Land Sale Program will be available to pay interest on the Timber Notes, in accordance with the Timber Notes Indenture. During the first nine months of 2006, ScoPac sold properties available under the program for \$13.1 million. The aggregate estimated market value of the remaining properties included in the ScoPac Land Sale Program should cover ScoPac's expected future interest payment shortfalls, and the sale of enough of these properties to cover the expected future interest payment shortfalls should not materially reduce estimated average annual harvest levels over the next decade. There can be no assurance that the marketing efforts for the ScoPac Land Sale Program properties will be successful or that the resulting proceeds, if any, will be sufficient to cover ScoPac's expected future interest payment shortfalls. The properties included in the ScoPac Land Sale Program may change from time to time.

In an effort to address ScoPac's 2006 operating cash shortfalls, ScoPac and MGI consummated three timber/log purchases that provided ScoPac an aggregate of \$8.1 million of additional liquidity to pay its expenses, including interest due in respect of the Timber Notes on the Timber Notes payment dates in January 2006 and July 2006, as discussed below. In July 2006, ScoPac also requested that Palco make an early payment of \$2.1 million, in respect of certain logs that had already been delivered to and purchased by Palco from ScoPac. Palco approved and delivered the early log payment, which was used to pay ScoPac's expenses, including a portion of the interest due in respect of the July 2006 Timber Notes payment date.

On the Timber Notes payment date in January 2006, ScoPac used its existing cash resources, all of the remaining funds available under the ScoPac Line of Credit, and the additional funds made available from a \$2.3 million timber/log purchase by MGI, to pay all of the \$27.7 million of interest due (\$25.8 million net of interest due in respect of Timber Notes held in the SAR Account). ScoPac also repaid \$19.3 million of principal on the Timber Notes (\$11.9 million net of principal in respect of Timber Notes held in the SAR Account), an amount equal to Scheduled Amortization, using funds held in the SAR Account.

On the Timber Notes payment date in July 2006, ScoPac used its existing cash resources, all of the remaining funds available under the ScoPac Line of Credit, \$10.2 million of funds from the ScoPac Land Sale Program, a \$3.7 million timber/log purchase by MGI, and the \$2.1 million early log payment by Palco to pay all of the \$27.1 million of interest due (\$25.4 million net of interest due in respect of Timber Notes held in the SAR Account). ScoPac also repaid \$10.0 million of principal on the Timber Notes (\$6.2 million net of principal in respect of Timber Notes held in the SAR Account), an amount equal to Scheduled Amortization, using funds held in the SAR Account.

As noted above, ScoPac also expects to continue to incur substantial interest payment shortfalls over at least the next several years. The failure of ScoPac to pay all of the interest on the Timber Notes when due would constitute an

event of default under the Timber Notes Indenture. There can be no assurance that ScoPac will be able to generate sufficient additional liquidity to fund the expected future cash shortfalls. To the extent that ScoPac is unable to generate sufficient liquidity from the ScoPac Land Sale Program or other sources, the Company expects that ScoPac will be forced to take extraordinary actions, which may include: laying off employees, shutting down various operations, and seeking protection by filing under the Bankruptcy Code.

Palco Liquidity Update

As of December 31, 2005, and June 30, 2006, Palco and Britt were in default under the Old Palco Term Loan and the Old Palco Revolving Credit Facility due to financial covenant breaches. In the first half of 2006, additional liquidity was needed at Palco and Palco borrowed an aggregate of \$20.0 million from MGI to meet its cash shortfalls. Palco's liquidity shortfalls during the first half of 2006 resulted primarily from reduced log supply from ScoPac and operational inefficiencies related to the large log processing line at Palco's Scotia sawmill.

On July 18, 2006, Palco and Britt, as Borrowers, closed on the New Palco Term Loan, a five-year \$85.0 million secured term loan, and the New Palco Revolving Credit Facility, a five-year \$60.0 million secured asset-based revolving credit facility, and terminated the Old Palco Revolving Credit Facility and the Old Palco Term Loan. The New Palco Term Loan was fully funded at closing. The New Palco Term Loan and the New Palco Revolving Credit Facility required MGI to provide a \$10.0 million subordinated loan to the Borrowers, which was also funded at closing. The Borrowers used approximately (i) \$34.0 million of the New Palco Term Loan to pay off the Old Palco Term Loan; (ii) \$22.5 million of the New Palco Term Loan to pay off the Old Palco Revolving Credit Facility and cash collateralize previously-existing letters of credit; and (iii) \$6.0 million to pay transaction costs. The remaining \$32.5 million of loan proceeds were used for general corporate purposes. As of September 30, 2006, \$84.6 million was outstanding under the New Palco Term Loan, \$10.8 million was outstanding under the New Palco Revolving Credit Facility, and the maximum remaining availability under the New Palco Revolving Credit Facility was \$36.5 million.

The amount available for borrowings under the New Palco Revolving Credit Facility is normally the sum of 85% of the Borrowers' eligible accounts receivable plus the lesser of (i) 80% of the book value of Borrowers' eligible inventory or (ii) 85% of the net orderly liquidation value of such inventory. However, during each period from October 15 through January 15, the amount available for borrowing under the New Palco Revolving Credit Facility is the sum of 95% of Borrowers' eligible accounts receivable plus the lesser of (i) 90% of the book value of Borrowers' eligible inventory or (ii) 95% of the net orderly liquidation value of such inventory. The amount available under the New Palco Revolving Credit Facility may not exceed \$60.0 million, subject to limitations such as the ability of the lender to establish reasonable reserves.

The New Palco Term Loan bears interest at the rate of LIBOR plus 8.75%. Loans under the New Palco Revolving Credit Facility bear interest at the rate of LIBOR plus 2.75% or prime plus 0.75%, at the Borrowers' option; however, incremental borrowings made during the period from October 15 through January 15 bear interest at the rate of LIBOR plus 4.50% or prime plus 2.50%, as applicable.

Both the New Palco Term Loan and the New Palco Revolving Credit Facility contain substantially identical restrictive covenants that limit the Borrowers' ability to incur debt, grant liens, make investments, pay dividends, make capital expenditures or merge or consolidate, and require the Borrowers to maintain specified minimum levels of EBITDA throughout the life of the facilities and specified minimum fixed charge coverage ratios and maximum leverage ratios commencing December 31, 2007. The operating cash flow estimates used to establish the EBITDA maintenance covenant are subject to a number of assumptions about future operating cash flows and actual results could differ materially from these estimates. The New Palco Term Loan also requires the Borrowers to repay a substantial portion of the outstanding principal of the New Palco Term Loan with the net proceeds from various required asset sales, including the real property associated with Palco's former Fortuna and Carlotta sawmills, and Palco-owned homes to be sold after certain milestones have been met. Any remaining principal balance of the New Palco Term Loan is due on the maturity date. Accordingly, continued compliance with these new debt facilities is dependent on Palco's ability to meet its EBITDA projections and timely complete required asset sales. There can be no assurance that Palco will be able to meet these financial covenants in future periods. The New Palco Term Loan and the New Palco Revolving Credit Facility contain customary events of default and customary remedies with respect to the occurrence of an event of default and are each secured by a security interest in the stock of Palco held by MGI, and substantially all of the assets of the Borrowers (other than Palco's equity interest in ScoPac).

The Borrowers did not meet the required minimum EBITDA maintenance covenant for the three month period ended September 30, 2006, due to an unplanned severance charge and a legal settlement. The Borrowers expect the lenders to issue a limited waiver of the default through December 14, 2006. Until such time as the default is resolved, amounts outstanding under the New Palco Term Loan and the New Palco Revolving Credit Facility have been classified as a current liability in the Company's consolidated financial statements. Additionally, the Borrowers have notified the

lenders that changing market conditions and other factors will likely impact the Borrowers' ability to comply with the financial covenants in future periods. The Borrowers are evaluating various cost-cutting initiatives to improve profitability, but there can be no assurance that these efforts will generate sufficient liquidity to enable the Borrowers to comply with the financial covenants in future periods. The Borrowers are pursuing discussions with the lenders in an effort to amend the New Palco Term Loan and the New Palco Revolving Credit Agreements to reflect these changing market conditions and other factors; however, there can be no assurance that the Borrowers will be successful in their efforts. In the event that the Borrowers are unable to improve profitability or amend the two facilities as needed, they may be forced to take extraordinary actions.

The New Palco Term Loan and New Palco Revolving Credit Facility each include prepayment premiums of 3%, 2% and 1% that will be payable in connection with any prepayment of the New Palco Term Loan or reduction or termination of the New Palco Revolving Credit Facility during the facilities' first, second and third years, respectively. Under the New Palco Term Loan and New Palco Revolving Credit Facility, Palco is permitted to invest up to \$5.0 million in ScoPac. No such investment has been made or committed to be made by Palco, and there can be no assurance that Palco would in the future determine or be able to make any such investment in whole or part.

Potential Impact on Registrant and Certain Related Entities

The liquidity issues being experienced by ScoPac, and those recently experienced by Palco should they recur, could result in claims against and could have adverse impacts on MAXXAM Parent, MGHI and/or MGI. For example, under ERISA, 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 termination obligation attributable to Palco's pension plan as of December 31, 2005, is estimated to have been approximately \$31.0 million based upon annuity placement interest rate assumptions as of December 31, 2005. In addition, it is possible that certain transactions could be completed in connection with a potential restructuring or reorganization of Palco or ScoPac, such as a sale of all or a portion of the equity ownership in Palco and/or ScoPac, a sale of a substantial portion of Palco's and/or ScoPac's assets and/or a cancellation of some or all of Palco's and/or ScoPac'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 or other tax attributes for federal and state income tax purposes and could require tax payments.

Another action that could be considered by ScoPac and/or Palco is seeking protection by filing for bankruptcy. 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. Were Palco and/or ScoPac to file for bankruptcy financial results of the filing entities would be deconsolidated on the date of such filing, and the Company would begin reporting its investment in such subsidiaries using the cost method. The resulting impact on the Company's consolidated financial statements would be significant.

The following condensed pro forma financial information reflects MGI's results on a deconsolidated basis, and the impact of reporting the Company's investment in MGI on the cost method (in millions). This information is, however, on a pro forma basis only and the actual impact of a deconsolidation at some point in the future 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.

	Three Months Ended September 30, 2006	Nine Months Ended September 30, 2006
Revenues	\$ 39.9	\$ 112.0
Costs and expenses	(32.3)	(90.7)
Reversal of net investment in Kaiser	430.9	430.9
Operating income	438.5	452.2
MAXXAM's equity in MGI's losses	(15.2)	(51.1)
Other expenses, net	(4.6)	(7.3)
Cumulative effect of accounting change	—	(0.7)
Income tax benefit	—	4.2
Net income	<u>\$ 418.7</u>	<u>\$ 397.3</u>

	As of September 30, 2006
Current assets	\$ 223.7
Property, plant and equipment (net)	231.5
Other assets	155.1
Total assets	<u>\$ 610.3</u>
Current liabilities	42.9
Long-term debt, less current maturities	217.2
Other liabilities	54.7
Losses recognized in excess of investment in MGI and certain intercompany items	496.2
Total liabilities	811.0
Stockholders' deficit	(200.7)
Total liabilities and stockholders' deficit	<u>\$ 610.3</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.

Reclassifications

Certain reclassifications have been made to prior years' consolidated financial statements to be consistent with the current year's presentation. Cash held in brokerage accounts has been reclassified from marketable securities to cash and cash equivalents in the Consolidated Balance Sheets and in the Consolidated Statements of Cash Flows.

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 and classification 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 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 Securities and Exchange Commission. Adjustments made to estimates often relate to improved information not previously available. Uncertainties are inherent in such estimates and related assumptions; 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 actual results, the Company's consolidated financial statements or liquidity could be affected.

2. New Accounting Standards

Accounting for Stock Options

The Company adopted SFAS No. 123 (R) effective January 1, 2006. SFAS No. 123 (R) requires 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. Compensation cost is required to be recognized over the period that an employee provides service in exchange for the award and these awards are required to be re-measured each reporting period. The adoption of this standard resulted in an expense of \$0.7 million in the first quarter of 2006 representing the cumulative impact of awards exercisable on January 1, 2006.

Exchanges of Nonmonetary Assets

In December 2004, the FASB issued SFAS No. 153. 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. The adoption of SFAS No. 153 on January 1, 2006, did not have an impact on the Company's consolidated financial statements.

Accounting Changes and Error Corrections

In May 2005, the FASB issued SFAS No. 154, which changes the requirements applicable to accounting for, and reporting of, a change in accounting principle. SFAS No. 154 requires retrospective application of a change in accounting principle to prior periods' financial statements, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The adoption of SFAS No. 154 on January 1, 2006, did not have an impact on the Company's consolidated financial statements.

Accounting for Uncertainty in Income Taxes

In June 2006, the FASB issued FIN No. 48, which defines the threshold for recognizing the benefits of uncertain tax return positions in the financial statements. FIN No. 48 is effective for fiscal years beginning after December 15, 2006. The Company is in the process of evaluating the effects of FIN No. 48 on its consolidated financial statements.

Fair Value Measurements

In September 2006, the FASB issued SFAS No. 157, which is intended to increase consistency and comparability in fair value measurements by defining fair value, establishing a framework for measuring fair value, and expanding disclosures about fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company will adopt SFAS 157 on January 1, 2008, and has not yet determined the impact, if any, on its consolidated financial statements.

Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans

In September 2006, the FASB issued SFAS No. 158, which requires an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan as an asset or liability in its statement of financial position, and to recognize through comprehensive income changes in that funded status in the year in which the changes occur. Additionally, it requires an employer to measure the funded status of a plan as of the date of its fiscal year-end, with limited exceptions. SFAS 158 is effective as of the end of fiscal years ending after December 15, 2006; however, the requirement to measure plan assets and benefit obligations as of the fiscal year-end is not effective until fiscal years ending after December 15, 2008. The Company will adopt all requirements of SFAS 158 in accordance with this timeline. The Company is in the process of evaluating the effects of SFAS No. 158 on its consolidated financial statements.

