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

**FORM 10-Q**

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

**For the quarterly period ended September 30, 2004**

Commission File Number 1-3924

**MAXXAM INC.**

(Exact name of Registrant as specified in its charter)

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

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

**5847 San Felipe, Suite 2600**  
**Houston, Texas**  
(Address of Principal Executive Offices)

**77057**  
(Zip Code)

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

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

Yes ☒ No ☐

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

Yes ☐ No ☒

The aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, as of the last business day of the registrant's most recently completed second fiscal quarter: \$82.4 million.

Number of shares of common stock outstanding at November 5, 2004: 5,976,466

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**MAXXAM INC. AND SUBSIDIARIES**

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

	September 30, 2004	December 31, 2003
	(Unaudited)	
<b>Assets</b>		
Current assets:		
Cash and cash equivalents .....	\$ 35.9	\$ 35.0
Marketable securities and other short-term investments .....	96.9	116.9
Receivables:		
Trade, net of allowance for doubtful accounts of \$0.4 for both periods .....	11.7	12.4
Other .....	2.7	2.6
Inventories:		
Lumber .....	15.2	17.7
Logs .....	16.0	11.8
Prepaid expenses and other current assets .....	29.0	31.6
Total current assets .....	207.4	228.0
Property, plant and equipment, net of accumulated depreciation of \$180.5 and \$164.6, respectively .....	372.2	367.9
Timber and timberlands, net of accumulated depletion of \$220.2 and \$214.2, respectively .....	215.0	217.9
Real estate .....	64.9	68.1
Deferred income taxes .....	95.2	95.2
Restricted cash, marketable securities and other investments .....	22.0	43.6
Long-term receivables and other assets .....	40.3	40.1
	<u>\$ 1,017.0</u>	<u>\$ 1,060.8</u>
<b>Liabilities and Stockholders' Deficit</b>		
Current liabilities:		
Accounts payable .....	\$ 10.9	\$ 10.8
Accrued interest .....	11.6	25.8
Accrued compensation and related benefits .....	15.4	12.8
Other accrued liabilities .....	28.7	23.4
Short-term borrowings and current maturities of long-term debt .....	69.0	28.5
Total current liabilities .....	135.6	101.3
Long-term debt, less current maturities .....	916.6	953.5
Accrued pension and other postretirement benefits .....	36.4	32.9
Losses in excess of investment in Kaiser .....	516.2	516.2
Other noncurrent liabilities .....	61.4	58.8
Total liabilities .....	1,666.2	1,662.7
Commitments and contingencies (see Note 9)		
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; 669,040 shares issued; 668,195 shares outstanding .....	0.3	0.3
Common stock, \$0.50 par value; 13,000,000 shares authorized; 10,063,359 shares issued; 5,976,466 shares outstanding .....	5.0	5.0
Additional capital .....	225.3	225.3
Accumulated deficit .....	(665.6)	(619.8)
Accumulated other comprehensive loss .....	(89.5)	(88.0)
Treasury stock, at cost (shares held: preferred – 845; common – 4,086,893) .....	(124.7)	(124.7)
Total stockholders' deficit .....	(649.2)	(601.9)
	<u>\$ 1,017.0</u>	<u>\$ 1,060.8</u>

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

**MAXXAM INC. AND SUBSIDIARIES**

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
	(Unaudited)			
Net sales:				
Forest products . . . . .	\$ 49.6	\$ 56.1	\$ 149.2	\$ 156.6
Real estate . . . . .	20.3	20.4	55.1	48.7
Racing . . . . .	11.6	12.9	38.6	37.5
	<u>81.5</u>	<u>89.4</u>	<u>242.9</u>	<u>242.8</u>
Costs and expenses:				
Cost of sales and operations:				
Forest products . . . . .	36.9	38.4	109.7	106.2
Real estate . . . . .	8.5	5.8	20.0	18.0
Racing . . . . .	10.0	10.6	32.2	30.8
Selling, general and administrative expenses . . . . .	19.1	15.3	53.6	45.3
Gain on sales of timberlands and other assets . . . . .	(0.2)	(0.1)	(0.2)	(0.9)
Impairment of assets . . . . .	—	1.4	—	1.4
Depreciation, depletion and amortization . . . . .	8.7	9.1	26.6	27.9
	<u>83.0</u>	<u>80.5</u>	<u>241.9</u>	<u>228.7</u>
Operating income (loss):				
Forest products . . . . .	1.0	6.8	3.2	16.9
Real estate . . . . .	3.2	4.9	10.3	4.3
Racing . . . . .	(1.5)	(0.7)	(1.7)	(1.3)
Corporate . . . . .	(4.2)	(2.1)	(10.8)	(5.8)
	<u>(1.5)</u>	<u>8.9</u>	<u>1.0</u>	<u>14.1</u>
Other income (expense):				
Investment and interest income (loss) . . . . .	(0.3)	3.1	5.3	8.2
Other income . . . . .	0.3	0.7	3.7	10.7
Interest expense . . . . .	(18.0)	(18.5)	(54.0)	(56.3)
Amortization of deferred financing costs . . . . .	(0.6)	(0.5)	(1.7)	(1.6)
Loss before income taxes . . . . .	<u>(20.1)</u>	<u>(6.3)</u>	<u>(45.7)</u>	<u>(24.9)</u>
Provision for income taxes . . . . .	(0.1)	—	(0.1)	—
Net loss . . . . .	<u>\$ (20.2)</u>	<u>\$ (6.3)</u>	<u>\$ (45.8)</u>	<u>\$ (24.9)</u>
Basic and diluted loss per common and common equivalent share . . . . .	<u>\$ (3.37)</u>	<u>\$ (0.96)</u>	<u>\$ (7.66)</u>	<u>\$ (3.81)</u>

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

**MAXXAM INC. AND SUBSIDIARIES**

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

	Nine Months Ended September 30,	
	2004	2003
	(Unaudited)	
<b>Cash flows from operating activities:</b>		
Net loss	\$ (45.8)	\$ (24.9)
Adjustments to reconcile net loss to net cash used for operating activities:		
Depreciation, depletion and amortization	26.6	27.9
Gain on sales of timberlands and other assets	(0.2)	(0.9)
Net losses (gains) on marketable securities	0.7	(13.5)
Amortization of deferred financing costs	1.7	1.6
Equity in (earnings) loss of unconsolidated affiliates, net of dividends received	1.1	(1.2)
Reserve for environmental remediation	1.9	—
Other	(0.1)	—
Increase (decrease) in cash resulting from changes in:		
Receivables	1.1	2.0
Inventories	(1.8)	3.4
Prepaid expenses and other assets	0.4	1.2
Accounts payable	0.1	0.6
Other accrued liabilities	4.4	(2.8)
Accrued interest	(14.2)	(13.8)
Long-term assets and long-term liabilities	9.7	4.8
Other	(0.2)	0.9
Net cash used for operating activities	<u>(14.6)</u>	<u>(14.7)</u>
<b>Cash flows from investing activities:</b>		
Net proceeds from dispositions of property and investments	0.2	3.5
Net sales of marketable securities and other investments	21.2	1.2
Capital expenditures	(27.3)	(14.5)
Other	0.3	0.3
Net cash used for investing activities	<u>(5.6)</u>	<u>(9.5)</u>
<b>Cash flows from financing activities:</b>		
Proceeds from issuances of long-term debt	3.1	1.2
Redemptions, repurchases of and principal payments on long-term debt	(37.2)	(24.4)
Borrowings under revolving and short-term credit facilities	42.6	20.3
Restricted cash withdrawals, net	13.4	11.8
Other	(0.8)	(0.2)
Net cash provided by financing activities	<u>21.1</u>	<u>8.7</u>
<b>Net increase (decrease) in cash and cash equivalents</b>	<b>0.9</b>	<b>(15.5)</b>
<b>Cash and cash equivalents at beginning of the period</b>	<b>35.0</b>	<b>45.6</b>
<b>Cash and cash equivalents at end of the period</b>	<b><u>\$ 35.9</u></b>	<b><u>\$ 30.1</u></b>
<b>Supplemental disclosure of non-cash investing and financing activities:</b>		
Repurchases of debt using restricted cash	\$ 4.8	\$ 3.4
<b>Supplemental disclosure of cash flow information:</b>		
Interest paid, net of capitalized interest	\$ 68.3	\$ 70.1

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 reviewed 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 indicated or the context indicates otherwise. All references to "Kaiser," "MGHI," "MGI," "Palco," "MPC" and "SHRP, Ltd." refer to the respective companies and their subsidiaries, unless otherwise indicated 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, 2004, the consolidated results of operations for the three and nine months ended September 30, 2004 and 2003, and the consolidated cash flows for the nine months ended September 30, 2004 and 2003.