3. Cash, Cash Equivalents, Marketable Securities and Investments in Limited Partnerships

The following table presents cash, cash equivalents, marketable securities and other investments, in the aggregate (in millions):

	September 30, 2006	December 31, 2005
Cash and cash equivalents	\$ 55.6	\$ 84.4
Marketable securities	116.0	128.9
Investments in limited partnerships	30.6	31.2
	202.2	244.5
Less: restricted cash and marketable securities	(36.5)	(37.0)
Unrestricted cash and marketable securities	<u>\$ 165.7</u>	<u>\$ 207.5</u>

Cash, marketable securities and other investments include the following amounts which are restricted (in millions):

	September 30, 2006	December 31, 2005
Current:		
Restricted cash and cash equivalents	\$ 19.4	\$ 6.1
Restricted marketable securities held in the SAR Account	8.9	23.0
	<u>28.3</u>	<u>29.1</u>
Non Current:		
Restricted Timber Notes held in the SAR Account ⁽¹⁾	41.3	52.9
Other amounts restricted under the Timber Notes Indenture	2.5	2.5
Other long-term restricted amounts	5.7	5.4
Less: Amounts attributable to Timber Notes held in the SAR Account ⁽¹⁾	(41.3)	(52.9)
	<u>8.2</u>	<u>7.9</u>
Total restricted cash and cash equivalents and marketable securities	<u>\$ 36.5</u>	<u>\$ 37.0</u>

⁽¹⁾ This amount represents the aggregate amount price paid by ScoPac for the Class A-1 and Class A-2 Timber Notes held in the SAR Account. The Class A-2 Timber Notes held in the SAR Account were sold in October 2006, and the net proceeds from the sale of approximately \$30.2 million were deposited in the SAR Account.

Amounts in the SAR Account, including the Timber Notes held in the SAR Account, are being held by the Trustee to support principal payments on the Timber Notes. See Note 5 for further discussion of the SAR Account.

4. Segment Information and Other Items

Net sales and operating income (loss) for each reportable segment are presented in the Consolidated Statements of Operations. Operating 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 reversal of the Company's net investment in Kaiser in the third quarter of 2006 resulted in a gain of \$430.9 million in the Consolidated Statement of Operations. Additionally, the Company's forest products segment has recognized cumulative gains of \$11.2 million in 2006 from the sale of certain properties as part of the ScoPac Land Sale Program.

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

	Reportable Segments				Consolidated	
	Forest Products	Real Estate	Racing	Corporate	Total	
Selling, general and administrative expenses for the three months ended:						
September 30, 2006	\$ 5.2	\$ 6.2	\$ 2.1	\$ 1.2	\$	14.7
September 30, 2005	7.5	5.1	2.5	7.1		22.2
Selling, general and administrative expenses for the nine months ended:						
September 30, 2006	\$ 16.4	\$ 14.4	\$ 6.4	\$ 2.1	\$	39.3
September 30, 2005	18.9	16.8	6.4	8.4		50.5
Depreciation, depletion and amortization for the three months ended:						
September 30, 2006	\$ 5.1	\$ 3.1	\$ 0.4	\$ 0.1	\$	8.7
September 30, 2005	4.3	3.6	0.4	—		8.3
Depreciation, depletion and amortization for the nine months ended:						
September 30, 2006	\$ 14.5	\$ 10.3	\$ 1.1	\$ 0.2	\$	26.1
September 30, 2005	14.1	10.7	1.2	0.1		26.1
Total assets as of:						
September 30, 2006	\$ 421.1	\$ 339.2	\$ 38.0	\$ 193.8	\$	992.1
December 31, 2005	421.4	345.3	36.4	245.2		1,048.3

5. Debt

Principal amounts of outstanding debt consist of the following (in millions):

	September 30, 2006	December 31, 2005
Old Palco Revolving Credit Facility ⁽¹⁾	\$ —	\$ 24.0
Old Palco Term Loan ⁽¹⁾	—	34.7
New Palco Term Loan due July 18, 2011 ⁽¹⁾	84.6	—
New Palco Revolving Credit Facility due July 18, 2011 ⁽¹⁾	10.8	—
ScoPac Line of Credit due as described below	47.8	31.3
6.55% ScoPac Class A-1 Timber Notes due July 20, 2028	7.3	36.6
7.11% ScoPac Class A-2 Timber Notes due July 20, 2028	243.2	243.2
7.71% ScoPac Class A-3 Timber Notes due July 20, 2028	463.3	463.3
7.56% Lakepointe Notes due June 8, 2021	113.9	114.8
7.03% Motel Notes due May 1, 2018	45.1	46.1
6.08% Beltway Notes due November 9, 2024	28.8	29.2
7.19% Palmas Notes due December 20, 2030	28.9	29.2
Other notes and contracts, primarily secured by receivables, buildings, real estate and equipment	5.0	5.1
Total Principal Outstanding	1,078.7	1,057.5
Less: Current Maturities	(174.1)	(112.5)
Class A-1 Timber Notes held in the SAR Account, at par value ⁽²⁾	(2.8)	(13.9)
Class A-2 Timber Notes held in the SAR Account, at par value ⁽²⁾⁽³⁾	(41.5)	(41.5)
	<u>\$ 860.3</u>	<u>\$ 889.6</u>

⁽¹⁾ At December 31, 2005, and September 30, 2006, Palco's credit facilities were classified as short-term borrowings due to financial covenant breaches.

⁽²⁾ The Timber Notes Indenture provides that a Timber Note does not cease to be outstanding because ScoPac holds the instrument. Consequently, ScoPac is required to pay and has paid interest and principal on the Timber Notes held in the SAR Account.

⁽³⁾ The Class A-2 Timber Notes held in the SAR Account were sold in October 2006.

Palco Credit Agreements

At December 31, 2005, and June 30, 2006, Palco and Britt were in default under the Old Palco Term Loan and the Old Palco Revolving Credit Facility due to financial covenant breaches. The existence of the defaults required Palco to pay interest on amounts borrowed under the Old Palco Term Loan at a per annum rate 2% higher than the rate at which

interest would have been owed had no default existed.

On July 18, 2006, Palco and Britt, as Borrowers, closed on the New Palco Term Loan, a five-year \$85.0 million secured term loan, and the New Palco Revolving Credit Facility, a five-year \$60.0 million secured asset-based revolving credit facility, and terminated the Old Palco Revolving Credit Facility and the Old Palco Term Loan. The New Palco Term Loan was fully funded at closing. The New Palco Term Loan and the New Palco Revolving Credit Facility required MGI to provide a \$10.0 million subordinated loan to the Borrowers, which was also funded at closing. The Borrowers used approximately (i) \$34.0 million of the New Palco Term Loan to pay off the Old Palco Term Loan; (ii) \$22.5 million of the New Palco Term Loan to pay off the Old Palco Revolving Credit Facility and cash collateralize previously-existing letters of credit; and (iii) \$6.0 million to pay transaction costs. The remaining \$32.5 million of loan proceeds were used for general corporate purposes. As of September 30, 2006, \$84.6 million was outstanding under the New Palco Term Loan, \$10.8 million was outstanding under the New Palco Revolving Credit Facility, and the maximum remaining availability under the New Palco Revolving Credit Facility was \$36.5 million.

The amount available for borrowings under the New Palco Revolving Credit Facility is normally the sum of 85% of the Borrowers' eligible accounts receivable plus the lesser of (i) 80% of the book value of Borrowers' eligible inventory or (ii) 85% of the net orderly liquidation value of such inventory. However, during each period from October 15 through January 15, the amount available for borrowing under the New Palco Revolving Credit Facility is the sum of 95% of Borrowers' eligible accounts receivable plus the lesser of (i) 90% of the book value of Borrowers' eligible inventory or (ii) 95% of the net orderly liquidation value of such inventory. The amount available under the New Palco Revolving Credit Facility may not exceed \$60.0 million, subject to limitations such as the ability of the lender to establish reasonable reserves.

The New Palco Term Loan bears interest at the rate of LIBOR plus 8.75%. Loans under the New Palco Revolving Credit Facility bear interest at the rate of LIBOR plus 2.75% or prime plus 0.75%, at the Borrowers' option; however, incremental borrowings made during the period from October 15 through January 15 bear interest at the rate of LIBOR plus 4.50% or prime plus 2.50%, as applicable.

Both the New Palco Term Loan and the New Palco Revolving Credit Facility contain substantially identical restrictive covenants that limit the Borrowers' ability to incur debt, grant liens, make investments, pay dividends, make capital expenditures or merge or consolidate, and require the Borrowers to maintain specified minimum levels of EBITDA throughout the life of the facilities and specified minimum fixed charge coverage ratios and maximum leverage ratios commencing December 31, 2007. The operating cash flow estimates used to establish the EBITDA maintenance covenant are subject to a number of assumptions about future operating cash flows and actual results could differ materially from these estimates. The New Palco Term Loan also requires the Borrowers to repay a substantial portion of the outstanding principal of the New Palco Term Loan with the net proceeds from various required asset sales, including the real property associated with Palco's former Fortuna and Carlotta sawmills, and Palco-owned homes to be sold after certain milestones have been met. Any remaining principal balance of the New Palco Term Loan is due on the maturity date. Accordingly, continued compliance with these new debt facilities is dependent on Palco's ability to meet its EBITDA projections and timely complete required asset sales. There can be no assurance that Palco will be able to meet these financial covenants in future periods. The New Palco Term Loan and the New Palco Revolving Credit Facility contain customary events of default and customary remedies with respect to the occurrence of an event of default and are each secured by a security interest in the stock of Palco held by MGI, and substantially all of the assets of the Borrowers (other than Palco's equity interest in ScoPac).

The Borrowers did not meet the required minimum EBITDA maintenance covenant for the three month period ended September 30, 2006, due to an unplanned severance charge and a legal settlement. The Borrowers expect the lenders to issue a limited waiver of the default through December 14, 2006. Until such time as the default is resolved, amounts outstanding under the New Palco Term Loan and the New Palco Revolving Credit Facility have been classified as a current liability in the Company's consolidated financial statements. Additionally, the Borrowers have notified the lenders that changing market conditions and other factors will likely impact the Borrowers' ability to comply with the financial covenants in future periods. The Borrowers are evaluating various cost-cutting initiatives to improve profitability, but there can be no assurance that these efforts will generate sufficient liquidity to enable the Borrowers to comply with the financial covenants in future periods. The Borrowers are pursuing discussions with the lenders in an effort to amend the New Palco Term Loan and the New Palco Revolving Credit Agreements to reflect these changing market conditions and other factors; however, there can be no assurance that the Borrowers will be successful in their efforts. In the event that the Borrowers are unable to improve profitability or amend the two facilities as needed, they may be forced to take extraordinary actions.

The New Palco Term Loan and New Palco Revolving Credit Facility each include prepayment premiums of 3%, 2% and 1% that will be payable in connection with any prepayment of the New Palco Term Loan or reduction or

termination of the New Palco Revolving Credit Facility during the first, second and third years, respectively. Under the New Palco Term Loan and New Palco Revolving Credit Facility, Palco is permitted to invest up to \$5.0 million in ScoPac. No such investment has been made or committed to be made by Palco, and there can be no assurance that Palco would in the future determine or be able to make any such investment in whole or part.

ScoPac Line of Credit

The ScoPac Line of Credit allows ScoPac to borrow up to one year's interest on the aggregate outstanding principal balance of the Timber Notes. On May 18, 2006, the ScoPac Line of Credit was extended to July 6, 2007. At or near the completion of such extension, ScoPac intends to request that the ScoPac Line of Credit be extended for an additional period of not less than 364 days. If not extended, ScoPac may draw upon the full amount available. The amount drawn would, to the extent of available funds, be repayable in 12 semiannual installments on each Timber Notes 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, 2006, the maximum availability under the ScoPac Line of Credit was \$53.5 million, and outstanding borrowings were \$47.8 million.

ScoPac Timber Notes

On the Timber Notes payment date in January 2006, ScoPac used its existing cash resources, all of the remaining funds available under the ScoPac Line of Credit, and the additional funds made available from a \$2.3 million timber/log purchase by MGI, to pay all of the \$27.7 million of interest due (\$25.8 million net of interest due in respect of Timber Notes held in the SAR Account). ScoPac also repaid \$19.3 million of principal on the Timber Notes (\$11.9 million net of principal in respect of Timber Notes held in the SAR Account), an amount equal to Scheduled Amortization, using funds held in the SAR Account.

On the Timber Notes payment date in July 2006, ScoPac used its existing cash resources, all of the remaining funds available under the ScoPac Line of Credit, \$10.2 million of funds from the ScoPac Land Sale Program, a \$3.7 million timber/log purchase by MGI, and a \$2.1 million early log payment by Palco to pay all of the \$27.1 million of interest due (\$25.4 million net of interest due in respect of Timber Notes held in the SAR Account). ScoPac also repaid \$10.0 million of principal on the Timber Notes (\$6.2 million net of principal in respect of Timber Notes held in the SAR Account), an amount equal to Scheduled Amortization, using funds held in the SAR Account.

As discussed further in Note 1, ScoPac is experiencing financial difficulties due to regulatory restrictions on harvesting, and other factors. As a result, ScoPac expects to incur substantial interest payment shortfalls over at least the next several years. Such an event would constitute an event of default under the Timber Notes Indenture. In the event of a failure to pay interest or principal on the Timber Notes in full when due, the Trustee 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 or ScoPac to perform its respective covenants or agreements under the Master Purchase Agreement or by Palco to perform its covenants or agreements under the Services Agreement, which failure in the case of certain covenants or agreements 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 ScoPac Line of Credit may also accelerate the advances then outstanding. If such accelerations of Timber Notes and/or advances under the ScoPac 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 ScoPac Timber Property and ScoPac Timber Rights and other assets and using the proceeds thereof to pay accelerated amounts. In the event that ScoPac 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 ScoPac Line of Credit could be accelerated. The foregoing rights of the Trustee and holders of Timber Notes would be subject to the rights of ScoPac under the Bankruptcy Code if it sought protection by filing under the Bankruptcy Code.

U.S. Bank, the Trustee under the Timber Notes Indenture, resigned effective May 1, 2006. ScoPac appointed Deutsche Bank National Trust Company as successor Trustee under the Timber Notes Indenture, which appointment became effective May 1, 2006. Deutsche Bank National Trust Company resigned effective August 25, 2006 and ScoPac appointed Bank of New York as successor Trustee, which appointment became effective August 25, 2006.

SAR Account

Amounts on deposit in the SAR Account are used on each Timber Notes payment date to make principal payments on the Timber Notes in accordance with Scheduled Amortization. However, if the amount on deposit in the SAR Account on a Timber Notes payment date is less than what is needed to reduce outstanding principal in accordance with

Scheduled Amortization, only the amount on deposit in the SAR Account is required to be paid as a principal payment on the Timber Notes.

At September 30, 2006, the SAR Account balance was \$50.2 million (consisting of \$41.3 million of Timber Notes held in the SAR Account and \$8.9 million in marketable securities). On October 11, 2006, ScoPac completed a private placement of the \$41.5 million par value of Class A-2 Timber Notes held in the SAR Account at a sales price of \$750 per \$1,000 principal amount, plus accrued interest from July 20, 2006. The net proceeds of approximately \$30.2 million were deposited into the SAR Account. The Company expects that cash and marketable securities on deposit in the SAR Account will not be sufficient to cover all of the Scheduled Amortization on the January 20, 2008, Timber Notes payment date and beyond.

Letters of Credit

As a result of S&P credit rating actions related to Palco in 2005, Palco was required to post a \$9.9 million letter of credit with the State of California to secure its workers compensation liabilities. In connection with Palco's refinancing in July 2006, Palco cash collateralized these letters of credit using proceeds from the New Palco Term Loan. In October 2006, following the adoption of an amendment to the New Palco Revolving Credit Facility, Palco cancelled the cash collateralized letters of credit and reissued the letters of credit using availability under the New Palco Revolving Credit Facility. In addition to the reissued letters of credit, Palco used availability under the New Palco Revolving Credit Facility, to post letters of credit in the amount of \$3.5 million to satisfy certain liability insurance obligations.

At September 30, 2006, the Company's real estate segment had letters of credit outstanding in the amount of \$9.0 million to satisfy certain liability insurance policy requirements. In October 2006, these letters of credit were reduced by \$3.5 million.

6. Income Taxes

The Company generated income before income taxes and cumulative effect of accounting change of \$418.7 million and \$393.8 million for the third quarter and first nine months of 2006, respectively, primarily as a result of the reversal of the Company's investment in Kaiser, which is considered a capital loss for tax purposes, rather than taxable income. However, the Company has not recorded any tax provision or benefit related to current period income or loss as the Company anticipates an effective tax rate of zero for the year ended December 31, 2006. The Company evaluates appropriate factors in determining the realizability of the deferred tax assets attributable to losses and credits generated during each period as well as those being carried forward. 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, 2006. These valuation allowances were in addition to the valuation allowances provided in prior years.

As a result of the cancellation of the Company's Kaiser Shares in 2006, the Company expects it will take a worthless stock deduction on its 2006 consolidated federal income tax return. However, due to uncertainties regarding whether the Company will ultimately realize the resulting tax asset of approximately \$135.8 million, the Company has established a full valuation allowance related to this tax asset.

Texas House Bill 3, signed into law in May 2006, eliminates the taxable capital and earned surplus components of the existing Texas franchise tax and replaces these components with a margin-based franchise tax. There will be no impact on the Company's 2006 Texas state income taxes as the new law is effective for reports due on or after January 1, 2008 (based on business activity during 2007). The Company is required to include in income for the period that includes the date of enactment the impact of the tax law change on its deferred state income taxes. This tax law change resulted in a reduction in the Company's deferred state income taxes in the amount of \$4.1 million, net of federal benefit, and the net tax benefit was recognized in the second quarter of 2006.

7. Employee Benefit Plans

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

	<u>Pension Benefits</u>		<u>Medical/Life Benefits</u>		<u>Pension Benefits</u>		<u>Medical/Life Benefits</u>	
	<u>Three Months Ended September 30,</u>				<u>Nine Months Ended September 30,</u>			
	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
Components of net periodic benefit costs:								
Service cost	\$ —	\$ 0.4	\$ 0.1	\$ 0.1	\$ —	\$ 2.3	\$ 0.3	\$ 0.3
Interest cost	1.3	1.4	0.2	0.2	4.0	4.3	0.4	0.6
Expected return on assets	(1.5)	(1.3)	—	—	(4.3)	(3.9)	—	—
Amortization of prior service costs	—	—	(0.1)	(0.1)	—	—	(0.1)	(0.3)
Recognized net actuarial (gain) loss	—	0.2	—	(0.1)	0.2	0.6	—	(0.1)
Net periodic benefit costs	<u>\$ (0.2)</u>	<u>\$ 0.7</u>	<u>\$ 0.2</u>	<u>\$ 0.1</u>	<u>\$ (0.1)</u>	<u>\$ 3.3</u>	<u>\$ 0.6</u>	<u>\$ 0.5</u>

The MAXXAM Pension Plan and Palco Retirement Plan were frozen effective December 31, 2005; as a result, these plans will continue, but no additional benefits will accrue to participants subsequent to December 31, 2005.

8. Regulatory and Environmental Factors and Contingencies

Regulatory and Environmental Factors

Regulatory and environmental matters and litigation have had a significant adverse effect on the Company's forest products segment, 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, air and water quality and other matters. Compliance with such laws and regulations also plays a significant role in the Company's Forest Products business.

Environmental Plans

From March 1999 until October 2002, ScoPac prepared THPs in accordance with the SYP. The SYP was intended to comply with regulations of the CDF requiring timber companies to demonstrate sustained yield, i.e. that their projected average annual harvest for any decade within a 100-year planning period would not exceed the average annual growth level at the end of the 100-year planning period. These regulations 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 (see "Contingencies—Timber Harvest Litigation"), in October 2003, the California trial court hearing the *EPIC-SYP/Permits lawsuit* entered a judgment invalidating the SYP and the California Permits, although an appellate court reversed that decision in December 2005. The plaintiffs appealed the appellate court's decision to the California Supreme Court, which has indicated it will review the matter. As a result of an earlier stay order and the trial court's judgment, ScoPac from October 2002 until March 2005 obtained review and approval of its THPs under an alternative procedure in the California forest practice rules known as Option C. Option C is available to landowners who have submitted an "Option A" plan to the CDF for review (as was done by Palco). An approved Option A plan is an alternative to obtaining approval of a sustained yield plan. Palco's Option A plan was approved by the CDF in March 2005. ScoPac is currently relying upon the Option A Plan to obtain THP approvals, and will likely continue to do so in the future.

The Federal Permits allow incidental "take" of certain federally listed species located on the Palco 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 Environmental Plans, 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 the Palco Companies 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 Palco Timberlands and in some cases, clean-up or preventive measures; actions by the North Coast Water Board during the THP approval process imposing certain operational requirements on individual THPs; and the development of WWDRs by the North Coast Water Board and its staff 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 Palco Timberlands. On the Palco Timberlands, the relevant contaminant is simple sediment – dust, dirt and gravel – that is abundant in watercourses largely as a function of the area’s normally heavy rainfall and soil that erodes easily. The Company expects the process of establishing TMDLs to continue until at least 2010. The EPA has issued reports dealing with TMDLs on three of the nine watercourses. The agency has indicated that the requirements under the HCP would significantly address the sediment issues that resulted in TMDL requirements for these watercourses. Presently, the North Coast Water Board is in the process of establishing the TMDL requirements applicable to two other watercourses, Freshwater and Elk River, on the Palco Timberlands, with a targeted completion of 2007 for these two watercourses. ScoPac’s scientists are actively working with North Coast Water Board staff to ensure that these TMDLs recognize and incorporate the environmental protection measures of the HCP. The final TMDL requirements applicable to the Palco 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. Those requirements could further restrict harvesting on the Palco Timberlands.

For each of the winter periods since 2002, Palco and ScoPac have been required to submit reports on sediment discharges and erosion control practices to the North Coast Water Board in order to conduct winter harvesting operations in the Freshwater and Elk River watersheds. After consideration of these reports, the North Coast Water Board imposed requirements on the Palco Companies to implement additional mitigation and erosion control practices in these watersheds for each of these winter operating periods. The North Coast Water Board has also extended the requirements for certain mitigation and erosion control practices to three additional watersheds (Bear, Jordan and Stitz Creek). The Palco Companies and the North Coast Water Board are currently in discussions to determine what these measures will be. The requirements imposed to date have significantly increased operating costs; future additional requirements could further increase costs and cause additional delays in THP approvals.

The North Coast Water Board has also issued the Elk River Orders, which are aimed at addressing existing sediment production sites through cleanup actions. The North Coast Water Board has also initiated the process that 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 Orders have resulted in increased costs that could extend over a number of years. Additional orders for other watersheds (should they be issued) may also result in further cost increases.

On May 8, 2006, the North Coast Water Board adopted the Freshwater and Elk River WWDRs. The decision allows harvesting in these two watersheds, up to approximately 50% of the applicable CDF Harvest Limit, once the staff of the North Coast Water Board reviews and enrolls THPs submitted by ScoPac. The North Coast Water Board’s decision also allowed the enrollment of additional THPs, bringing the total to approximately 75% of the CDF Harvest Limit for these two watersheds, upon approval of a monitoring and reporting program by the Executive Officer of the North Coast Water Board staff. The monitoring and reporting program was approved on September 29, 2006, allowing enrollment by the staff of the North Coast Water Board of the additional THPs for these two watersheds planned for harvest in 2006. This monitoring and reporting program will also govern future THPs in these two watersheds. However, there can be no assurance that additional THPs in these two watersheds will ultimately be enrolled or harvested as planned in 2006 or future years. The North Coast Water Board’s adoption of these WWDRs has been appealed to the State Water Board, but the appeals are being held in abeyance in order to see how the implementation of the WWDRs proceeds. As harvesting activities on the Palco 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 various other matters described herein are expected to result in reduced harvest levels in 2006 and beyond.

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 that will ultimately result from Senate Bill 810; however, because substantially all rivers and waterbodies on the Palco Timberlands are classified as sediment-impaired, implementation of this law could result in additional delays in obtaining approvals of THPs, lower harvest levels, increased costs, and additional protection measures beyond those contained in the HCP.

Contingencies

Certain present and former directors and officers of the Company are defendants in certain of the actions described below. 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.

Timber Harvest Litigation

In March 1999, the *EPIC-SYP/Permits lawsuit* was filed. This action alleged, among other things, various violations of the California Endangered Species Act and the California Environmental Quality Act, and challenged, among other things, the validity and legality of the SYP and the California Permits and sought, among other things, to prevent implementation of THPs approved in reliance upon these documents. A similar action, the *USWA lawsuit*, was filed on the same day, and the two actions were consolidated for trial.

Following the trial, the Court in October 2003 entered a judgment invalidating the SYP and the California Permits, and in September 2004 granted the plaintiffs' request for reimbursement of an aggregate of \$5.8 million in attorneys' fees and other expenses. The Palco Companies and the State of California appealed both decisions. On December 12, 2005, an appellate court reversed the trial court's decision invalidating the SYP and the California Permits. The plaintiffs have appealed the appellate court's decision to the California Supreme Court, which has indicated it will review the matter. The defendants' appeal of the trial court's award of attorneys' fees and expenses is still pending at the appellate court. There can be no assurance that this appeal will be successful.

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 ScoPac's 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. In October 2003, the Court upheld the validity of an EPA regulation that 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 that 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. On April 28, 2006, the Court denied separate motions for summary judgment that had been filed by the Palco Companies and the plaintiff. On June 30, 2006, the plaintiff filed a motion for partial summary judgment seeking to establish the Palco Companies' liability and the Palco Companies filed a new motion for summary judgment asserting that the plaintiff lacks standing to maintain the lawsuit. A hearing on these motions was held on October 3, 2006, and the Court took the matter under submission.

Should the Court's October 2003 decision ultimately become final and be held to apply to all of the timber operations of Palco and ScoPac, 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. The Company believes that civil penalties should not be awarded for operations that occurred prior to the Court's decision due to timber companies' historical reliance upon 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 Palco Timberlands will not reach levels harmful to the environment. While the impact of a conclusion to this case that upholds the October 2003 ruling may be adverse, the Company does not believe that such an outcome should 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 and Cave actions* were filed, which name Palco and certain affiliates as defendants. 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 Palco 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 Palco Timberlands). On October 13, 2005, the *Johnson action* was filed and contains allegations similar to the *Cave* and *Cook actions*. 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 the harvest of significantly more trees 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 and prior rulings of the Court substantially diminished the exposure of the Palco Companies with respect to this matter.

In December 2005, Palco and ScoPac filed the *California Headwaters action* with the Claims Board. The *California Headwaters action* alleges that the defendants have substantially impaired the contractual and legal rights of Palco and ScoPac under the Headwaters Agreement and the related permits, authorizations and approvals. The *California Headwaters action* also alleges that the actions of the defendants have caused the companies substantial damages, but does not specify an amount. While the Claims Board has indicated that it is investigating the matter, it failed to approve or deny the claim by the statutory deadline. As a result, the *California Headwaters action* is by operation of law treated as having been denied, and Palco and ScoPac may now file a claim for damages in California state court. Palco and ScoPac are considering how best to proceed with respect to this matter.

OTS Contingency and Related Matters

In December 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 110 days of proceedings before an administrative law judge during 1997-1999, and over two years of post-trial briefing, in September 2001, the administrative law judge 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 the *OTS action*, a related civil action, the *FDIC action*, alleging damages in excess of \$250 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).

In May 2000, the Respondents filed a counterclaim to the *FDIC action*. In November 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, as a sanction, to be made whole for the attorneys' fees they have paid (plus interest) in connection with the *OTS* and *FDIC actions*. As of December 31, 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 Respondents \$72.3 million. The FDIC has appealed the District Court decision to the Fifth Circuit Court of Appeals. The U.S. District Court award has not been accrued as of December 31, 2005 or September 30, 2006. There can be no assurance that the Company will ultimately collect this award.

In January 2001, the *Kahn lawsuit* was filed seeking, among other things, that Federated and certain of the Company's directors be required to reimburse the Company for all costs and expenses incurred by the Company in connection with the *OTS* and *FDIC actions*. On January 31, 2005, the *Kahn lawsuit* was administratively dismissed by the court.