#### *Reclassifications*

Certain reclassifications have been made to the consolidated financial statements of prior periods to be consistent with the current period's presentation. Pari-mutuel commissions for the Company's racing segment have been reclassified and presented on a gross basis to reflect current industry reporting practice. Revenues from pari-mutuel commissions were previously reported net of pari-mutuel costs and expenses. Pari-mutuel costs and expenses have been reclassified as costs of sales and operations.

#### *Deconsolidation of Kaiser*

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

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

The Company expects it will consider reversal of its losses in excess of its investment in Kaiser when either: (1) Kaiser's bankruptcy is resolved and the amount of the Company's remaining investment in Kaiser is determined or (2) the Company disposes of its shares of Kaiser common stock. Accordingly, these consolidated financial statements do not reflect any adjustments related to the deconsolidation of Kaiser other than presenting the Company's investment in Kaiser using the cost method. When either of the events described above occurs, the Company will re-evaluate the appropriate accounting treatment of its investment in Kaiser based upon the facts and circumstances at such time. It is likely that the Company's ownership interest in Kaiser will be cancelled. In such event, the Company will reverse the \$516.2 million of losses in excess of its investment in Kaiser, and recognize the entire amount in income for the period. Such benefit would be reduced, however, by losses, if any, related to Kaiser which the Company estimates it would be

obligated to fund. See Note 8 for further discussion of the Company's investment in Kaiser.

## 2. New Accounting Standards

In May 2004, the FASB issued FSP FAS 106-2 related to the Prescription Drug Act. FSP FAS 106-2 applies only to sponsors of single-employer defined benefit postretirement health care plans for which (1) the employer has concluded that prescription drug benefits available under the plan to some or all participants, for some or all future years, are "actuarially equivalent" to Medicare Part D and thus qualify for the subsidy provided by the Prescription Drug Act, and (2) the expected subsidy will offset or reduce the employer's share of the cost of the underlying postretirement prescription drug coverage on which the subsidy is based. FSP FAS 106-2 provides guidance on the accounting for the effects of the Prescription Drug Act on a company's accumulated postretirement benefit obligation. In addition, FSP FAS 106-2 addresses accounting for plan amendments and requires certain financial statement disclosures regarding the Prescription Drug Act and its effects.

FSP FAS 106-2 is effective for the first interim period beginning after June 15, 2004. The Company has concluded that the benefits provided by the Company's plan are actuarially equivalent to Medicare Part D, and that the effects of the subsidy provided by the Prescription Drug Act on its accumulated postretirement benefit obligation and net periodic benefit cost are not material.

## 3. Segment Information and Other Items

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

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

	Reportable Segments			Corporate	Consolidated Total
	Forest Products	Real Estate	Racing		
Depreciation, depletion and amortization for the three months ended:					
September 30, 2004	\$ 4.8	\$ 3.5	\$ 0.4	\$ —	\$ 8.7
September 30, 2003	5.1	3.6	0.4	—	9.1
Depreciation, depletion and amortization for the nine months ended:					
September 30, 2004	14.8	10.5	1.3	—	26.6
September 30, 2003	15.8	10.8	1.2	0.1	27.9
Total assets as of:					
September 30, 2004	458.6	342.9	33.4	182.1	1,017.0
December 31, 2003	483.6	359.5	33.6	184.1	1,060.8

### *Forest Products*

During the second quarter of 2004, Palco implemented a voluntary reduction in workforce related to the curtailment of production at Palco's Carlotta mill. In connection with the reduction, Palco charged \$1.4 million against earnings for employee severance and benefit costs. This amount is reflected in selling, general and administrative expenses in the Consolidated Statement of Operations for the nine months ended September 30, 2004. The employee severance and benefit costs were related to the termination of approximately 107 regular employees, the majority of whom were engaged in direct manufacturing activities at Palco's sawmill facilities. As of September 30, 2004, all of the \$1.4 million in severance and benefits had been paid.

### *Real Estate*

In April 2004, a subsidiary of the Company and a third party real estate development company formed a joint venture to develop a residential parcel located in the Mirada development. The Company is accounting for the joint venture under the equity method. In connection with the formation of the joint venture, the Company sold a 50% interest in the parcel for \$4.5 million and contributed the remainder of the parcel to the joint venture in return for a 50% interest in the venture.

In connection with the 2003 lease termination of the Company's casino facility at its Palmas del Mar operation in Puerto Rico, the Company recorded a charge to operating expense of \$1.4 million in the third quarter of 2003 related to the write-down of casino related assets to estimated fair value.

#### *Corporate*

In connection with a suit filed by the Company against a group of its insurers in which it sought reimbursement of expenses related to the *OTS* and *FDIC* actions, the Company settled with the insurers for \$8.0 million in the first quarter of 2003. This amount is reflected in other income in the Consolidated Statement of Operations.

The Company recorded a charge to operating expense of \$1.9 million in the third quarter of 2004 in connection with an environmental matter associated with a former subsidiary of the Company. See Note 9 for further discussion.

#### **4. Restricted Cash, Cash Equivalents, Marketable Securities and Other Investments**

In addition to the non-current restricted cash, marketable securities and other investments reflected on the Company's balance sheet, the following current amounts are restricted under various agreements (in millions):

	September 30, 2004	December 31, 2003
Cash and cash equivalents . . . . .	\$ 4.2	\$ 4.0
Marketable securities and other short-term investments . . . . .	25.1	22.2

#### **5. Debt**

At September 30, 2004, \$12.1 million in borrowings and \$0.3 million in letters of credit were outstanding under the Palco Credit Agreement. In accordance with the agreement, Palco is required to maintain a certain base level of borrowings through February 12, 2005, based on certain collateral balances. Palco is also required to meet certain quarterly earnings thresholds under a covenant of the Palco Credit Agreement. Palco was in compliance with these covenants at September 30, 2004.

At September 30, 2004, Scotia LLC had unused availability of \$25.6 million under the Scotia LLC Line of Credit, and there was \$31.4 million outstanding under this facility.

During the first nine months of 2004, \$4.8 million of funds from the SAR Account were used to repurchase \$5.0 million principal amount of Timber Notes, as permitted under the Timber Notes Indenture, resulting in a small gain (net of unamortized deferred financing costs) on the repurchase of debt, which is included in other income in the accompanying financial statements.

Subsequent to September 30, 2004, \$5.7 million of funds from the SAR Account were used to repurchase \$5.7 million principal amount of Timber Notes, as permitted under the Timber Notes Indenture, resulting in a loss of \$0.3 million (net of unamortized deferred financing costs) on the repurchased debt.

#### **6. Income Taxes**

The Company generated a loss before income taxes of \$20.1 million for the third quarter and \$45.7 million for the first nine months of 2004; however, the Company has recorded no tax benefit associated with the loss for these periods. Each period, the Company evaluates appropriate factors in determining the realizability of the deferred tax assets attributable to losses and credits generated in the current period and those being carried forward. These factors are discussed further in Note 10 to the Company's consolidated financial statements included in the Form 10-K. Based on this evaluation, the Company provided valuation allowances with respect to the deferred tax assets attributable to the losses and credits generated during the three and nine months ended September 30, 2004. These valuation allowances were in addition to the valuation allowances which were provided in prior years.

## 7. Employee Benefit Plans

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

	<b>Pension Benefits</b>		<b>Medical/Life Benefits</b>		<b>Pension Benefits</b>		<b>Medical/Life Benefits</b>	
	<b>Three Months Ended September 30,</b>		<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2004</b>	<b>2003</b>	<b>2004</b>	<b>2003</b>	<b>2004</b>	<b>2003</b>	<b>2004</b>	<b>2003</b>
Components of net periodic benefit costs:								
Service cost	\$ 0.7	\$ 0.7	\$ 0.1	\$ 0.1	\$ 2.1	\$ 2.1	\$ 0.3	\$ 0.3
Interest cost	1.4	1.3	0.2	0.2	4.2	3.9	0.6	0.6
Expected return on assets	(1.3)	(1.2)	—	—	(3.9)	(3.6)	—	—
Amortization of prior service costs	—	—	(0.1)	—	—	—	(0.3)	—
Recognized net actuarial loss	—	—	—	—	0.1	—	—	—
Curtailment	—	—	—	—	—	—	(0.1)	—
Net periodic benefit costs	<u>\$ 0.8</u>	<u>\$ 0.8</u>	<u>\$ 0.2</u>	<u>\$ 0.3</u>	<u>\$ 2.5</u>	<u>\$ 2.4</u>	<u>\$ 0.5</u>	<u>\$ 0.9</u>

Through October 31, 2004, the Company had contributed \$1.0 million to such plans. Management expects that no additional contributions to the Company's benefit plans will be made in 2004.

## 8. Investment in Kaiser

As discussed further in the Form 10-K, Kaiser, its wholly owned subsidiary, KACC, and 24 of KACC's subsidiaries have filed separate voluntary petitions in the Bankruptcy Court for reorganization under Chapter 11 of the Code. The Debtors currently believe that, with limited exceptions, it is likely that substantially all pre-Filing Date claims will be settled at less than 100% of their face value and the equity interests of Kaiser's stockholders, including the Company, will be cancelled without consideration.

As provided by the Code, the Debtors had the exclusive right to propose a plan of reorganization for 120 days following the initial Filing Date. The Bankruptcy Court has subsequently approved several extensions of the exclusivity period for the Debtors. Most recently, the Bankruptcy Court approved an extension of exclusivity as to all Debtors to February 28, 2005, but the approved order provides that exclusivity can be terminated earlier with respect to certain Debtors in accordance with the terms of an intercompany settlement agreement that is pending before the Bankruptcy Court. Kaiser has indicated that additional extensions may be sought. However, no assurance can be given that any such future extension requests will be granted by the Bankruptcy Court. If the Debtors fail to file a plan of reorganization during the exclusivity period, or if such plan is not accepted by the requisite number of creditors and equity holders entitled to vote on the plan, other parties in interest in the Cases may be permitted to propose their own plan(s) of reorganization for the Debtors.

Kaiser's common stock is publicly traded on the OTC Bulletin Board under the trading symbol "KLUCQ." The market value for the 50,000,000 Kaiser Shares, based on the price per share quoted at the close of business on November 5, 2004, was \$2.5 million. There can be no assurance that such value would be realized should the Kaiser Shares be sold.

Since Kaiser's results are no longer consolidated with the Company's results, and the Company believes it is not probable that it will be obligated to fund losses related to its investment in Kaiser, any material uncertainties related to Kaiser are not expected to impact the Company's financial results.

## 9. Contingencies

### *Forest Products Operations*

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

### *Environmental Plans*

From March 1999 until October 2002, the Company prepared THPs in accordance with the SYP. The SYP was intended to comply with regulations of the California Board of Forestry and Fire Protection requiring timber companies to project timber growth and harvest on their timberlands over a 100-year planning period and to demonstrate that their projected average annual harvest for any decade within a 100-year planning period would not exceed the average annual

growth level during the last decade of the 100-year planning period. The forest practice rules allow companies which do not have a sustained yield plan to follow an alternative procedure to document compliance with the sustained yield requirements. As discussed below, on October 31, 2003, the Court hearing the *EPIC-SYP/Permits lawsuit* entered a judgment invalidating the SYP and the California Permits. As a result of an earlier stay order issued in this case, Palco has since October 2002 been obtaining review and approval of THPs under this alternative procedure and expects to follow this procedure for the foreseeable future.

The HCP and related Federal Permits allow incidental “take” of certain federally listed species located on the Company’s 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 required in connection with the implementation of the Environmental Plans, and this work could continue for several more years.

#### *Water Quality*

Laws and regulations dealing with water quality are impacting the Company primarily in three areas: efforts by the EPA and the North Coast Water Board to establish TMDLs in water courses 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 Company’s timberlands and in some cases, clean-up or prevention measures; and other actions by the North Coast Water Board during the THP approval process which impose certain operational requirements on individual THPs.

Under the California Water Quality Control Act and the CWA, the EPA is required to establish the TMDLs in water courses 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 water courses that flow within the Company’s timberlands. The Company expects this process to continue into 2010. The final TMDL requirements applicable to the Company’s 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.

Since the 2002-2003 winter operating period, Palco has been required to submit “Reports of Waste Discharge” to the North Coast Water Board each year in order to conduct winter harvesting activities in the Elk River and Freshwater watersheds. After consideration of these reports, the North Coast Water Board imposed requirements on Palco to implement additional mitigation and erosion control practices in these watersheds for the last two winter operating periods. In addition, the North Coast Water Board has extended the requirements for certain mitigation and erosion control practices to the Bear, Jordan and Stitz watersheds. Reporting and mitigation requirements imposed by the North Coast Water Board have modestly increased operating costs and may in the future further increase costs, cause delays in THP approvals or lower harvest levels. In addition, the North Coast Water Board has issued the Elk River Order which is aimed at addressing existing sediment production sites in the Elk River watershed through clean up actions. The North Coast Water Board has also initiated the process which could result in similar orders for the Freshwater and Bear Creek watersheds, and is contemplating similar actions for the Jordan and Stitz Creek watersheds. The Elk River Order has resulted in increased costs to Palco that could extend over a number of years. Additional orders in other watersheds (should they be issued) may also result in increased costs. Palco’s appeal of the Elk River Order to the State Water Board was denied. Palco is in the process of appealing in state court the decision of the State Water Board. These matters could reduce harvest levels as Palco is not able to readily move its harvesting activities between watersheds due to, among other things, historic harvest patterns, adjacency restrictions, and the age classes of trees.

Effective January 1, 2004, California Senate Bill 810 provides regional water quality control boards with additional authority related to the approval of THPs on land within impaired watersheds. The Company is uncertain of the operational and financial effects which will ultimately result from Senate Bill 810; however, because substantially all rivers and waterbodies on the Company’s timberlands are classified as impaired, implementation of this law could result in delays in obtaining approvals of THPs, lower harvest levels and increased costs and additional protection measures beyond those contained in the HCP.

#### *Timber Harvest Litigation*

A California state court has invalidated the SYP in connection with two lawsuits filed against Palco, as described below, which decision has been appealed. Other judicial and administrative proceedings are pending which could have the result of preventing the Company from implementing the HCP, implementing certain of the Company’s approved THPs, or carrying out certain other operations.

In March 1999, the *EPIC-SYP/Permits lawsuit* was filed. This action alleged, among other things, various violations of the CESA and the California Environmental Quality Act, and challenged, among other things, the validity and legality of the SYP and the California Permits. The plaintiffs sought, among other things, to set aside California's approval of the SYP and the California Permits and injunctive relief to prevent implementation of THPs approved in reliance upon these documents. In March 1999, the *USWA lawsuit*, a similar action, was filed challenging the validity and legality of the SYP. The *EPIC-SYP/Permits* and *USWA lawsuits* were consolidated for trial. On October 31, 2003, the Court entered a judgment invalidating the SYP and the California Permits due to several deficiencies in agency procedures and the failure of Palco to submit a complete and comprehensible SYP. The Court's decision, however, allowed for harvesting on THPs which rely on the SYP and were approved prior to July 23, 2003. The short-term effect of the ruling was to preclude approval, under the SYP, of a small number of THPs which were under review but had not been approved, and a minor reduction in 2003 harvesting that had been expected from these specific THPs. As a result of this case, Palco has since October 2002, when the Court issued a stay order preventing future reliance upon the SYP, been obtaining review and approval of new THPs under a procedure provided for in the forest practice rules that does not depend upon the SYP and the California Permits and expects to follow this procedure for the foreseeable future. In November 2003, Palco appealed the October 31, 2003, decision. In January 2004, the plaintiffs in these lawsuits filed claims against the defendants totaling \$5.8 million for reimbursement of attorneys fees and other expenses incurred in connection with these matters, and the trial judge granted the request for reimbursement on September 24, 2004. Palco and the State of California have appealed this decision.