Other Matters

On September 2, 2004, MGI was advised the NJDEP alleged that one of MGI's former subsidiaries is a successor to a company that manufactured munitions for the U.S. Navy during World War II. The owner of the underlying property, which is located in Cranbury, New Jersey, was seeking MGI's participation in efforts to address contamination of the site that resulted from such operations. In January 2005, MGI and the owner of the property entered into an Administrative Consent Order with the NJDEP providing for, among other things, cleanup of the facility. In April 2005, MGI filed a Complaint against the United States of America, the U.S. Navy, and the U.S. Army for cost recovery and contribution; the defendants subsequently denied all of the claims. In early 2006, the property was sold to a new owner and MGI entered into an amendment to the Administrative Consent Order substituting the new owner for the original property owner. MGI also reached an agreement with several potentially responsible parties regarding cleanup at the site, the terms of which the Company believes will not result in a material adverse effect on the Company's consolidated

financial position, results of operations or liquidity and under which MGI retained its cause of action against the government parties noted above.

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

Under the Company's stock-based compensation plans, stock options and similar instruments may be granted to employees and outside directors at no less than the fair market value of the Company's Common Stock on the date of grant. Grants generally vest ratably over a five-year period for grants to employees and over a four-year period for grants to outside directors and expire ten years after the grant date. Grants have generally been settled in cash upon exercise.

Grants issued to employees and outside directors were previously accounted for under the intrinsic value method of accounting as defined by APB Opinion No. 25 and related interpretations. Effective January 1, 2006, the Company prospectively adopted the fair value-based method of accounting for stock-based employee compensation as prescribed by SFAS No. 123 (R) and recognized a \$0.7 million charge in January 2006, representing the cumulative effect of the accounting change.

The fair value of grants is determined using a Black-Scholes option-pricing model. The following assumptions apply to the options granted through the periods presented.

	Nine Months Ended September 30,	
	2006	2005
Expected volatility	33%	40%
Expected dividends	—	—
Expected term (in years)	6.22	6.63
Risk-free rate	4.59%	4.18%

Expected volatilities are based on historical volatility of the Company's Common Stock. The dividend yield on the Company's Common Stock is assumed to be zero since the Company has not paid dividends in the past five years and has no current plans to do so. The expected term represents the period of time that the options granted are expected to remain outstanding. The Company uses historical experience regarding exercises of grants to determine the grants' expected term. The risk-free interest rate is based on the U.S. Treasury yield curve in effect for the expected term of the option at the reporting date.

A summary of activity under the Company's plans as of September 30, 2006 is presented below:

	Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (in millions)
Balance at January 1, 2006	1,114,306	\$ 25.06		
Granted	22,400	32.50		
Exercised	(38,000)	16.91		
Forfeited or expired	(76,429)	26.20		
Balance at September 30, 2006	1,022,277	\$ 25.44	5.46	\$ 7.4
Exercisable at September 30, 2006	677,854	\$ 26.38	4.42	\$ 5.2

Total compensation cost for share-based payment arrangements for the nine months ended September 30, 2006, was a benefit of \$3.7 million due primarily to a reduction in the per share market price of the Company's Common Stock. As of September 30, 2006, total estimated compensation related to non-vested grants not yet recognized is \$4.0 million and the weighted average period over which it is expected to be recognized is 1.8 years, although the Company may ultimately not have to pay all of such amount.

The following table illustrates the pro forma effect on net loss and loss per share for the three months and nine months ended September 30, 2005, respectively, had the Company accounted for its grants under the fair value method

of accounting (in millions, except per share information).

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005		2005	
Net income (loss), as reported	\$	4.3	\$	(19.5)
Add: Non-cash stock-based employee compensation expenses included in reported net income (loss), net of related tax effects		4.1		0.3
Deduct: Total stock-based employee compensation expense determined under the fair value method for all awards, net of related tax effects		(3.9)		0.2
Pro forma net income (loss)	\$	<u>4.5</u>	\$	<u>(19.0)</u>
Basic income (loss) per share:				
As reported	\$	0.72	\$	(3.26)
Pro forma		0.76		(3.19)
Diluted income (loss) per share:				
As reported	\$	0.62	\$	(3.26)
Pro forma		0.65		(3.19)

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,	
	2006	2005	2006	2005
Weighted average number of common shares outstanding-basic . . .	5,259,315	5,967,942	5,628,438	5,973,608
Effect of dilution ⁽¹⁾ :				
Conversion of Class A Convertible Preferred Stock	668,119	668,119	668,119	—
Exercise of stock options	<u>112,803</u>	<u>311,886</u>	<u>101,702</u>	<u>—</u>
Weighted average number of common shares outstanding - diluted	<u>6,040,237</u>	<u>6,947,947</u>	<u>6,398,259</u>	<u>5,973,608</u>

⁽¹⁾ The Class A Convertible Preferred Stock and options were not included in the computation of basic or diluted earnings per share for the nine months ended September 30, 2005 because the Company had a loss for that period.

11. Comprehensive Income (Loss)

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Net income (loss):	\$ 418.7	\$ 4.3	\$ 397.3	\$ (19.5)
Other comprehensive income (loss):				
Reversal of other comprehensive income related to Kaiser	85.3	—	85.3	—
Unrealized income (loss) on available-for-sale investments	<u>0.3</u>	<u>—</u>	<u>0.5</u>	<u>(0.1)</u>
Total comprehensive income (loss)	<u>\$ 504.3</u>	<u>\$ 4.3</u>	<u>\$ 483.1</u>	<u>\$ (19.6)</u>

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 Report. 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 second paragraph of Item 2. for cautionary information with respect to such forward-looking statements.

The Company operates in three industries: forest products, through MGI and its wholly owned subsidiaries, principally Palco, ScoPac and Britt; real estate investment and development, through various subsidiaries and 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 previously owned 63% of the common stock of Kaiser, a producer of fabricated aluminum products that recently emerged from bankruptcy. See Note 1 for information regarding the Company's investment in Kaiser. Any reference herein to a company includes the subsidiaries of that company unless otherwise noted or the context indicates otherwise.

Consolidated Operations

Selected Operational Data

The following table presents selected financial information for the periods indicated for the Company's consolidated operations (in millions).

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Net sales	\$ 77.8	\$ 105.8	\$ 221.5	\$ 276.0
Costs and expenses	(70.5)	(86.1)	(211.8)	(247.1)
Gains on sales of timberlands and other assets	5.3	—	11.2	0.1
Reversal of net investment in Kaiser	430.9	—	430.9	—
Operating income	443.5	19.7	451.8	29.0
Other income, net	(0.1)	4.1	6.6	9.6
Interest expense, including amortization of deferred loan costs	(24.7)	(19.5)	(64.6)	(58.1)
Income (loss) before income taxes and cumulative effect of accounting change	418.7	4.3	393.8	(19.5)
Benefit (provision) for income taxes	—	—	4.2	—
Income (loss) before cumulative effect of accounting change	418.7	4.3	398.0	(19.5)
Cumulative effect of accounting change, net of tax	—	—	(0.7)	—
Net Income (loss)	<u>\$ 418.7</u>	<u>\$ 4.3</u>	<u>\$ 397.3</u>	<u>\$ (19.5)</u>

Overview of Consolidated Results of Operations

Net Sales

Consolidated net sales for the three months ended September 30, 2006, declined \$28.0 million, as compared to the prior year period. Real estate sales declined \$23.4 million during the quarter due to reduced acreage sales at Palmas and a reduction in the number of lots sold at Fountain Hills, partially offset by increased lot sales at Mirada. Sales at the Company's forest products segment declined \$4.7 million due to a 16.3% decline in lumber shipments and a decline in Douglas-fir lumber prices.

Consolidated net sales for the nine months ended September 30, 2006, declined \$54.5 million, as compared to the prior year period. Real estate sales declined \$28.1 million due to reduced acreage sales at Palmas and a reduction in the number of lots sold at Fountain Hills, partially offset by increased lot sales at Mirada and deferred profit recognized at Palmas. Sales for the Company's forest products segment declined \$27.3 million as a result of a lower log supply from ScoPac, an increase in the volume of lumber placed into Palco's redwood lumber drying program and a decline in Douglas-fir lumber prices.

Operating Income

Consolidated operating income was \$443.5 million for the third quarter of 2006, as compared to \$19.7 million the prior year period. In February 2002, Kaiser and certain of its subsidiaries filed for reorganization under Chapter 11 of the Bankruptcy Code. Kaiser's plan of reorganization provided for the cancellation of Kaiser's equity, including the Company's Kaiser Shares, without consideration or obligation. Kaiser's plan of reorganization became effective on July 6, 2006, and Kaiser emerged from bankruptcy. Since the Company's Kaiser Shares were cancelled without obligation, the Company reversed the \$516.2 million of losses in excess of its investment in Kaiser along with the accumulated other comprehensive losses of \$85.3 million related to Kaiser, resulting in a net gain of \$430.9 million, recognized in the third quarter of 2006. Operating income for the real estate segment declined \$20.3 million, primarily as a result of a decline in real estate sales, as discussed above. Operating income for the forest products segment increased \$7.1 million due to a \$5.3 million gain from the sale of certain properties and a significant reduction in legal and other professional fees as compared to the same period a year ago. In 2005, the Company incurred substantial legal and other professional fees relating to ScoPac's efforts to pursue a negotiated restructuring of the Timber Notes. Absent the gain from asset sales in 2006 and the effect of the impact of the legal and other professional fees incurred in 2005, operating results for the forest products segment declined significantly, as compared to the prior year, due to a decline in lumber shipments as a result of lower log supply from ScoPac, an increase in the volume of lumber placed into Palco's redwood drying program and operational inefficiencies at the Scotia sawmill. Operating losses at the Corporate segment decreased as a result of lower stock-based compensation due to a decline in the fair market value of the Company's Common Stock.

Consolidated operating income for the nine months ended September 30, 2006, was \$451.8 million as compared to \$29.0 million in the prior year period. The substantial increase is the result of the reversal of the Company's investment in Kaiser (discussed above). A \$21.6 million decrease in operating income, due to reduced acreage sales by the Company's real estate segment, was partially offset by an \$11.2 million gain from the sale of certain properties by the forest products segment. The nine months ended September 30, 2005 included substantial legal and other professional fees relating to ScoPac's efforts to pursue a negotiated restructuring of the Timber Notes and a onetime benefit of \$3.1 million due to an insurance settlement. Absent the gain from asset sales in 2006 and the effect of the impact of the legal and other professional fees incurred in 2005, operating results for the forest products segment declined significantly as compared to the prior year due to the factors discussed above. Operating losses at the Corporate segment decreased as a result of lower stock-based compensation due a decline in the fair market value of the Company's Common Stock.

Other Income, net

Consolidated other income (loss) for the three and nine month periods ended September 30, 2006, declined primarily due to lower investment levels.

Interest Expense

Consolidated interest expense for the three and nine months ended September 30, 2006, increased to \$24.7 million and \$64.6 million, respectively, from \$19.5 million and \$58.1 million, respectively, a year ago. The increase is the result of higher debt levels and interest rates under Palco's new debt facilities and the write off of deferred loan costs related to Palco's old debt facilities.

Net Income

Net income for the three and nine months ended September 30, 2006 was \$418.7 million and \$397.3 million, respectively. The substantial increase over the comparable prior year periods is the result of the reversal of the Company's investment in Kaiser (discussed above).

A tax benefit of \$4.2 million was recognized during the nine months ended September 30, 2006, due to the reversal of deferred tax liabilities established based on the current Texas franchise tax. During the second quarter of 2006, the Texas Legislature passed House Bill 3 that, among other things, changed the Texas franchise tax from a tax on the greater of capital or net income to a tax on gross margin. As a result of this change, the deferred state tax liabilities referred to above are no longer required.

Forest Products Operations

Industry Overview and Selected Financial and Operating Data

The Company's forest products operations are conducted through MGI and its wholly owned subsidiaries, principally Palco, ScoPac and Britt. The segment's operations have become increasingly unpredictable due to continued regulatory constraints, ongoing litigation challenges and other factors. Additionally, the segment's operations are somewhat seasonal, with its net sales having historically been higher in the months of April through November than in the months of December through March. Management expects that the segment's revenues and cash flows will continue to be unpredictable. Accordingly, the segment'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 had and are expected to continue to adversely affect the Company's forest products operations. See Item 1. "Business—Forest Products Operations—Regulatory and Environmental Factors" and Item 1A. "Risk Factors" of the Form 10-K and in this Form 10-Q and Note 8 for information regarding these matters. Regulatory compliance and related litigation have caused and are expected to continue to cause delays in approval of THPs and delays in harvesting on THPs once they are approved. This has resulted and is expected to continue to result in a significant decline in harvest and increased costs.

ScoPac's management has concluded that, in the absence of significant regulatory relief and accommodations, ScoPac's annual timber harvest levels and cash flows from operations will for at least several years be substantially below both historical levels and the minimum levels necessary to allow ScoPac to satisfy its debt service obligations in respect of the Timber Notes. To the extent that ScoPac is unable to generate sufficient liquidity from the ScoPac Land Sale Program (see "—Financial Condition and Investing and Financing Activities—Forest Products Operations") or other sources, the Company expects that ScoPac will be forced to take extraordinary actions, which may include: laying off employees, shutting down various operations, and seeking protection by filing under the Bankruptcy Code.

Palco experienced substantial liquidity shortfalls in the first six months of 2006 as a result of a lower log supply from ScoPac, and operational inefficiencies related to the Scotia sawmill. On July 18, 2006, Palco and Britt closed on the New Palco Term Loan and New Palco Revolving Credit Facility and terminated the Old Palco Term Loan and Old Palco Revolving Credit Facility. Palco's new debt facilities contain financial covenants that are subject to a number of assumptions about future operating cash flows, and actual results could materially differ from these estimates. The Borrowers did not meet the required minimum EBITDA maintenance covenant for the three month period ended September 30, 2006, due to an unplanned severance charge and a legal settlement. The Borrowers expect the lenders to issue a limited waiver of the default through December 14, 2006. There can be no assurance that Palco will be able to meet these financial covenants in future periods. For further information regarding these new debt facilities, see "—Financial Condition and Investing and Financing Activities—Forest Products Operations."