In July 2001, the *Bear Creek lawsuit* was filed and later amended to add the EPA as a defendant. The lawsuit alleges that Palco's harvesting and other forestry activities under certain of its approved THPs will result in discharges of pollutants in violation of the CWA. The plaintiff asserts that the CWA requires the defendants to obtain a permit from the North Coast Water Board before beginning timber harvesting and road construction activities and is seeking to enjoin these activities until such permit has been obtained. The plaintiff also seeks civil penalties of up to \$27,500 per day for the defendant's alleged continued violation of the CWA. On October 14, 2003, in connection with certain motions that had been filed, the Court upheld the validity of an EPA regulation which exempts harvesting and other forestry activities from certain discharge requirements. Both state and federal agencies, along with Palco and other timber companies, have relied upon this regulation for more than 25 years. However, the Court interpreted the regulation in such a way as to narrow the forestry operations which are exempted, thereby limiting the regulation's applicability and subjecting culverts and ditches to permit requirements. This ruling has widespread implications for the timber industry in the United States. The case is not yet final as the trial has not yet been held, and there are many unresolved issues involving interpretation of the Court's decision and its application to actual operations. Should the decision ultimately become final and held to apply to all Palco's timber operations, it may have some or all of the following effects: impose additional permitting requirements, delay approvals of THPs, increase harvesting costs, and add water protection measures beyond those contained in the HCP. Nonetheless, it is not likely that civil penalties will be awarded for operations that occurred prior to the Court's decision due to the historical reliance by timber companies on the regulation and the Company's belief that the requirements under the HCP are adequate to ensure that sediment and pollutants from its harvesting activities will not reach levels harmful to the environment. While the impact of a conclusion to this case that upholds the October 14, 2003, ruling may be adverse, the Company does not believe that such an outcome would have a material adverse impact on the Company's consolidated financial condition, results of operations or liquidity. Nevertheless, due to the numerous ways in which the Court's interpretation of the regulation could be applied to actual operations, there can be no assurance that this will be the case.

In November 2002, the *Cook* and the *Cave actions* were filed which name Palco and certain affiliates as defendants. In April 2003, the plaintiffs in these actions filed amended complaints and served the defendants with notice of the actions. The *Cook action* alleges, among other things, that defendants' logging practices have contributed to an increase in flooding along Freshwater Creek (which runs through Palco's 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 Palco's timberlands). The Company does not believe the resolution of these actions should result in a material adverse effect on its financial condition, results of operations or liquidity.

In February 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 Palco, Scotia LLC and Salmon Creek used certain unfair business practices in connection with completion of the Headwaters Agreement, and that this resulted in the ability to harvest significantly more trees under the Environmental Plans than would have otherwise been the case. The suit sought a variety of remedies including a civil penalty of \$2,500 for each additional tree that has been or will be harvested due

to this alleged increase in harvest, as well as restitution and an injunction in respect of the additional timber harvesting allegedly being conducted. In response to motions filed by Palco for sanctions and dismissal of this suit, on April 30, 2004, the Court issued a ruling requiring the District Attorney to amend his suit to prove that “extrinsic” fraud occurred. In addition, the Court eliminated the remedies being sought, other than for civil penalties, and suggested that it would be inappropriate to base civil penalties on the additional trees harvested. The Court also ruled that it declined “at this juncture” to impose sanctions on the District Attorney. The Company believes that this suit is without merit and that the April 30 ruling diminished significantly its exposure with respect to this matter; however, there can be no assurance that Palco will ultimately prevail or that an adverse outcome would not be material to the Company’s consolidated financial condition, results of operations and/or liquidity.

In December 2003, the *HWC 2003 lawsuit*, naming Palco as a real party in interest, was filed. The plaintiffs allege that the North Coast Water Board should have required waste discharge reports in respect of all timber harvesting activities in the Freshwater and Elk River watersheds, and are seeking to have this requirement imposed on Palco. The Company does not believe that the resolution of this action should result in a material adverse effect on its financial condition, results of operations or liquidity.

On November 2, 2004, the *EPIC-USFWS/NOAA lawsuit* was filed. The lawsuit alleges that two federal agencies have violated certain federal laws and related regulations in connection with their oversight of the HCP and Federal Permits. The plaintiff also alleges that the Federal Permit for the northern spotted owl was unlawfully issued and that Palco violated California’s unfair competition law by using false advertising and making misleading environmental claims. The plaintiff seeks a variety of remedies including requiring additional actions by the federal agencies and precluding them from authorizing take of the northern spotted owl, an injunction requiring Palco to cease certain alleged unlawful activities, as well as restitution and remediation by Palco. Palco is still in the process of evaluating this lawsuit.

The *Van Duzen THPs lawsuit* was filed on November 4, 2004, seeking a writ of mandate to stay or set aside CDF’s approval of six THPs along the Van Duzen River submitted by Palco. The plaintiffs allege that these THPs rely on information submitted to CDF by Palco intended to demonstrate Palco’s compliance with California’s sustained yield requirements that was not made available for public review and comment. In addition to the relief described above, the plaintiffs seek a writ of mandate ordering CDF to conduct further review and analysis of the six THPs and to refrain from reliance on the information not made public. Palco is still in the process of evaluating this lawsuit.

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

#### *OTS Contingency and Related Matters*

In 1995, the OTS initiated the *OTS action* against 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. On October 17, 2002, the *OTS action* was settled for \$0.2 million with no admission of wrongdoing on the part of the Respondents. Also in 1995, the FDIC filed the *FDIC action* alleging damages in excess of \$250.0 million based on the allegation that Mr. Charles Hurwitz (Chairman and Chief Executive Officer of the Company) was a controlling shareholder, *de facto* senior officer and director of USAT, and was involved in certain decisions which contributed to the insolvency of USAT. The *FDIC action* has been dismissed as a result of the settlement of the *OTS action*. This dismissal does not affect the Sanctions Motion described in the following paragraph.

In connection with the *FDIC action*, the Respondents filed the Sanctions Motion which states that the FDIC illegally paid the OTS to bring claims against the Respondents and that the FDIC illegally sued for an improper purpose. 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 September 30, 2004, such fees were in excess of \$40.8 million. The Respondents are pursuing this claim vigorously.

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.

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

#### *Other Matters*

On September 2, 2004, the Company was advised that one of its former subsidiaries is a successor to a company which manufactured munitions for the U.S. Navy during World War II. The current owner of the property is seeking the Company's participation in efforts to address contamination of the site which resulted from such operations. The current owner estimates that the costs to determine what remedial actions are needed, and to perform any remedial actions determined necessary, could range from \$3.0 million to \$8.0 million. Costs for the investigation and remediation could exceed \$8.0 million as the result of information learned during the investigation. The Company is currently in the process of determining the extent of its liability, which could require payment of a substantial portion of the costs, as well as the availability of funding from the U.S. Navy and insurance coverage for these activities. Such investigation is anticipated to take several months to complete. Selling, general and administrative expenses for the three and nine months ended September 30, 2004, included \$1.9 million related to this matter.

On January 21, 2004, the owner of the Candelero Hotel located at Palmas filed a lawsuit against PDMPI claiming an easement on certain property owned by PDMPI. The trial court subsequently ruled that the hotel owner has rights to the easement. The lawsuit also included a claim for damages. On September 30, 2004, this matter was settled by an agreement in which the hotel owner dismissed all of its claims and agreed to purchase for \$9.0 million a parcel of land that included the area covered by the alleged easement. This transaction closed in November 2004 and resulted in no loss to PDMPI.

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.

## **10. Stock-Based Compensation Plans**

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
Net loss, as reported	\$ (20.2)	\$ (6.3)	\$ (45.8)	\$ (24.9)
Add: Stock-based employee compensation expenses included in reported net loss, net of related tax effects	0.4	—	2.3	—
Deduct: Total stock-based employee compensation expense determined under the fair value method for all awards, net of related tax effects	(0.4)	(0.4)	(1.3)	(1.3)
Pro forma net loss	<u>\$ (20.2)</u>	<u>\$ (6.7)</u>	<u>\$ (44.8)</u>	<u>\$ (26.2)</u>
Basic and diluted loss per share:				
As reported	\$ (3.37)	\$ (0.96)	\$ (7.66)	\$ (3.81)
Pro forma	(3.38)	(1.03)	(7.49)	(4.02)

## 11. Per Share Information

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
Weighted average shares outstanding:				
Common Stock	5,976,466	6,517,691	5,976,466	6,522,435
Effect of dilution:				
Class A Preferred Stock <sup>(1)</sup>	—	—	—	—
Weighted average number of common and common equivalent shares - Basic earnings per share	5,976,466	6,517,691	5,976,466	6,522,435
Effect of dilution:				
Stock options <sup>(1)</sup>	—	—	—	—
Weighted average number of common and common equivalent shares - Diluted earnings per share	<u>5,976,466</u>	<u>6,517,691</u>	<u>5,976,466</u>	<u>6,522,435</u>

<sup>(1)</sup> The Class A Preferred Stock and options were not included in the computation of basic or diluted earnings per share because the Company had a loss for the three and nine months ended September 30, 2004 and 2003, respectively.

## 12. Comprehensive Loss

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
Net loss:	\$ (20.2)	\$ (6.3)	\$ (45.8)	\$ (24.9)
Other comprehensive income (loss):				
Unrealized gains (losses) on available-for-sale investments	0.3	(0.4)	(1.5)	0.4
Applicable income tax benefit (expense)	—	—	—	—
Total comprehensive loss	<u>\$ (19.9)</u>	<u>\$ (6.7)</u>	<u>\$ (47.3)</u>	<u>\$ (24.5)</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 section and in Part II. Item 1. "Legal Proceedings." Such statements can be identified by the use of forward-looking terminology such as "believes," "expects," "may," "estimates," "will," "should," "plans" 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 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

The Company operates in three industries: forest products, through MGI and its wholly owned subsidiaries, principally Palco, Scotia LLC and Britt; real estate investment and development, through various subsidiaries; and racing operations through SHRP, Ltd. MGHI owns 100% of MGI and is a wholly owned subsidiary of the Company. In addition, the Company owns approximately 63% of Kaiser, an integrated aluminum producer. All references to the "Company," "Kaiser," "MGHI," "MGI," "Palco," "MPC" and "SHRP, Ltd." refer to the respective companies and their subsidiaries, unless otherwise indicated or the context indicates otherwise.

#### Consolidated Operations

##### Selected Operational Data

The following table presents selected financial information for the three and nine months ended September 30, 2004 and 2003 for the Company's consolidated operations.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
Net sales .....	\$ 81.5	\$ 89.4	\$ 242.9	\$ 242.8
Costs and expenses .....	(83.2)	(80.5)	(242.1)	(228.7)
Gains on sales of timberlands and other assets .....	0.2	—	0.2	—
Operating income .....	(1.5)	8.9	1.0	14.1
Other income, net .....	—	3.8	9.0	18.9
Interest expense .....	(18.6)	(19.0)	(55.7)	(57.9)
Loss before income taxes .....	<u>\$ (20.1)</u>	<u>\$ (6.3)</u>	<u>\$ (45.7)</u>	<u>\$ (24.9)</u>

##### Deconsolidation of Kaiser

See Notes 1 and 8 for information regarding the deconsolidation of Kaiser's financial results and the Company's investment in Kaiser.

#### Overview of Consolidated Results of Operations

##### Net Sales

Consolidated net sales for the third quarter of 2004 totaled \$81.5 million, compared to \$89.4 million for the third quarter of 2003. Net sales for the Company's forest products segment declined by \$6.5 million due primarily to a decrease in sales volumes of lumber as production levels were temporarily adversely impacted by the transition to

Palco's new sawmill. See Note 3 and Item 7. "Management Discussion and Analysis of Financial Condition and Results of Operations—Financial Condition and Investing and Financing—Forest Products Operations" of the Form 10-K for a discussion of Palco's new sawmill. Net sales for the real estate segment were essentially unchanged, while net sales for the racing segment decreased \$1.3 million due to a decrease in average daily attendance.

Consolidated net sales for the nine months ended September 30, 2004 totaled \$242.9 million, compared to \$242.8 million for the prior year period. Net sales for the Company's forest products segment decreased \$7.4 million due to decreases in lumber and log volumes and net sales of wood chips, cogeneration power and other product lines. Net sales for the real estate segment increased \$6.4 million due to higher sales of real estate acreage and increases in net sales from resort and commercial operations. Net sales for the racing segment increased \$1.1 million due to more live race days being held.

#### *Operating Income (Loss)*

The Company recorded an operating loss of \$1.5 million in the third quarter of 2004 compared to operating income of \$8.9 million in the third quarter of 2003. Operating results for the forest products segment declined by \$5.8 million, primarily as a result of lower lumber volumes and higher per unit operating expenses due to Palco's transition of operations to its new sawmill noted above. Operating income for the real estate segment declined by \$1.7 million, driven largely by lower gross margins at Fountain Hills where real estate sales were derived primarily from lot sales in 2004 versus acreage sales in 2003, which contributed to higher operating income for that period. The racing segment's operating loss increased from \$0.7 million for the third quarter of 2003 to \$1.5 million for the third quarter of 2004 primarily due to the lower average daily attendance noted above. The corporate segment's operating loss increased \$2.1 million due primarily to an accrual for an environmental matter discussed under "Other Matters" in Note 9.

The Company recorded operating income of \$1.0 million for the nine months ended September 30, 2004 compared to operating income of \$14.1 million for the prior year period. Operating results for the forest products segment declined by \$13.7 million, primarily as a result of lower lumber and log volumes and higher per unit operating expenses noted above. The real estate segment recorded operating income of \$10.3 million versus operating income of \$4.3 million for the year-ago period primarily due to the increases in net sales noted above. The racing segment's operating loss increased by \$0.4 million despite the increase in live race days noted above due to an increase in marketing and development costs. The corporate segment's operating loss increased by \$5.0 million due primarily to an increase in stock-based compensation expense which is adjusted as the market value of the Company's Common Stock changes and an accrual for an environmental matter noted above.

#### *Loss Before Income Taxes*

The Company's consolidated loss before income taxes increased by \$13.8 million in the third quarter of 2004 compared to the prior year third quarter, principally due to the decrease in operating income for the forest products segment, increased operating loss for the corporate segment, and a decline in investment and interest income of \$3.4 million.

The Company's consolidated loss before income taxes increased by \$20.8 million for the nine months ended September 30, 2004 compared to the prior year period, as results for 2003 included income related to an \$8.0 million reimbursement from an insurer for certain costs incurred in connection with *OTS* and *FDIC* actions. In addition, operating income for the forest products segment decreased by \$13.7 million, operating loss for the corporate segment increased by \$5.0 million, and investment and interest income declined by \$2.9 million. Results for the current period were favorably impacted, however, by a \$6.0 million improvement in operating income for the real estate segment.

### **Forest Products Operations**

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

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

The Company's forest products operations are conducted by MGI, principally through Palco, Scotia LLC and Britt. The segment's business is somewhat seasonal, and its net sales have historically been higher in the months of April through November than in the months of December through March. Management expects that MGI's revenues and cash flows will continue to be somewhat seasonal. Accordingly, MGI's results for any one quarter are not necessarily indicative of results to be expected for the full year.

Regulatory and environmental matters as well as certain pending legal matters play a significant role in the Company's forest products operations. Furthermore, there can be no assurance that future governmental regulations, legislation or judicial or administrative decisions, adverse weather conditions, or low lumber or log prices, will not have a material adverse effect on the Company's financial condition, results of operations or liquidity. See Note 9 and Item 1. "Business – Forest Products Operations – Regulatory and Environmental Factors" of the Form 10-K for a discussion of these matters.

The following table presents selected operational and financial information for the three and nine months ended September 30, 2004 and 2003, for the Company's forest products operations.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
	(In millions of dollars, except shipments and prices)			
Shipments:				
Lumber: <sup>(1)</sup>				
Redwood upper grades	4.7	7.5	14.2	19.8
Redwood common grades	53.3	53.3	154.5	162.1
Douglas-fir upper grades	0.4	1.3	1.7	2.9
Douglas-fir common grades	10.6	12.9	39.1	32.9
Other	–	3.4	5.0	6.5
Total lumber	69.0	78.4	214.5	224.2
Cogeneration power <sup>(2)</sup>	43.6	42.2	120.4	123.0
Average sales price:				
Lumber: <sup>(3)</sup>				
Redwood upper grades	\$ 1,355	\$ 1,215	\$ 1,349	\$ 1,263
Redwood common grades	616	632	615	602
Douglas-fir upper grades	971	1,078	1,060	1,321
Douglas-fir common grades	501	366	453	348
Cogeneration power <sup>(4)</sup>	66	65	65	64
Net sales:				
Lumber, net of discount	\$ 44.0	\$ 48.6	\$ 133.6	\$ 137.8
Logs	1.2	3.0	3.6	4.9
Cogeneration power	3.0	2.8	8.1	8.8
Wood chips	0.6	0.8	1.9	2.7
Other	0.8	0.9	2.0	2.4
Total net sales	\$ 49.6	\$ 56.1	\$ 149.2	\$ 156.6
Operating income	\$ 1.0	\$ 6.8	\$ 3.2	\$ 16.9
Loss before income taxes	\$ (13.5)	\$ (6.1)	\$ (37.5)	\$ (22.7)

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

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

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

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

#### *Net Sales*

Net sales for the forest products segment decreased \$6.5 million for the third quarter of 2004 as compared to the same period of 2003. Net sales of lumber decreased \$4.6 million, primarily as a result of lower sales volumes of lumber as production levels were temporarily adversely impacted by the transition to Palco's new sawmill. Net sales of wood chips also decreased due to the transition to the new sawmill. Net sales of logs decreased due to decreased harvest.