Since 2001, comprehensive external and internal reviews have been conducted of Palco's business operations. Those reviews were conducted in an effort to identify ways in which Palco could operate on a more efficient and cost-effective basis. Palco has implemented a number of changes, including: consolidating its sawmill operations; eliminating certain of its operating activities such as its company-staffed logging operations (now relying exclusively on contract loggers), its Scotia finishing and remanufacturing plant, and its soil amendment and concrete block activities; and adopting various cost saving measures. Palco continues to examine ways to achieve cost savings. In April 2004, Palco commenced a mill improvement project, including a new sawmill located in Scotia, California. The new sawmill was constructed in two phases. The first phase of the project, the processing of smaller diameter second growth logs (up to 24" in diameter) is a high-speed processing line that includes advanced scanning and optimization technology intended to maximize lumber recovery. The second phase, the relocation of the large log equipment from Palco's former Carlotta mill, came on line in October 2005. This phase allows for processing of larger logs up to 60" in diameter. Although there were more difficulties than Palco expected, since commencing production, Palco has made substantial progress in refining the production process in the new mill, particularly the high-speed small log processing line. While there

were delays in fully completing the large log processing line, causing it to operate at lower-than-planned production rates, the line was substantially completed in November 2006. Palco also completed a new planer project in Scotia in January 2004. This high-speed system processes rough-sawn boards into finished lumber at rates up to four times faster than the planers at Palco's former Carlotta and Fortuna mills. Palco has spent \$29.9 million through September 30, 2006, on the sawmill and planer project and estimates that it will expend an additional \$2.3 million on the project in the fourth quarter.

In addition to the matters described above, there can be no assurance that certain other pending legal, regulatory and environmental matters or future governmental regulations, additional litigation, legislation, judicial or administrative decisions, adverse weather conditions, or low lumber or log prices, will not also have material adverse effects 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 Factors," Item 1A. "Risk Factors," and Item 3. "Legal Proceedings—Forest Products Operations" of the Form 10-K Part II, Item 1A. "Risk Factors" in this Form 10-Q and Note 8 (under "Regulatory and Environmental Factors" and "Contingencies—Timber Harvest Litigation") for further information regarding regulatory and legislative matters and legal proceedings relating to the Company's forest products operations.

The following table presents selected operational and financial information for the periods indicated, for the Company's forest products operations.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
(In millions of dollars, except shipments and prices)				
Timber harvest ⁽¹⁾	38.9	44.4	74.2	109.9
Shipments:				
Lumber: ⁽²⁾				
Redwood upper grades	0.6	1.3	2.7	5.9
Redwood common grades	39.3	40.8	103.3	126.9
Douglas-fir upper grades	—	0.1	—	0.5
Douglas-fir common grades	15.0	23.5	60.4	81.2
Other	—	(0.1)	1.6	1.5
Total lumber	54.9	65.6	168.0	216.0
Cogeneration power ⁽³⁾	35.6	41.3	89.1	125.3
Average sales price:				
Lumber: ⁽⁴⁾				
Redwood upper grades	\$ 1,569	\$ 1,199	\$ 1,701	\$ 1,253
Redwood common grades	708	606	682	619
Douglas-fir upper grades	—	739	—	1,037
Douglas-fir common grades	340	379	359	374
Cogeneration power ⁽⁵⁾	81	66	75	65
Net sales:				
Lumber, net of discount	\$ 33.1	\$ 36.0	\$ 96.2	\$ 117.2
Logs	0.1	2.4	1.7	6.3
Cogeneration power	3.0	2.8	6.9	8.3
Wood chips	0.7	0.6	2.2	2.7
Other	1.0	0.8	2.5	2.3
Total net sales	\$ 37.9	\$ 42.6	\$ 109.5	\$ 136.8
Operating income (loss) ⁽⁶⁾	\$ 5.0	\$ (2.1)	\$ (0.4)	\$ (8.0)
Loss before income taxes and cumulative effect of accounting change	\$ (15.4)	\$ (15.9)	\$ (51.3)	\$ (50.3)

⁽¹⁾ Timber harvest is expressed in millions of board feet, net Scribner scale.

⁽²⁾ Lumber shipments are expressed in millions of board feet.

⁽³⁾ Power deliveries are expressed in thousands of megawatt hours.

⁽⁴⁾ Dollars per thousand board feet.

⁽⁵⁾ Dollars per megawatt hour.

⁽⁶⁾ Includes a gain of \$5.3 million and \$11.2 million on the sale of certain properties in the third quarter and nine months of 2006, respectively.

Net Sales

Total net sales for forest products operations declined \$4.7 million for the third quarter of 2006 and \$27.3 million for the nine months ended September 30, 2006, as compared to the prior year periods. The decrease in net sales was due

to a decline in lumber shipments resulting from a lower log supply from ScoPac and an increase in the volume of lumber placed into Palco's redwood lumber drying program during 2006. The lower log supply from ScoPac was due to adverse weather conditions in early 2006 and harvest restrictions.

Operating income (loss)

The forest products segment generated operating income of \$5.0 million for the third quarter of 2006 and an operating loss of \$0.4 million for the nine months ended September 30, 2006. These results include gains from the sale of properties under the ScoPac Land Sale Program of \$5.3 million and \$11.2 million for the three and nine-month period ended September 30, 2006, respectively. The forest products segment has incurred substantial operating losses in 2006 due to harvest restrictions at ScoPac, adverse weather conditions, and operational inefficiencies at the sawmill in Scotia. Additionally, the forest products segment's operating results for the third quarter of 2006 were negatively impacted by a severance charge and a legal settlement. The forest products segment's operating results for the nine months ended September 30, 2005 include substantial legal and other professional fees relating to ScoPac's efforts to pursue a negotiated restructuring of the Timber Notes and the first quarter of 2005 includes a one time benefit of \$3.1 million relating to an insurance settlement.

Loss Before Income Taxes and Cumulative Effect of Accounting Change

Forest products operations' loss before income taxes and cumulative effect of accounting change for the three and nine months ended September 30, 2006 of \$15.4 million and \$51.3 million, respectively, was relatively flat as compared to the respective prior year periods. These losses are the result of interest expense in excess of operating income in respect of the Timber Notes and Palco's new debt facilities. See "—Financial Condition and Investing and Financing Activities—Forest Products Operations—ScoPac Liquidity Update and Palco Liquidity Update" for further information regarding ScoPac's and Palco's liquidity.

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, 2006 and 2005, for the Company's real estate operations.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
	(In millions of dollars)			
Net sales:				
Real estate:				
Fountain Hills	\$ 4.6	\$ 10.4	\$ 7.8	\$ 33.3
Mirada	10.2	4.3	26.1	8.6
Palmas	5.7	28.4	16.2	35.5
Other	—	—	—	0.1
Total	<u>20.5</u>	<u>43.1</u>	<u>50.1</u>	<u>77.5</u>
Resort, commercial and other:				
Fountain Hills	0.7	1.4	2.8	4.4
Palmas	2.7	3.0	9.8	9.4
Commercial lease properties	4.6	4.6	13.8	13.7
Other	0.4	0.2	0.6	0.2
Total	<u>8.4</u>	<u>9.2</u>	<u>27.0</u>	<u>27.7</u>
Total net sales	<u>\$ 28.9</u>	<u>\$ 52.3</u>	<u>\$ 77.1</u>	<u>\$ 105.2</u>
Operating income (loss):				
Fountain Hills	\$ 2.3	\$ 5.9	\$ 2.4	\$ 17.9
Mirada	6.5	2.0	14.6	3.4
Palmas	(0.7)	20.9	4.0	21.8
Commercial lease properties	2.6	2.8	6.8	6.2
Other	(0.3)	(0.9)	(1.0)	(0.9)
Total operating income	<u>\$ 10.4</u>	<u>\$ 30.7</u>	<u>\$ 26.8</u>	<u>\$ 48.4</u>
Investment, interest and other income (expense), net:				
Equity in losses from real estate joint ventures	\$ (0.4)	\$ (0.3)	\$ (0.7)	\$ (0.7)
Other	1.4	0.7	4.2	2.2
	<u>\$ 1.0</u>	<u>\$ 0.4</u>	<u>\$ 3.5</u>	<u>\$ 1.5</u>
Income (loss) before income taxes, and cumulative effect of accounting change	<u>\$ 7.2</u>	<u>\$ 26.8</u>	<u>\$ 17.4</u>	<u>\$ 36.9</u>

Net Sales

Total net sales for the real estate operations for the third quarter of 2006 were \$28.9 million, as compared to \$52.3 million in the prior year period. This significant decline was primarily due to reduced acreage sales at Palmas and a reduction in the number of lots sold at Fountain Hills, partially offset by increased lot sales at Mirada. The decrease in total net sales for real estate operations for the nine months of 2006 to \$77.1 million, as compared to \$105.2 million in the prior year period was primarily due to reduced acreage sales at Palmas and a substantial reduction in the number of lots sold at Fountain Hills, partially offset by increased lot sales at Mirada and deferred profits recognized at Palmas.

Operating Income and Income Before Income Taxes and Cumulative Effect of Accounting Change

Operating income decreased by \$20.3 million and \$21.6 million for the third quarter and nine months of 2006, respectively, as compared to the prior year periods, primarily as a result of the decreased sales noted. The third quarter of 2006 was also impacted by the write-off of capitalized costs related to certain real estate projects. The segment's income before income taxes and cumulative effect of accounting change decreased by \$19.6 million and \$19.5 million for the third quarter and nine months of 2006, respectively, as compared to the prior year periods, primarily due to the decline in operating results noted above.

Racing Operations

Industry Overview and Selected Operational Data

SHRP, Ltd. 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 for these facilities are generally not comparable 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 three and nine months ended September 30, 2006 and 2005, for the Company's racing operations.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
	(In millions of dollars)			
Number of live race days:				
Sam Houston Race Park	35	35	88	88
Valley Race Park	—	—	72	68
Handle:				
Sam Houston Race Park:				
On-track handle	\$ 32.1	\$ 30.2	\$ 99.2	\$ 94.1
Off-track handle	9.5	9.7	98.8	96.0
Total	<u>\$ 41.6</u>	<u>\$ 39.9</u>	<u>\$ 198.0</u>	<u>\$ 190.1</u>
Valley Race Park:				
On-track handle	\$ 3.4	\$ 3.9	\$ 13.7	\$ 14.3
Off-track handle	—	—	2.8	1.7
Total	<u>\$ 3.4</u>	<u>\$ 3.9</u>	<u>\$ 16.5</u>	<u>\$ 16.0</u>
Net sales:				
Sam Houston Race Park:				
Gross pari-mutuel commissions	\$ 7.3	\$ 7.0	\$ 24.6	\$ 23.6
Other revenues	2.8	2.9	6.4	6.4
Total	<u>10.1</u>	<u>9.9</u>	<u>31.0</u>	<u>30.0</u>
Valley Race Park:				
Gross pari-mutuel commissions	0.7	0.9	3.2	3.3
Other revenues	0.2	0.1	0.7	0.7
Total	<u>0.9</u>	<u>1.0</u>	<u>3.9</u>	<u>4.0</u>
Total net sales	<u>\$ 11.0</u>	<u>\$ 10.9</u>	<u>\$ 34.9</u>	<u>\$ 34.0</u>
Operating loss:				
Sam Houston Race Park	\$ (0.9)	\$ (1.6)	\$ (1.4)	\$ (2.2)
Valley Race Park	(0.2)	(0.1)	(0.5)	(0.3)
Other	(0.3)	(0.1)	(1.2)	(0.4)
Total operating loss	<u>\$ (1.4)</u>	<u>\$ (1.8)</u>	<u>\$ (3.1)</u>	<u>\$ (2.9)</u>
Loss before income taxes and cumulative effect of accounting change ..	<u>\$ (1.4)</u>	<u>\$ (1.9)</u>	<u>\$ (3.0)</u>	<u>\$ (3.0)</u>

Net Sales

Total net sales for racing operations were relatively flat in the third quarter of 2006 compared to the prior year period. Total net sales for racing increased slightly in the first nine months of 2006 compared to the prior year period, primarily due to higher simulcast wagering and increased average daily attendance at Sam Houston Race Park.

Operating Loss and Loss Before Income Taxes and Cumulative Effect of Accounting Change

Racing operations' operating loss and loss before income taxes decreased slightly in the third quarter of 2006 compared to the prior year period, primarily due to increased simulcast wagering at Sam Houston Race Park. The

operating loss for the first nine months of 2006 increased slightly compared to the comparable period of 2005 principally due to expenditures related to the Company's efforts to obtain an additional racing license in Laredo, Texas. The loss before income taxes and cumulative effect in accounting change for the first nine months of 2006 was equal to the comparable period in 2005, as increased racing revenues were offset by the higher expenses associated with the application for an additional racing license in Laredo, Texas.

Other Items Not Directly Related to Industry Segments

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
	(In millions of dollars)			
Operating income (loss), including reversal of investment in Kaiser	\$ 429.5	\$ (7.1)	\$ 428.5	\$ (8.5)
Income (loss) before income taxes	428.3	(4.7)	430.7	(3.1)

Operating Income (Loss), Including Reversal of Investment in Kaiser

Corporate operating income (loss) represents general and administrative expenses that are not attributable to the Company's industry segments, including stock-based compensation expense and the Company's investment in Kaiser. Kaiser's plan of reorganization under Chapter 11 of the Bankruptcy Code, which provided for the cancellation of the Company's Kaiser Shares without consideration or obligation, became effective on July 6, 2006. Since the Company's Kaiser Shares were cancelled without obligation in the third quarter of 2006, the Company reversed its net investment in Kaiser, resulting in a net gain of \$430.9 million in that reporting period. The Corporate segment's operating losses improved \$5.7 million for the third quarter of 2006, excluding the gain from the reversal at the Company's investment in Kaiser, as compared to the prior year period, primarily due to a \$4.3 million decline in stock-based compensation expense and continued cost cutting initiatives.

The Corporate segment's operating losses improved \$6.1 million for the nine months ended September 30, 2006 as compared to the prior year period, primarily due to a \$3.9 million decline in stock-based compensation expense.

Financial Condition and Investing and Financing Activities

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

Overview

The Company conducts its operations primarily through its subsidiaries. Accordingly, 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 ScoPac, 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. ScoPac is highly leveraged and has significant debt service requirements. Palco is also highly leveraged and has significant debt service requirements as well as financial covenants that it must satisfy, and covenants that restrict its activities.