Net sales for the nine months ended September 30, 2004, decreased \$7.4 million from the comparable prior year period as a result of the lower sales volumes of lumber and logs and decreases in net sales of wood chips and cogeneration power. In particular, wood chips decreased \$0.8 million due to the new sawmill transition discussed above. Also, sales of surplus power from Palco's cogeneration power plant declined \$0.7 million due to lower production of power caused by a lower quality of fuel compared to the prior year period, reducing the availability of surplus power for sale to third parties.

#### *Operating Income*

Operating results for the segment declined for both the third quarter and nine months ended September 30, 2004

compared to the same periods of 2003, primarily due to lower net sales and higher operating expenses. Declines in harvest have resulted in increased purchases of logs from third parties, increasing cost of goods sold by approximately \$6.1 million for the first nine months of 2004 as compared to the prior year period. The decline in harvest has also led to higher fixed costs per unit of volume. Selling, general and administrative expenses for the first nine months of 2004 also increased, primarily due to \$1.4 million in severance and benefit payments as a result of Palco's voluntary reduction in workforce (see Note 3). In addition, operating results for the first nine months of 2003 included net gains on sales of timberlands and other assets of \$0.9 million, compared to \$0.2 million for the first nine months of 2004.

#### *Loss Before Income Taxes*

The forest products segment's loss before income taxes increased for the third quarter and nine months ended September 30, 2004, as compared to the prior year periods, primarily due to the decreases in operating results discussed above. In addition, earnings on cash, cash equivalents and other investments declined, although these declines were partially offset by decreases in interest expense.

### **Real Estate Operations**

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

The Company, principally through its wholly owned subsidiaries, invests in and develops residential and commercial real estate primarily in Arizona, California, Puerto Rico, and Texas. The following table presents selected operational and financial information for the three and nine months ended September 30, 2004 and 2003, for the Company's real estate operations.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
	(In millions of dollars)			
Net sales:				
Real estate:				
Fountain Hills .....	\$ 5.1	\$ 9.0	\$ 8.5	\$ 16.0
Mirada .....	3.8	3.4	9.5	5.3
Palmas .....	2.3	0.7	10.4	5.8
Total .....	<u>11.2</u>	<u>13.1</u>	<u>28.4</u>	<u>27.1</u>
Resort, commercial and other:				
Fountain Hills .....	1.7	1.2	5.0	3.0
Mirada .....	0.1	0.2	0.1	0.2
Palmas .....	2.8	1.9	8.6	6.3
Commercial lease properties .....	4.4	3.9	12.8	11.9
Other .....	0.1	0.1	0.2	0.2
Total .....	<u>9.1</u>	<u>7.3</u>	<u>26.7</u>	<u>21.6</u>
Total net sales .....	<u>\$ 20.3</u>	<u>\$ 20.4</u>	<u>\$ 55.1</u>	<u>\$ 48.7</u>
Operating income (loss):				
Fountain Hills .....	\$ 2.2	\$ 6.8	\$ 3.1	\$ 9.3
Mirada .....	1.6	1.8	3.3	0.7
Palmas .....	(2.3)	(5.0)	(0.5)	(9.5)
Commercial lease properties .....	1.9	1.4	5.3	4.4
Other .....	(0.2)	(0.1)	(0.9)	(0.6)
Total operating income .....	<u>\$ 3.2</u>	<u>\$ 4.9</u>	<u>\$ 10.3</u>	<u>\$ 4.3</u>
Investment, interest and other income, net:				
Equity in earnings from real estate joint ventures .....	\$ —	\$ 0.2	\$ 2.9	\$ 1.2
Other .....	0.6	0.5	3.7	1.8
	<u>\$ 0.6</u>	<u>\$ 0.7</u>	<u>\$ 6.6</u>	<u>\$ 3.0</u>
Income (loss) before income taxes .....	<u>\$ (0.7)</u>	<u>\$ 0.8</u>	<u>\$ 3.1</u>	<u>\$ (7.0)</u>

#### *Net Sales*

Net sales for the real estate segment for the third quarter of 2004 were comparable to the results for the prior year

period as the decline in Fountain Hills acreage sales was offset by increased acreage sales at Palmas del Mar and increases in net sales from commercial operations at Palmas del Mar and Fountain Hills.

Net sales for the real estate segment increased \$6.4 million for the nine months ended September 30, 2004, as compared to the prior year period, largely driven by acreage sales at Palmas del Mar and Mirada, in addition to increases in net sales from commercial operations at Palmas del Mar and Fountain Hills.

*Operating Income (Loss) and Income (Loss) Before Income Taxes*

Operating results declined by \$1.7 million for the third quarter of 2004 versus the same period of 2003 despite comparable net sales between the periods. This was primarily a result of net sales for Fountain Hills being largely attributable to sales of lots, which typically generate lower gross margins, in the 2004 third quarter, whereas the third quarter for 2003 reflects the impact of a higher margin acreage sale in Fountain Hills. Operating results increased by \$6.0 million for the nine months ended September 30, 2004 versus the same period of 2003, primarily due to the change in net sales discussed above. The segment realized a loss before income taxes of \$0.7 million for the third quarter of 2004, as compared to earnings of \$0.8 million for the same period of 2003, due to the lower operating results discussed above. The segment realized income before income taxes of \$3.1 million for the nine months ended September 30, 2004 versus a loss of \$7.0 million for the comparable period of 2003, due to the higher operating results discussed above as well as an increase in equity earnings from FireRock, LLC and interest income.

***Racing Operations***

*Industry Overview and Selected Operational Data*

The Company indirectly owns SHRP, Ltd., a Texas limited partnership, which owns and operates Sam Houston Race Park, a Class 1 horse racing facility in Houston, Texas, and Valley Race Park, a greyhound racing facility located in Harlingen, Texas. Results of operations between periods are generally not comparable due to the timing, varying lengths and types of racing meets held. 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. However, as discussed further in the Form 10-K, Sam Houston Race Park was granted additional live race days in 2004. As a result, the number of live race days increased by 39 in the first nine months of 2004.

The following table presents selected operational and financial information for the three and nine months ended September 30, 2004 and 2003, for the Company's racing operations.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
	(In millions of dollars)			
Number of live race days:				
Sam Houston Race Park .....	46	43	130	91
Valley Race Park .....	—	—	81	82
Handle:				
Sam Houston Race Park:				
On-track handle .....	\$ 33.1	\$ 37.1	\$ 105.3	\$ 103.6
Off-track handle .....	19.0	19.6	137.1	121.9
Total .....	<u>\$ 52.1</u>	<u>\$ 56.7</u>	<u>\$ 242.4</u>	<u>\$ 225.5</u>
Valley Race Park:				
On-track handle .....	\$ 3.9	\$ 4.3	\$ 15.2	\$ 15.8
Off-track handle .....	—	—	3.0	3.2
Total .....	<u>\$ 3.9</u>	<u>\$ 4.3</u>	<u>\$ 18.2</u>	<u>\$ 19.0</u>
Net sales:				
Sam Houston Race Park:				
Gross pari-mutuel commissions .....	\$ 7.8	\$ 8.8	\$ 26.9	\$ 26.2
Other revenues .....	2.8	3.0	7.3	6.7
Total .....	<u>10.6</u>	<u>11.8</u>	<u>34.2</u>	<u>32.9</u>
Valley Race Park:				
Gross pari-mutuel commissions .....	0.9	0.9	3.6	3.8
Other revenues .....	0.1	0.2	0.8	0.8
Total .....	<u>1.0</u>	<u>1.1</u>	<u>4.4</u>	<u>4.6</u>
Total net sales .....	<u>\$ 11.6</u>	<u>\$ 12.9</u>	<u>\$ 38.6</u>	<u>\$ 37.5</u>
Operating loss:				
Sam Houston Race Park .....	\$ (1.2)	\$ (0.6)	\$ (1.2)	\$ (0.9)
Valley Race Park .....	(0.3)	(0.1)	(0.5)	(0.4)
Total operating loss: .....	<u>\$ (1.5)</u>	<u>\$ (0.7)</u>	<u>\$ (1.7)</u>	<u>\$ (1.3)</u>
Loss before income taxes .....	<u>\$ (1.5)</u>	<u>\$ (0.4)</u>	<u>\$ (1.7)</u>	<u>\$ (1.1)</u>

#### *Net Sales*

Net sales for the racing segment decreased \$1.3 million for the third quarter of 2004, compared to the prior year period, primarily due to a lower average daily attendance at Sam Houston Race Park. Net sales for the nine months ended September 30, 2004, increased \$1.1 million compared to the prior year period of 2003 due to 39 more live race days at Sam Houston Race Park. Net sales for Valley Race Park for both the third quarter and the first nine months of 2004 were comparable to the prior year periods.

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

The racing segment's operating loss and loss before taxes for the third quarter of 2004 increased versus the prior year period due to the lower net sales discussed above. Despite an increase in net sales for the nine months of 2004, the operating loss increased versus the prior year period primarily due to higher marketing and development costs.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
	(In millions of dollars)			
Operating loss .....	\$ (4.2)	\$ (2.1)	\$ (10.8)	\$ (5.8)
Income (loss) before income taxes .....	(4.4)	(0.6)	(9.6)	5.9

The operating losses in the table above represent corporate general and administrative expenses that are not allocated to the Company's industry segments. For the quarter ended September 30, 2004, such losses include \$1.9 million related to an accrual for an environmental matter discussed under "Other Matters" in Note 9. In addition to this accrual, results for the nine months ended September 30, 2004 include \$2.3 million related to an increase in stock-based compensation expense, which is adjusted as the market value of the Company's Common Stock changes. Income before income taxes for 2003 includes \$8.0 million related to reimbursement by an insurer for certain costs incurred in connection with the *OTS* and *FDIC actions* (see Note 9).

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

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

### ***Overview***

The Company conducts its operations primarily through its subsidiaries. Creditors of subsidiaries of the Company have priority with respect to the assets and earnings of such subsidiaries over the claims of the creditors of the Company. Certain of the Company's subsidiaries, principally Palco and Scotia LLC, are restricted by their various debt instruments as to the amount of funds that can be paid in the form of dividends or loaned to affiliates. Scotia LLC is highly leveraged and has significant debt service requirements. In addition, Palco's anticipated capital expenditures for investments in new sawmill equipment will require cash from existing resources as well as Palco's credit facility (see "Forest Product Operations" below for further information regarding Palco's credit facility). "MAXXAM Parent" is used in this section to refer to the Company on a stand-alone basis without its subsidiaries.

### ***Cash Flow***

#### ***Operating Activities***

Net cash used for operating activities of \$14.6 million for the nine months ended September 30, 2004, principally reflects a net loss, after adding back depreciation, depletion and amortization, and reserve for environmental remediation, of \$17.3 million. In addition, \$14.2 million related to the payments of interest on the Timber Notes was offset by an increase in long-term assets and other accrued liabilities of \$14.1 million.

#### ***Investing Activities***

Net cash used for investing activities of \$5.6 million for the nine months ended September 30, 2004, principally reflects capital expenditures of \$27.3 million, \$18.6 million of which were related to Palco's new sawmill project (see Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations - Financial Condition and Investing and Financing Activities - Forest Products Operations" of the Form 10-K for a discussion of Palco's new sawmill project), offset by proceeds from the sale of marketable securities and other short-term investments of \$21.2 million.

#### ***Financing Activities***

Net cash provided by financing activities of \$21.1 million for the nine months ended September 30, 2004, principally reflects net borrowings on the Scotia LLC and Palco Lines of Credit of \$31.4 million and \$12.1 million, respectively, offset by a \$13.5 million repayment on a real estate credit facility related to the Mirada real estate development.

### ***MAXXAM Parent***

MAXXAM Parent believes that its existing resources will be sufficient to fund its working capital requirements for the next year. With respect to long-term liquidity, MAXXAM Parent believes that its existing cash and cash resources, together with distributions from the real estate and racing segments, should be sufficient to meet its working capital requirements. However, there can be no assurance that this will be the case.

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

On September 30, 2004, Scotia LLC had unused availability of \$25.6 million under the Scotia LLC Line of Credit, and there was \$31.4 million outstanding under this facility.

On the note payment date in January 2004, Scotia LLC had \$4.1 million set aside in the note payment account to

pay the \$27.2 million of interest due (net of \$2.0 million of additional interest due in respect of Timber Notes held by Scotia LLC). The funds available under the Scotia LLC Line of Credit were used to pay the remaining amount of interest due. Scotia LLC repaid \$12.7 million of principal on the Timber Notes (an amount equal to Scheduled Amortization) using funds held in the SAR Account.

On the note payment date in July 2004, Scotia LLC used \$26.6 million (net of \$2.1 million of additional interest due in respect of Timber Notes held by Scotia LLC) of the funds available under the Scotia LLC Line of Credit to pay the entire amount of interest due. Scotia LLC repaid \$4.5 million of principal on the Timber Notes (an amount equal to Scheduled Amortization) using funds held in the SAR Account.

With respect to the note payment date in January 2005, Scotia LLC expects to use the funds available under the Scotia LLC Line of Credit to pay the entire \$26.3 million of interest which will be due (net of \$2.2 million of additional interest which would be due in respect of Timber Notes held by Scotia LLC). Scotia LLC expects to repay \$10.8 million of principal on the Timber Notes (an amount equal to Scheduled Amortization) using funds held in the SAR Account.

During the first nine months of 2004, \$4.8 million of funds from the SAR Account were used to repurchase \$5.0 million principal amount of Timber Notes, as permitted under the Timber Notes Indenture, resulting in a small gain (net of unamortized deferred financing costs) on the repurchase of debt.

Subsequent to September 30, 2004, \$5.7 million of funds from the SAR Account were used to repurchase \$5.7 million principal amount of Timber Notes, as permitted under the Timber Notes Indenture, resulting in a loss of \$0.3 million (net of unamortized deferred financing costs) on the repurchased debt.

Due to its highly leveraged condition, Scotia LLC is more sensitive than less leveraged companies to factors affecting its operations, including low log prices, governmental regulation and litigation affecting timber harvesting practices on its timberlands (see Note 9), and general economic conditions. Scotia LLC's cash flows from operations are significantly impacted by harvest volumes and log prices. In June 2004, the State Board of Equalization adopted the new Harvest Value Schedule for the second half of 2004. The prices published in that schedule reflected a 1.6% increase in the SBE Price for small redwood logs and a 14.3% increase for small Douglas-fir logs from the prices published for the first half of 2004.

On June 8, 2004, Standard & Poor's Ratings Service announced that it was lowering its ratings on all classes of the Timber Notes. Ratings on the Class A-1 Timber Notes were lowered from BBB+ to BBB-; ratings on the Class A-2 Timber Notes were lowered from BBB to BB; and ratings on the Class A-3 Timber Notes were lowered from BB to B. Standard & Poor's also indicated that all ratings were removed from the agency's negative CreditWatch, where they were placed in November 2002, and that the lowered ratings reflect the negative impact that depressed timber prices, lower harvest levels and higher capital/operating costs have had on Scotia LLC's cash flow available for debt service.

With respect to short-term liquidity, Scotia LLC believes that cash flows from operations and funds available under the Scotia LLC Line of Credit (in respect of interest payments) and the SAR Account (in respect of principal payments), should provide sufficient funds to meet its working capital, capital expenditures and debt service obligations for the next twelve months; however, there can be no assurance that this will be the case. With respect to long-term liquidity, although Scotia LLC believes that cash flows from operations and funds available under the Scotia LLC Line of Credit and the SAR Account should be adequate to meet its working capital, capital expenditure and debt service obligations, unless log prices continue to improve there can be no assurance that this will be the case. In addition, liquidity, capital resources and results of operations will be adversely affected if harvest levels decline or costs increase as a result of the various regulatory, environmental and litigation matters discussed in Note 9.

At September 30, 2004, \$12.1 million in borrowings and \$0.3 million in letters of credit were outstanding under the Palco Credit Agreement. In accordance with the agreement, Palco is required to maintain a certain base level of borrowings through February 12, 2005, based on certain collateral balances. Palco is required to meet certain quarterly earnings thresholds under a covenant of the Palco Credit Agreement and was in compliance with these covenants at September 30, 2004.