Cash Flow

The following table summarizes certain data related to financial condition and to investing and financing activities of the Company and its subsidiaries (in millions):

	Forest Products			Real			MAXXAM	
	Scotia	Palco	MGI	Estate	Racing	MGHI	Parent	Total
	LLC	and Other						
<u>Indebtedness (excluding intercompany notes)</u>								
Short-term borrowings and current maturities of long-term debt:								
September 30, 2006	\$ 74.3 ⁽¹⁾	\$ 95.4 ⁽²⁾	\$ —	\$ 4.2	\$ 0.2	\$ —	\$ —	\$ 174.1
December 31, 2005	49.4	58.9 ⁽²⁾	—	4.1	0.1	—	—	112.5
Long-term debt, excluding current maturities:								
September 30, 2006	\$ 643.1	\$ —	\$ —	\$ 217.0	\$ 0.2	\$ —	\$ —	\$ 860.3
December 31, 2005	669.6	—	—	219.7	0.3	—	—	889.6
<u>Cash, cash equivalents, marketable securities and other investments and availability of lender credit at September 30, 2006:</u>								
Cash and cash equivalents	\$ 1.7	\$ 2.3	\$ 0.1	\$ 16.9	\$ 5.2	\$ —	\$ 4.3	\$ 30.5
Marketable securities and other investments	—	—	—	39.4	—	—	95.8	135.2
Current restricted cash and marketable securities	10.6	10.8	—	4.3	2.6	—	—	28.3
Long-term restricted amounts	2.5 ⁽³⁾	2.4	—	3.3	—	—	—	8.2
	<u>\$ 14.8</u>	<u>\$ 15.5</u>	<u>\$ 0.1</u>	<u>\$ 63.9</u>	<u>\$ 7.8</u>	<u>\$ —</u>	<u>\$ 100.1</u>	<u>\$ 202.2</u>
Unused and available credit	5.7	36.5	—	—	—	—	—	42.2
	<u>\$ 20.5 ⁽³⁾</u>	<u>\$ 52.0</u>	<u>\$ 0.1</u>	<u>\$ 63.9</u>	<u>\$ 7.8</u>	<u>\$ —</u>	<u>\$ 100.1</u>	<u>\$ 244.4</u>

Table and Notes continued on next page

	Forest Products				Real Estate	Racing	MGHI	MAXXAM Parent	Total
	Scotia LLC	Palco and Other	MGI		(In millions of dollars)				
Capital expenditures:									
September 30, 2006	\$ 4.4	\$ 2.4	\$ –	\$ 1.2	\$ 0.4	\$ –	\$ –	\$ –	8.4
September 30, 2005	4.8	6.9	–	1.0	3.1	–	0.4	–	16.2
Net proceeds from dispositions of property and investments:									
September 30, 2006	\$ 13.1	\$ 2.8	\$ –	\$ –	\$ –	\$ –	\$ –	\$ –	15.9
September 30, 2005	–	0.1	–	–	–	–	–	–	0.1
Borrowings (repayments) of debt and credit facilities, net of financing costs:									
September 30, 2006	\$ (1.7)	\$ 28.0	\$ –	\$ (2.9)	\$ –	\$ –	\$ –	\$ –	23.4
September 30, 2005	14.0	28.5	–	(3.5)	(0.1)	–	–	–	38.9
Dividends, advances and intercompany loans, including interest paid and tax sharing payments received (paid):									
September 30, 2006	\$ –	\$ 30.0 ⁽⁴⁾	\$ 9.3 ⁽⁵⁾	\$ (19.4)	\$ 1.1	\$ 0.1	\$ (21.1)	\$ –	–
September 30, 2005	–	–	2.7	(13.8)	5.8	0.1	5.2	–	–

(1) Includes borrowings outstanding under the ScoPac Line of Credit of \$47.8 million and the current portion of Scheduled Amortization on the Timber Notes of \$26.5 million.

(2) At December 31, 2005, and September 30, 2006, Palco's credit facilities were classified as short-term borrowings due to financial covenant breaches.

(3) Excludes the Timber Notes held in the SAR Account. In October 2006, ScoPac sold the Class A-2 Timber Notes in the SAR Account and the net proceeds of approximately \$30.2 million resulting from the sale were deposited in the SAR Account.

(4) Reflects \$20.0 million of intercompany loans from MAXXAM Parent to Palco that Palco used to fund its liquidity shortfalls during the first six months of 2006 and \$10.0 million of additional intercompany loans from MAXXAM Parent required in connection with the closing of Palco's new debt facilities.

(5) Advances of \$8.1 million were used by MGI to fund timber/log purchases from ScoPac during the nine months ended September 30, 2006.

Operating Activities

Net cash used for operating activities of \$52.7 million for the nine months ended September 30, 2006, resulted primarily from operating cash shortfalls at the Company's forest products segment. Net cash provided by operating activities of \$14.8 million for the nine months ended September 30, 2005 was primarily the result of higher cash collections related to real estate sales, partially offset by operating cash shortfalls at the Company's forest products segment.

Investing Activities

Net cash provided by investing activities of \$9.4 million for the nine months ended September 30, 2006, primarily reflects net proceeds from the ScoPac Land Sale Program, offset by capital expenditures at the Company's forest products segment. Net cash used for investing activities of \$20.0 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 in respect of Palco's sawmill project, infrastructure requirements at ScoPac and Fountain Hills, and capital expenditures at the Company's horse racing facility.

Financing Activities

The \$0.9 million of net cash provided by financing activities for the nine months ended September 30, 2006, principally reflects treasury stock purchases of \$22.5 million by MAXXAM Parent offset by net proceeds from the Palco refinancing that occurred in July 2006. Net cash provided by financing activities of \$38.7 million for the nine months ended September 30, 2005, principally reflects the net proceeds from the Palco refinancing that occurred in April 2005.

MAXXAM Parent

MAXXAM Parent has in the past provided, and may from time to time in the future, under appropriate circumstances provide, various forms of financial assistance to its subsidiaries, or may enter into financing or other transactions with its subsidiaries, including secured or unsecured loans, or asset purchases. There can be no assurance that MAXXAM Parent's subsidiaries will have sufficient liquidity in the future to repay intercompany loans.

Although there are no restrictions on the Company's ability to pay dividends on its capital stock, the Company has not paid any dividends for a number of years and has no present intention to do so. Additionally, the Company may from time to time purchase additional shares of its Common Stock on national exchanges or in privately negotiated transactions. During the first nine months of 2006, MAXXAM Parent purchased 710,285 shares of its Common Stock for an aggregate cost of \$22.5 million.

At September 30, 2006, MAXXAM Parent had unrestricted cash, cash equivalents and marketable securities and other investments of \$100.1 million and MAXXAM Parent did not have any external debt. 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 future distributions from the real estate segment, will be sufficient to meet its long-term working capital requirements. See Note 1, "–Potential Impact on Registrant and Certain Related Entities" regarding potential adverse impacts upon MAXXAM Parent as a result of the liquidity issues being experienced by ScoPac and those recently experienced by Palco.

Forest Products Operations

Substantially all of MGI's consolidated assets are owned by Palco, and a substantial portion of Palco's consolidated assets are owned by ScoPac. The holders of the Timber Notes have priority over the claims of creditors of Palco with respect to the assets and cash flows of ScoPac. Palco's debt facilities contain certain restrictive covenants which effectively preclude the distribution of funds from Palco to MGI.

Future Harvest Levels

ScoPac has conducted extensive reviews and analyses of its assets, operations and future prospects. As a result of these extensive reviews and analyses, ScoPac has concluded that, in the absence of significant regulatory relief and accommodations, its future annual timber harvest levels and cash flows from operations for at least the next several years will be substantially below both historical harvest levels and the minimum levels necessary in order to allow it to satisfy its debt service obligations in respect of the Timber Notes. ScoPac has previously disclosed that its estimated average annual harvest levels over the ten-year period beginning in 2006 is estimated to be approximately 100 million board feet per year. This harvest level reflects ScoPac's estimate of the cumulative impact of ongoing regulatory limitations, watershed prescriptions, the requirements of the HCP and other matters and is based on a number of assumptions that may or may not prove to be accurate. Actual harvest levels may even be lower, depending on the outcome of various assumptions.

Regulatory Matters

Regulatory and environmental matters as well as legal actions have had and are expected to continue to have a significant adverse effect on the Company's forest products operations and liquidity. The ability to harvest ScoPac Timber depends in large part upon ScoPac's ability to obtain regulatory approval of its THPs. ScoPac has experienced difficulties and delays in the approval of its THPs as the result of regulatory and litigation challenges and expects these challenges to persist. The foregoing matters have resulted in declines in actual and expected harvest levels and cash flows, significant increases in the cost of logging operations and increased costs related to timber harvest litigation, all of which have severely impacted the historical cash flows of both Palco and ScoPac. These adverse effects are expected to continue.

The North Coast Water Board is requiring Palco and ScoPac 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 Palco Timberlands. THPs in these two watersheds represent a significant portion of the harvest planned in 2006 and for the next several years.

On May 8, 2006, the North Coast Water Board adopted the Freshwater and Elk River WWDRs. The decision allows harvesting in these two watersheds, up to approximately 50% of the applicable CDF Harvest Limit, once the staff of the North Coast Water Board reviews and enrolls THPs submitted by ScoPac. The North Coast Water Board's decision also allowed the enrollment of additional THPs, bringing the total to approximately 75% of the CDF Harvest Limit for these two watersheds, upon approval of a monitoring and reporting program by the Executive Officer of the North Coast Water Board staff. The monitoring and reporting program was approved on September 29, 2006, allowing enrollment by the staff of the North Coast Water Board of the additional THPs for these two watersheds planned for harvest in 2006. This monitoring and reporting program will also govern future THPs in these two watersheds. However, there can be no assurance that additional THPs in these two watersheds will ultimately be enrolled or harvested as planned in 2006 or future years. The North Coast Water Board's adoption of these WWDRs has been appealed to the State Water Board, but the appeals are being held in abeyance in order to see how the implementation of the WWDRs proceeds. As harvesting activities on the Palco 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 various other matters described herein are expected to result in reduced harvest levels in 2006 and beyond.

ScoPac Liquidity Update

In the absence of significant regulatory relief and accommodations, ScoPac's annual timber harvest levels and cash flows from operations will, for at least the next several years, be substantially below both historical levels and the minimum levels necessary to allow ScoPac to satisfy its debt service obligations in respect of the Timber Notes.

In an effort to address the expected future interest payment shortfalls, ScoPac initiated the ScoPac Land Sale Program to sell certain timberland properties, as well as various non-timberland properties, such as ranchlands and recreational areas. ScoPac expects that all of the net proceeds from sales under the ScoPac Land Sale Program will be available to pay interest on the Timber Notes, in accordance with the Timber Notes Indenture. During the first nine months of 2006, ScoPac sold properties available under the program for \$13.1 million. The aggregate estimated market value of the remaining properties included in the ScoPac Land Sale Program should cover ScoPac's expected future interest payment shortfalls, and the sale of enough of these properties to cover the expected future interest payment shortfalls should not materially reduce estimated average annual harvest levels over the next decade. There can be no assurance that the marketing efforts for the ScoPac Land Sale Program properties will be successful or that the resulting proceeds, if any, will be sufficient to cover ScoPac's expected future interest payment shortfalls. The properties included in the ScoPac Land Sale Program may change from time to time.

In an effort to address ScoPac's 2006 operating cash shortfalls, ScoPac and MGI consummated three timber/log purchases that provided ScoPac an aggregate of \$8.1 million of additional liquidity to pay its expenses, including interest due in respect of the Timber Notes on the Timber Notes payment dates in January 2006 and July 2006, as discussed below. In July 2006, ScoPac also requested that Palco make an early payment of \$2.1 million, in respect of certain logs that had already been delivered to and purchased by Palco from ScoPac. Palco approved and delivered the early log payment, which was used to pay ScoPac's expenses, including a portion of the interest due in respect of the July 2006 Timber Notes payment date.

On the Timber Notes payment date in January 2006, ScoPac used its existing cash resources, all of the remaining funds available under the ScoPac Line of Credit, and the additional funds made available from a \$2.3 million timber/log purchase by MGI, to pay all of the \$27.7 million of interest due (\$25.8 million net of interest due in respect of Timber Notes held in the SAR Account). ScoPac also repaid \$19.3 million of principal on the Timber Notes (\$11.9 million net of principal in respect of Timber Notes held in the SAR Account), an amount equal to Scheduled Amortization, using funds held in the SAR Account.

On the Timber Notes payment date in July 2006, ScoPac used its existing cash resources, all of the remaining funds available under the ScoPac Line of Credit, \$10.2 million of funds from the ScoPac Land Sale Program, a \$3.7 million timber/log purchase by MGI, and the \$2.1 million early log payment by Palco to pay all of the \$27.1 million of interest due (\$25.4 million net of interest due in respect of Timber Notes held in the SAR Account). ScoPac also repaid \$10.0 million of principal on the Timber Notes (\$6.2 million net of principal in respect of Timber Notes held in the SAR Account), an amount equal to Scheduled Amortization, using funds held in the SAR Account.

As noted above, ScoPac also expects to continue to incur substantial interest payment shortfalls over at least the next several years. The failure of ScoPac to pay all of the interest on the Timber Notes when due would constitute an event of default under the Timber Notes Indenture. There can be no assurance that ScoPac will be able to generate sufficient additional liquidity to fund the expected future cash shortfalls. To the extent that ScoPac is unable to generate sufficient liquidity from the ScoPac Land Sale Program or other sources, the Company expects that ScoPac will be forced to take extraordinary actions, which may include: laying off employees, shutting down various operations, and seeking protection by filing under the Bankruptcy Code.

Palco Liquidity Update

As of December 31, 2005, and June 30, 2006, Palco and Britt were in default under the Old Palco Term Loan and the Old Palco Revolving Credit Facility due to financial covenant breaches. In the first half of 2006, additional liquidity was needed at Palco and Palco borrowed an aggregate of \$20.0 million from MGI to meet its cash shortfalls. Palco's liquidity shortfalls during the first half of 2006 resulted primarily from reduced log supply from ScoPac and operational inefficiencies related to the large log processing line at Palco's Scotia sawmill.

On July 18, 2006, Palco and Britt, as Borrowers, closed on the New Palco Term Loan, a five-year \$85.0 million secured term loan, and the New Palco Revolving Credit Facility, a five-year \$60.0 million secured asset-based revolving credit facility, and terminated the Old Palco Revolving Credit Facility and the Old Palco Term Loan. The New Palco Term Loan was fully funded at closing. The New Palco Term Loan and the New Palco Revolving Credit Facility

required MGI to provide a \$10.0 million subordinated loan to the Borrowers, which was also funded at closing. The Borrowers used approximately (i) \$34.0 million of the New Palco Term Loan to pay off the Old Palco Term Loan; (ii) \$22.5 million of the New Palco Term Loan to pay off the Old Palco Revolving Credit Facility and cash collateralize previously-existing letters of credit; and (iii) \$6.0 million to pay transaction costs. The remaining \$32.5 million of loan proceeds were used for general corporate purposes. As of September 30, 2006, \$84.6 million was outstanding under the New Palco Term Loan, \$10.8 million was outstanding under the New Palco Revolving Credit Facility, and the maximum remaining availability under the New Palco Revolving Credit Facility was \$36.5 million.

The amount available for borrowings under the New Palco Revolving Credit Facility is normally the sum of 85% of the Borrowers' eligible accounts receivable plus the lesser of (i) 80% of the book value of Borrowers' eligible inventory or (ii) 85% of the net orderly liquidation value of such inventory. However, during each period from October 15 through January 15, the amount available for borrowing under the New Palco Revolving Credit Facility is the sum of 95% of Borrowers' eligible accounts receivable plus the lesser of (i) 90% of the book value of Borrowers' eligible inventory or (ii) 95% of the net orderly liquidation value of such inventory. The amount available under the New Palco Revolving Credit Facility may not exceed \$60.0 million, subject to limitations such as the ability of the lender to establish reasonable reserves.

The New Palco Term Loan bears interest at the rate of LIBOR plus 8.75%. Loans under the New Palco Revolving Credit Facility bear interest at the rate of LIBOR plus 2.75% or prime plus 0.75%, at the Borrowers' option; however, incremental borrowings made during the period from October 15 through January 15 bear interest at the rate of LIBOR plus 4.50% or prime plus 2.50%, as applicable.

Both the New Palco Term Loan and the New Palco Revolving Credit Facility contain substantially identical restrictive covenants that limit the Borrowers' ability to incur debt, grant liens, make investments, pay dividends, make capital expenditures or merge or consolidate, and require the Borrowers to maintain specified minimum levels of EBITDA throughout the life of the facilities and specified minimum fixed charge coverage ratios and maximum leverage ratios commencing December 31, 2007. The operating cash flow estimates used to establish the EBITDA maintenance covenant are subject to a number of assumptions about future operating cash flows and actual results could differ materially from these estimates. The New Palco Term Loan also requires the Borrowers to repay a substantial portion of the outstanding principal of the New Palco Term Loan with the net proceeds from various required asset sales, including the real property associated with Palco's former Fortuna and Carlotta sawmills, and Palco-owned homes to be sold after certain milestones have been met. Any remaining principal balance of the New Palco Term Loan is due on the maturity date. Accordingly, continued compliance with these new debt facilities is dependent on Palco's ability to meet its EBITDA projections and timely complete required asset sales. There can be no assurance that Palco will be able to meet these financial covenants in future periods. The New Palco Term Loan and the New Palco Revolving Credit Facility contain customary events of default and customary remedies with respect to the occurrence of an event of default and are each secured by a security interest in the stock of Palco held by MGI, and substantially all of the assets of the Borrowers (other than Palco's equity interest in ScoPac).

The Borrowers did not meet the required minimum EBITDA maintenance covenant for the three month period ended September 30, 2006, due to an unplanned severance charge and a legal settlement. The Borrowers expect the lenders to issue a limited waiver of the default through December 14, 2006. Until such time as the default is resolved, amounts outstanding under the New Palco Term Loan and the New Palco Revolving Credit Facility have been classified as a current liability in the Company's consolidated financial statements. Additionally, the Borrowers have notified the lenders that changing market conditions and other factors will likely impact the Borrowers' ability to comply with the financial covenants in future periods. The Borrowers are evaluating various cost-cutting initiatives to improve profitability, but there can be no assurance that these efforts will generate sufficient liquidity to enable the Borrowers to comply with the financial covenants in future periods. The Borrowers are pursuing discussions with the lenders in an effort to amend the New Palco Term Loan and the New Palco Revolving Credit Agreements to reflect these changing market conditions and other factors; however, there can be no assurance that the Borrowers will be successful in their efforts. In the event that the Borrowers are unable to improve profitability or amend the two facilities as needed, they may be forced to take extraordinary actions.

The New Palco Term Loan and New Palco Revolving Credit Facility each include prepayment premiums of 3%, 2% and 1% that will be payable in connection with any prepayment of the New Palco Term Loan or reduction or termination of the New Palco Revolving Credit Facility during the facilities' first, second and third years, respectively. Under the New Palco Term Loan and New Palco Revolving Credit Facility, Palco is permitted to invest up to \$5.0 million in ScoPac. No such investment has been made or committed to be made by Palco, and there can be no assurance that Palco would in the future determine or be able to make any such investment in whole or part.

In addition to the material adverse effects being experienced by Palco and ScoPac due to continuing regulatory,

environmental and litigation difficulties, there can be no assurance that certain other pending legal, regulatory and environmental matters or future governmental regulations, additional litigation, legislation, judicial or administrative decisions, adverse weather conditions, or low lumber or log prices, will not also have material adverse effects on the financial condition, results of operations or liquidity of the Company's forest products operations. See Note 8 for further discussion of the regulatory and environmental matters and legal proceedings affecting the Company's forest products operations.

Capital expenditures for Palco were \$2.4 million for the nine months ended September 30, 2006 and are expected to be between \$3.0 million and \$4.4 million for the remainder of 2006. Capital expenditures for ScoPac were \$4.4 million for the nine months ended September 30, 2006 and are expected to be between \$3.5 million and \$4.0 million for the remainder of 2006. Palco's pension funding was \$7.8 million for the first nine months of 2006 and is expected to be \$0.2 million for the remainder of 2006.

Real Estate Operations

Capital expenditures and real estate improvements and development costs were \$10.2 million for the first nine months of 2006 and are expected to be between approximately \$5.0 million to \$7.0 million for the remainder of 2006, primarily for infrastructure construction at Fountain Hills. The Company expects that these expenditures will be funded by cash flows from operations, existing cash and available credit facilities.

Subject to available resources, the Company's real estate segment may from time to time purchase additional properties and/or seek other investment ventures as appropriate opportunities arise.

Real estate management believes that the existing cash and credit facilities are sufficient to fund the segment's working capital and capital expenditure requirements for 2006. With respect to the segment's long-term liquidity, real estate management believes that the ability to generate cash from the sale of existing assets, together with the ability to obtain financing and joint venture partners, should provide sufficient funds to meet the working capital and capital expenditure requirements.

Racing Operations

Capital expenditures were \$0.4 million for the first nine months of 2006 and an additional \$0.1 million is expected for the remainder of 2006.

Subject to available resources, the Company's racing segment may from time to time purchase additional properties and/or seek to expand its operations as appropriate opportunities arise.

During the first quarter of 2006, SHRP, Ltd. borrowed \$1.0 million from MAXXAM Parent to improve its working capital position. SHRP, Ltd.'s management expects that SHRP, Ltd. will require additional advances from MAXXAM Parent to fund its operations and capital expenditures in the future. SHRP, Ltd. is experiencing strong competition from Internet wagering and "racinos" in surrounding states. The Company expects that these factors will also have an adverse impact on the long-term liquidity of SHRP, Ltd.

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 Operations

Harvest levels at the Company forest products operations are expected to decline significantly, as compared to historical harvest levels, in 2006 and beyond. Consequently, cash flows from ScoPac's operations will not be sufficient for at least the next several years to allow ScoPac to satisfy its debt service obligations in respect of its Timber Notes. In an effort to address expected future cash shortfalls, ScoPac is seeking to sell certain timberland properties, as well as various non-timberland properties, such as ranchlands and recreational areas. Although certain sales have been completed, there can be no assurance that the marketing efforts in respect of the remaining properties will be successful.

Palco has commenced the Palco Asset Sale Program pursuant to which it is marketing certain assets. The New Palco Term Loan and New Palco Revolving Credit Facility require the Borrowers to complete transactions under the Palco Asset Sale Program in accordance with certain established deadlines. There can be no assurance that these marketing efforts will be successful or that regulatory approvals will be obtained to enable Palco to timely complete required asset sales.

There has been a substantial decline in the market prices of Douglas-fir logs and lumber and Palco's and Britt's future operating results will be negatively impacted by this development.

Real Estate Operations

The Company is engaged in marketing and sales programs of varying magnitude at its real estate developments. The Company intends to continue selling undeveloped acreage, semi-developed parcels and fully developed lots.

In 2005, the Company's real estate operations realized substantial revenues from sales at the Company's Fountain Hills, Mirada and Palmas developments. As the proceeds from these asset sales have not been redeployed on other real estate assets, this level of sales activity is not expected to recur for the foreseeable future.

Racing Operations

The next regular session of the Texas Legislature will begin in January of 2007. The Company has in the past and intends to continue to vigorously pursue gaming legislation favorable to it. As some legislation may 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 would be or its effect on the Company.

In January 2004, Laredo LLC and a third party filed competing applications with the Racing Commission for a license to construct and operate a Class 2 horse racing facility in Laredo, Texas. A hearing before two State administrative law judges reviewing the competing applications concluded in March 2006 and, in September 2006, the administrative law judges recommended to the Racing Commission that Laredo LLC be awarded the license. The Racing Commission must now decide how to proceed with respect to this matter. There can be no assurance that Laredo LLC will ultimately be awarded the additional license as, among other things, the Racing Commission is not required to accept the decision of the administrative law judges.

Another subsidiary of the Company has entered into a contract to sell the majority of its equity interest in Valley Race Park. Completion of the sale is, however, subject to various conditions such as the Racing Commission awarding a license to Laredo LLC.

Contractual Obligations

The following table presents information with respect to the Company's contractual obligations as of September 30, 2006 (in millions).

Contractual Obligations	Total	Payments Due by Period					
		2006	2007	2008	2009	2010	Thereafter
Principal payments on debt obligations ⁽¹⁾	\$ 1,078.7	\$ 59.9	\$ 38.7	\$ 35.4	\$ 29.5	\$ 33.6	\$ 881.6
Interest due on long-term debt obligations ⁽¹⁾ . .	610.9	36.2	80.8	73.6	68.4	65.3	286.6
Operating lease obligations	9.2	0.8	2.9	2.0	0.8	0.8	1.9
Purchase obligations ⁽²⁾	—	—	—	—	—	—	—
Pension funding obligations ⁽³⁾	12.4	2.1	6.5	3.2	0.6	—	—
Other long-term liabilities reflected on the Company's balance sheet ⁽⁴⁾⁽⁵⁾⁽⁶⁾⁽⁷⁾	6.1	1.5	1.3	3.3	—	—	—
Total	<u>\$ 1,717.3</u>	<u>\$ 100.5</u>	<u>\$ 130.2</u>	<u>\$ 117.5</u>	<u>\$ 99.3</u>	<u>\$ 99.7</u>	<u>\$ 1,170.1</u>

⁽¹⁾ Principal payments on debt obligations and interest due on debt obligations include required debt service obligations in respect of the Timber Notes held in the SAR Account. The Timber Notes Indenture provides that a Timber Note does not cease to be outstanding because ScoPac holds the Timber Note. Consequently, ScoPac is required to pay and has paid interest and principal on the Timber Notes held in the SAR Account.

⁽²⁾ Excludes ordinary course of business purchase orders.

⁽³⁾ Represents expected funding for pension benefits for 2006 and subsequent years.

⁽⁴⁾ Excludes reserves for litigation, environmental remediation, self-insurance claims, and other contingent liabilities due to uncertainty as to when cash payments will be required.

⁽⁵⁾ Includes \$0.1 million in 2006 and \$1.6 million in 2008 under the terms of various executive compensation agreements.

⁽⁶⁾ Includes \$0.4 million in 2007 and \$1.7 million in 2008 for a cost sharing agreement with the Puerto Rico Power Authority for the construction of an electrical substation that will provide capacity to new projects within Palmas.

⁽⁷⁾ Includes \$1.4 million in 2006 and \$0.9 million in 2007 for contractual amounts owed under agreements with various professional firms (principally audit and tax compliance fees).

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-K.

New Accounting Pronouncements

See Note 2 for a discussion of new accounting pronouncements and their impact on the Company's financial statements.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company is exposed to changes in interest rates primarily under the ScoPac Line of Credit and the New Palco Term Loan and New Palco Revolving Credit Facility, as well as certain other debt facilities used to finance real estate development activities. As of September 30, 2006, there were \$143.2 million in borrowings outstanding under all variable rate facilities. Based on the amount of borrowings outstanding under these facilities as of September 30, 2006, a 2.0% 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 \$2.0 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, 2006.

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 1A. RISK FACTORS

Part I, Item 1A of the Company's Form 10-K contains important risk factors that could cause the Company's actual results to differ materially from those projected in any forward-looking statement. Additional risks and uncertainties not currently known or that are currently deemed immaterial may materially adversely impact our business, financial condition or operating results.

The information presented below updates, and should be read in conjunction with, the risk factor information disclosed in the Form 10-K for the year ended December 31, 2005.

The Company has amended and restated the first item under "Risk Factors: Risks related to Forest Products Regulatory Matters" to read as follows:

Regulatory and legislative actions have the power to limit ScoPac's harvest levels and require ScoPac and Palco to incur additional costs and have other adverse consequences.