Palco will require funds available under the Palco Credit Agreement in order to meet its working capital and capital expenditure requirements for the next year. Furthermore, Palco's cash flows from operations may be adversely affected by diminished availability of logs from Scotia LLC, lower lumber prices, adverse weather conditions, and pending legal, regulatory and environmental matters. See Note 9 for further discussion of the regulatory, environmental and legal matters affecting harvest levels.

With respect to long-term liquidity, although MGI and its subsidiaries expect that their existing cash and cash equivalents, lines of credit and ability to generate cash flows from operations should provide sufficient funds to meet their debt service, working capital and capital expenditure requirements, until such time as Palco has adequate cash flows from operations and/or dividends from Scotia LLC, there can be no assurance that this will be the case. Liquidity, capital resources and results of operations in the long-term may continue to be adversely affected by the same factors discussed above which are affecting short-term cash flows from operations.

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

As discussed further in “Trends—Real Estate Operations” below, one of the Company’s development projects in Fountain Hills was delayed, and this delay will result in fewer lot sales for 2004.

The Company believes that the existing cash and credit facilities of its real estate subsidiaries are sufficient to fund the working capital and capital expenditure requirements of such subsidiaries for the next year. With respect to the long-term liquidity of such subsidiaries, the Company believes that their ability to generate cash from the sale of their existing real estate, together with their ability to obtain financing and joint venture partners, should provide sufficient funds to meet their working capital and capital expenditure requirements. PDMPI and its subsidiaries, however, have required advances from MAXXAM Parent in prior years to fund their operations, and although the Company does not expect that PDMPI will require advances in the current fiscal year, PDMPI may from time to time require such advances.

### ***Racing Operations***

SHRP, Ltd. has generated cash flows from operations during the nine months ended September 30, 2004, largely as a result of having more live race days than typical. However, in the short term, SHRP, Ltd.’s management expects that SHRP, Ltd. may require advances from MAXXAM Parent to fund its operations and capital expenditures. SHRP, Ltd. is experiencing strong competition from internet wagering and “racinos” in surrounding states. These factors will also play a role in SHRP, Ltd.’s long-term liquidity.

### ***Kaiser’s Operations***

With respect to the Company’s interest in Kaiser, the Debtors believe that the equity of Kaiser’s stockholders will be cancelled without consideration. See Note 1 and 8 for further information.

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

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

### **Trends**

*This section contains statements which constitute “forward-looking statements” within the meaning of the PSLRA. See this section and above for cautionary information with respect to such forward-looking statements.*

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

As discussed in the Form 10-K, PDMPI is considering various alternatives to accelerate sales of its remaining 1,180 acres of undeveloped land as well as disposition of other assets. In connection with the foregoing, PDMPI has retained an agent to assist in its efforts to solicit developer and investor interest in acquiring such acreage and other assets.

As indicated in the Form 10-K, the Arizona Department of Water Resources had notified the local utility which supplies water to the Company’s Fountain Hills development that the demand for water in the utility’s service area exceeded certain statutory requirements. In April 2004, the Arizona Department of Water Resources approved a modification and renewal of the utility’s Assured Water Supply designation, thereby satisfactorily resolving this matter (both for the utility and the Fountain Hills development). Nevertheless, this matter has delayed one of the Company’s Fountain Hills projects, and this delay will result in fewer lot sales at the Fountain Hills development in 2004 than would have otherwise been the case.

## ***Racing Operations***

The Texas legislature, which convenes its regular session every other year, considered a variety of alternatives during the January-June 2003 session to address a projected budget shortfall, including enhancing state revenues through additional forms of gaming such as video lottery terminals at existing horse and dog racing tracks, gaming on Indian reservations, keno, and full casinos. The Texas legislature did not enact any such legislation during its regular session or during a special session convened in April 2004 to consider changes to the current manner in which public education is funded.

Should changes be made to the manner in which public school financing is currently funded, the Company expects that video lottery terminals at existing horse and dog tracks will be among the alternatives considered to replace any diminishment of current funding sources. The Company is vigorously pursuing such legislation. As such legislation would likely require the approval of two-thirds of each legislative house and a majority of the state's voters, no assurance can be given that any such legislation will be enacted or become effective. Moreover, it is impossible to determine what the provisions of any such legislation will be or their effect on the Company.

## **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 and estimates. 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 potential impact on the Company.

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

The Company is exposed to changes in interest rates primarily under the Scotia LLC Line of Credit and the Palco Credit Agreement, as well as certain other debt facilities used to finance real estate development activities. As of September 30, 2004, there were \$47.3 million in borrowings outstanding under all variable rate facilities. Based on the amount of borrowings outstanding under these facilities during the nine months ended September 30, 2004, a 1% change in interest rates effective from the beginning of the year would have resulted in an increase or decrease in interest expense for the period of \$0.3 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 Securities and Exchange Commission, 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, the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and the Company's Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based on the foregoing, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective.

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 9 is incorporated herein by reference.

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

The Company may from time to time purchase shares of its Common Stock on national exchanges or in privately negotiated transactions. No such purchases occurred during the nine months ended September 30, 2004, or through the date of this report.

### **ITEM 6. EXHIBITS**

- \*10.1 Amendment No. 2 to Palco Credit Agreement dated as of October 20, 2004
- 10.2 Retention Agreement of Diane Dudley (incorporated herein by reference to current report on Form 8-K dated September 9, 2004)
- \*31.1 Section 302 Certification of Chief Executive Officer
- \*31.2 Section 302 Certification of Chief Financial Officer
- \*32.1 Section 906 Certification of Chief Executive Officer
- \*32.2 Section 906 Certification of Chief Financial Officer

\* Included with this filing

## SIGNATURES

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

MAXXAM INC.

Date: November 12, 2004

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

Date: November 12, 2004

By: /S/ ELIZABETH D. BRUMLEY  
Elizabeth D. Brumley  
Vice President and Controller  
(Principal Accounting Officer)

## Glossary of Defined Terms

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

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

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

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

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

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

*Cases:* The Chapter 11 proceedings of the Debtors

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

*CDF:* California Department of Forestry and Fire Protection

*CESA:* California Endangered Species Act

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

*Code:* The United States Bankruptcy Code

*Common Stock:* The Company’s \$.50 par value Common Stock

*Company:* MAXXAM Inc. and its majority and wholly owned subsidiaries, unless otherwise indicated or the context indicates otherwise

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

*CWA:* Federal Clean Water Act

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

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

*Environmental Plans:* The HCP and the SYP

*EPA:* 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.* pending in the Superior Court of Humboldt County, California (No. CV990445)

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

*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.

*Filing Date:* With respect to any particular Debtor, the date on which such Debtor filed its Case

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

*Form 10-K:* The Company's Annual Report on Form 10-K filed with the Securities and Exchange Commission for the fiscal year ended December 31, 2003

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

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

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

*Headwaters Agreement:* The September 1996 agreement between Palco, Scotia LLC, Salmon Creek, the United States and California which provided the framework for the acquisition by the United States and California of the Headwaters Timberlands

*Headwaters Timberlands:* Approximately 5,600 acres of Palco timberlands consisting of two forest groves commonly referred to as the Headwaters Forest and the Elk Head Springs Forest which were sold to the United States and California in March 1999

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

*HWC 2003 lawsuit:* An action entitled *Humboldt County Watershed Council, et al. v. North Coast Regional Water Quality Control Board, et al.* (No. CV030961), naming Palco as real party in interest, pending 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) pending in the Delaware Court of Chancery

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

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

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

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

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

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

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

*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 Credit Agreement:* January 2004 revolving credit facility between Palco and a bank which provides for borrowings up to \$35.0 million, based upon certain collateral balances

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

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

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

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

*PSLRA:* Private Securities Litigation Reform Act of 1995

*Respondents:* The Company, Federated, Mr. Charles Hurwitz and others

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

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

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

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

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

*Scotia LLC:* Scotia Pacific Company LLC, a wholly owned subsidiary of Palco

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

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

*State Board of Equalization:* The California State Board of Equalization

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

*SYP:* The sustained yield plan approved in March 1999 in connection with the consummation of the Headwaters Agreement

*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

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

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

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

*TMDLs:* Total maximum daily load limits

*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) pending in the Superior Court of Sacramento County, California

*Van Duzen THPs lawsuit:* An action entitled *Environmental Protection Information Center, et al. v. California Department of Forestry and Fire Protection, et al.* (No. CV04-0809), pending in the Superior Court of Humboldt County, California