Regulatory and legislative actions, among others, are now having, or have the potential to have material adverse impacts on ScoPac and Palco:

- The North Coast Water Board has adopted WWDRs for the Freshwater and Elk River watersheds. This decision allows harvesting in these two watersheds once THPs are reviewed and enrolled by the staff of the North Coast Water Board. In addition, the Executive Officer of the North Coast Water Board has approved a monitoring and reporting program, which has the effect of allowing enrollment by the staff of the North Coast Water Board of additional THPs for these two watersheds. There can be no assurance that THPs for these two watersheds will ultimately be enrolled or harvested as planned in 2006 or in future years. If there are delays in the enrollment of these THPs, there could be a further significant adverse impact on current and future harvest levels and the cash flows of both Palco and ScoPac.
- The final total maximum discharge limits requirements applicable to the Palco Timberlands may require aquatic protection measures that are different from or in addition to those in the HCP or that result from the watershed analysis process provided for in the HCP. These requirements may further reduce the harvesting on the Palco Timberlands and cash flows of ScoPac and Palco.
- The North Coast Water Board has issued the Elk River Orders, which are aimed at addressing existing sediment production sites through cleanup actions in the Elk River watershed, and has initiated the process which could result in similar orders for other watersheds. The Elk River Orders have resulted in increased costs that could extend over a number of years, and additional orders for other watersheds could have similar effects.
- The North Coast Water Board has imposed requirements for certain mitigation and erosion control practices in several watersheds within the Palco Timberlands. The requirements imposed to date have significantly increased operating costs. Additional requirements imposed in the future could further increase costs and cause delays in THP approvals.

- The Company is uncertain of the operational and financial effects that will ultimately result from Senate Bill 810, which provides regional water quality control boards with additional authority related to the approval of THPs on land within impaired watersheds. Implementation of this law could, however, result in delays in obtaining approvals of THPs, lower harvest levels, increased costs, and additional protection measures beyond those contained in the HCP.
- The designation of a species as endangered or threatened under the ESA or the CESA can significantly reduce harvest levels if that species inhabits the Palco Timberlands or if the habitat of the Palco Timberlands is deemed favorable to the species. While the HCP covers 17 different species, it is possible that additional species could be designated as endangered or threatened under both the ESA and the CESA
- Laws, regulations and related judicial decisions and administrative interpretations dealing with forest products operations are subject to change and new laws and regulations are frequently introduced concerning the California timber industry. Moreover, ballot initiatives relating to the Company's forest products operations are commenced from time to time.

The Company has removed, amended and/or has added several new items under "Risk Factors—Risks related to Liquidity and Capital Resources of Our Forest Products Subsidiaries", as follows:

ScoPac's annual cash flows from operations are expected to be substantially below the minimum levels necessary to satisfy its debt service obligations over at least the next several years.

The Company expects that ScoPac's cash flows from operations, together with funds available under the ScoPac Line of Credit, will be insufficient, by a substantial amount, to pay the interest on the Timber Notes in 2007. ScoPac also expect to incur principal and interest shortfalls for at least the next several years. Failure to pay interest on the Timber Notes when due would constitute an event of default under the Timber Notes Indenture.

Amounts on deposit in the SAR Account will not be sufficient to pay the Timber Notes in accordance with Scheduled Amortization in 2008 and beyond.

Amounts on deposit in the SAR Account are used on each Timber Notes payment date, as needed, to make principal payments on the Timber Notes in accordance with Scheduled Amortization. If the amount on deposit in the SAR Account on a Timber Notes payment date is less than what is needed to reduce outstanding principal in accordance with Scheduled Amortization, only the amount on deposit in the SAR Account is required to be paid as a principal payment on the Timber Notes. We do not expect that the amounts on deposit in the SAR Account as of the January 20, 2008, Timber Notes payment date will be sufficient to pay the Timber Notes in accordance with Scheduled Amortization.

The risk, *Palco is highly leveraged and is currently in default under its debt facilities*, has been amended as follows:

As noted elsewhere in this Form 10-Q, Palco and Britt expect the lenders to issue a limited waiver through December 14, 2006, of a default under their term and revolving credit facilities. Unless the default is permanently waived or the facilities are amended, or MGI exercises the right that it has under the two facilities to cure the default, the lenders would be entitled, upon expiration of the 30-day waiver period, to exercise a variety of rights and remedies, such as reducing the amount of funds available for borrowing under the New Palco Revolving Credit Facility, declaring any or all loans and other amounts owed under the New Palco Term Loan and the New Palco Revolving Credit Facility to be immediately due and payable, and exercising all rights to collateral.

The risk, *Palco is highly leveraged and debt covenant restrictions increase the difficulty of operating its business*, has been added, as follows:

Palco's high level of debt and covenant restrictions under the New Palco Term Loan and New Palco Revolving Credit Facility could have a variety of important negative consequences, including:

- limiting Palco's ability to borrow additional amounts for working capital, capital expenditures, debt service requirements, execution of its operating strategies or other purposes;
- increasing Palco's vulnerability to general adverse economic and industry conditions;
- limiting Palco's ability to capitalize on business opportunities, such as purchasing additional log inventories from third parties, and to react to competitive pressures and adverse government regulation and litigation developments; and
- limiting Palco's ability, or increasing the costs, to refinance its indebtedness.

The risk, *Palco may not be able to timely complete required asset sales* has been added, as follows:

Palco may not be able to complete the Palco Asset Sale Program in a timely manner. Regulatory approvals required to complete the program could delay receipt of liquidity or delay certain asset sales beyond the deadlines established under Palco's new credit facilities.

The risk, *ScoPac's and Palco's liquidity issues could result in claims and potential liabilities for certain affiliates*, has been amended as follows:

The liquidity issues being experienced by ScoPac, and those recently experienced by Palco should they recur, could result in claims against and could have adverse impacts on MAXXAM Parent, MGHI and/or MGI. For example, 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 (estimated to be approximately \$31.0 million at December 31, 2005). In addition, it is possible that transactions completed in connection with a potential restructuring or reorganization of Palco or ScoPac 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 or other tax attributes for federal and state income tax purposes and could require tax payments.

These risk factors and those set forth in the Form 10-K do not represent a comprehensive list of factors that could cause our results to differ from those that are currently anticipated and should be read together with the risk factors and other information set forth in the Form 10-K and in the Company's other filings with the Securities and Exchange Commission.

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

The following table contains information about the Company's purchases of equity securities during the three months ended September 30, 2006.

Issuer Purchases of Equity Securities		
Period	Total Number of Shares Purchased ⁽¹⁾	Average Price Paid Per Share
July 1-31, 2006	1,000	\$ 28.00
August 1-31, 2006	100	\$ 27.11
September 1-31, 2006	1,900	\$ 27.46
Total	3,000	\$ 27.63

⁽¹⁾ All of such purchases were made on national exchanges.

The Company may from time to time purchase additional shares of its Common Stock on national exchanges or in privately negotiated transactions.

ITEM 6. EXHIBITS

a. Exhibits:

- 10.1 Revolving Credit Agreement dated as of July 18, 2006, among The Pacific Lumber Company, Britt Lumber Co., Inc., the lenders from time to time party thereto and Marathon Structured Finance Fund L.P., as administrative agent (incorporated herein by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed on July 21, 2006)

- 10.2 Term Loan Agreement, dated as of July 18, 2006, among The Pacific Lumber Company, Britt Lumber Co., Inc., the lenders from time to time party thereto and Marathon Structured Finance Fund L.P., as administrative agent (incorporated herein by reference to Exhibit 10.2 to the July 21, 2006 Form 8-K)
 - 10.3 Guarantee and Collateral Agreement dated as of July 18, 2006, made by The Pacific Lumber Company, Britt Lumber Co., Inc., MAXXAM Group Inc., Salmon Creek LLC and Scotia Inn Inc. in favor of Marathon Structured Finance Fund L.P., as administrative agent for the Revolving Credit Agreement (incorporated herein by reference to Exhibit 10.3 to the July 21, 2006 Form 8-K)
 - 10.4 Guarantee and Collateral Agreement dated as of July 18, 2006, made by The Pacific Lumber Company, Britt Lumber Co., Inc., MAXXAM Group Inc., Salmon Creek LLC and Scotia Inn Inc. in favor of Marathon Structured Finance Fund L.P., as administrative agent for the Term Loan Agreement (incorporated herein by reference to Exhibit 10.4 to the July 21, 2006 Form 8-K)
 - 10.5 Deed of Trust, Security Agreement, Assignment of Rents And Leases And Fixture Filing, dated as of July 18, 2006, by and from The Pacific Lumber Company to Fidelity National Title Company, for the benefit of Marathon Structured Finance Fund L.P., as administrative agent for the Revolving Credit Agreement (incorporated herein by reference to Exhibit 10.5 to the July 21, 2006 Form 8-K)
 - 10.6 Deed of Trust, Security Agreement, Assignment of Rents And Leases And Fixture Filing, dated as of July 18, 2006, by and from The Pacific Lumber Company to Fidelity National Title Company, for the benefit of Marathon Structured Finance Fund L.P., as administrative agent for the Term Loan Agreement (incorporated herein by reference to Exhibit 10.6 to the July 21, 2006 Form 8-K)
 - 10.7 Omnibus Amendment to Revolving Credit Agreement and Guarantee and Collateral Agreement, dated October 12, 2006, among Palco, Britt, Marathon Structured Finance Fund L.P., LaSalle Business Credit, LLC and LaSalle Bank National Association (incorporated herein by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed on October 17, 2006)
 - * 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

SIGNATURE

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 has signed this report on behalf of the Registrant and as the principal financial and accounting officer of the Registrant.

MAXXAM INC.

Date: November 14, 2006

By: /S/ M. EMILY MADISON
M. Emily Madison
Vice President, Finance and
Interim Chief Financial Officer
(Principal Accounting Officer and
Interim Principal Financial 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

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 New Palco Term Loan and the New Palco Revolving Credit Facility

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

California Permits: The Permits issued by the State of California pursuant to the HCP

California Headwaters action: The claim filed by Palco and ScoPac with the Claims Board against the North Coast Water Board, the State Water Board and the State of California (Claim No. G558159) alleging that the defendants have substantially impaired their contractual and legal rights under the Headwaters Agreement

California Senate Bill 810: Bill that 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

CDF: California Department of Forestry and Fire Protection

CDF Harvest Limit: Annual harvest limit established by the CDF

Claims Board: The California Victim Compensation and Government Claims Board

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

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

EBITDA: As defined in Section 1.01 of the New Palco Term Loan and New Palco Revolving Credit Agreement which, among other things, excludes the results of ScoPac

Elk River Orders: Clean up and abatement orders 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)

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.

FIN: Financial Accounting Standards Board Interpretation

FIN No. 48: FASB FIN No. 48, “Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement 109”

Form 10-K: Annual Report on Form 10-K of the Company for the fiscal year ended December 31, 2005

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

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, ScoPac, 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

Johnson action: An action entitled *Edyth Johnson, et al. v. Charles E. Hurwitz, an individual, MAXXAM Inc., et al.* (No. DR040720) filed in the Superior Court of Humboldt County, California

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 former subsidiary of the Company engaged in aluminum operations

Kaiser Shares: 50,000,000 shares of the common stock of Kaiser that was owned by the Company and MGHI at the time of its cancellation in connection with Kaiser’s Chapter 11 bankruptcy

Laredo LLC: Laredo Race Park LLC, a wholly owned subsidiary of the Company

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

MAXXAM: MAXXAM Inc., including its subsidiaries

MAXXAM Parent: MAXXAM Inc., excluding its subsidiaries

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

MGI: MAXXAM Group Inc., an indirect wholly owned subsidiary of MGHI

Mirada: The Company's luxury resort-residential project located in Rancho Mirage, California

New Palco Revolving Credit Facility: The new five-year \$60.0 million secured asset-based revolving credit facility evidenced by the Revolving Credit Agreement dated as of July 18, 2006, among Palco and Britt, as borrowers, and Marathon Structured Finance Fund L.P., as amended

New Palco Term Loan: The new five-year \$85.0 million secured term loan evidenced by the Term Loan Agreement dated as of July 18, 2006, among Palco and Britt, as borrowers, and Marathon Structured Finance Fund L.P., as amended

NJDEP: New Jersey Department of Environmental Protection

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

Old Palco 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

Old Palco 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.

Option A Plan: Plan for complying with California's sustained yield requirements, which has been approved by the CDF, and is being used by the Palco Companies

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 Asset Sale Program: Palco's process for marketing certain of its assets

Palco Companies: Palco, ScoPac and Salmon Creek, collectively

Palco Timberlands: The ScoPac Timber Property and the timberlands owned by Palco and Salmon Creek

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

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

PSLRA: Private Securities Litigation Reform Act of 1995

Racing Commission: Texas Racing Commission

Respondents: The Company, Federated, Mr. Charles Hurwitz and the other respondents in the *OTS 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 operated by SHRP, Ltd.

Sanctions Motion: An amended counterclaim and motion for sanctions filed by the Respondents in November 2002 in

connection with the *FDIC action*

SAR Account: Reserve account titled the Scheduled Amortization Reserve Account that holds funds 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 ScoPac must pay through each Timber Note payment date in order to avoid prepayment or deficiency premiums

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

ScoPac Land Sale Program: ScoPac's program pursuant to which it is seeking to sell certain timberlands and various non-timberland properties, such as ranchlands and recreational areas.

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

ScoPac Timber: The timber in respect of the ScoPac Timber Property and the ScoPac Timber Rights

ScoPac Timber Property: Approximately 200,000 acres of timberlands owned by ScoPac

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

SEC: The Securities and Exchange Commission

second growth: Trees that have been growing for less than 200 years

Services Agreement: Agreement between ScoPac and Palco under which Palco provides certain operational, management and related services to ScoPac with respect to the ScoPac Timber

SFAS: Statement of Financial Accounting Standards

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

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

SFAS No. 154: SFAS No. 154, "Accounting Changes and Error Correction"

SFAS No. 157: SFAS No. 157, "Fair Value Measurements"

SFAS No. 158: SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans," an amendment of FASB Statements No. 87, 88, 106, and 132(R)

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

State Water Board: California State Water Resources Control Board

State Water Board Order: Order issued by the State Water Board on June 16, 2005

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

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

Timber Notes: ScoPac'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

Trustee: The trustee under the Timber Notes Indenture

TMDLs: Total maximum daily load limits

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

Valley Race Park: The Company's greyhound racing facility located in Harlingen, Texas

WWDRs: Watershed-wide discharge requirements