

B/S at \$2,212,000 ① of ②

Hypothetical Comparison of Sale
on the Open Market vs. Bargain Sale
to The Nature Conservancy
(numbers refer to attached footnotes below)


(Individual)

(See Sec. 1011(b) of the
Internal Revenue Code)

SALE AT FAIR MARKET VALUE	BARGAIN SALE TO THE NATURE CONSERVANCY
Sale Price (based on your appraisal) ¹ \$ <u>2,343,000</u>	Sale Price <u>\$1,852,000</u>
* reduction for brokers fees, financing, timing or sale subject to contingencies ²	
Net Selling Price _____	Net Selling Price <u>1,852,000</u>
Less Adjusted Basis ³ (Assumed) _____	Less Adjusted Basis <u>528,014</u>
Long-term Capital Gain _____	Long-term Capital Gain <u>1,323,986</u>
Less Federal LTCG Tax ⁴ (28% tax rate) _____	Less Federal LTCG Tax <u>370,716</u>
(State Income Tax not included)	(State Income Tax not included)
Return After Taxes _____	Return After Taxes <u>953,270</u>
Plus Adjusted Basis 3a _____	Plus Adjusted Basis <u>528,014</u>
	Plus Value of Tax Shelter from charitable contributions ⁵ (36% of \$ <u>491K</u> donation) <u>176,176</u> (<u>\$2,343K</u> - <u>\$1,852K</u>)
NET RETURN AFTER TAXES <u>1,620,956</u>	NET RETURN AFTER TAXES <u>1,658,044</u>

MEMORANDUM

TO: Steve McCormick, President

FROM: Cheryl Place, Director of Internal Audit 

DATE: September 6, 2002

SUBJECT: Review of the Galveston Bay Prairie Preserve Litigation

NOV 18 2003

At your request, I performed a review of the events leading to the litigation between TNC and the Russell Sage Foundation (RSF) over gas and oil exploration on TNC's Galveston Bay Prairie Preserve (the Preserve) located in Texas City, TX. The purpose of this review was to (1) examine the actions, inactions, and decisions of Texas State Program (TNCT) and Worldwide Office (WO) employees that prompted RSF to sue TNC (and others) for breaching fiduciary duties owed to RSF; (2) determine if current TNC policies and procedures (if followed) are adequate to prevent further such incidents; and (3) make recommendations that could mitigate the risks of similar occurrences. To complete this review, I examined court filings, witness depositions, and other legal documents pertinent to the case and interviewed TNCT, South Central Division, Legal Department, and WO personnel. Additionally, I contacted individuals who were not employed by TNC, but who had peripheral interests in the litigation. My review follows:

BACKGROUND

In 1995 Mobil Producing Texas & New Mexico Inc. (Mobil) donated 2,263 acres located on Galveston Bay in Texas City, TX to TNCT. The donated land, which TNC valued at \$2.2 million, is one of the last three remaining sites supporting wild Attwater's prairie chickens, an endangered species. In lieu of giving TNCT an endowment to support management of the property, Mobil donated the mineral rights to the land which gave TNCT claim to an annual income of approximately \$20,000 from producing gas wells located on the southern edge of the property.

Following a major gas discovery north of Texas City in the late 1990's, TNCT's then East Texas Program Manger, Ray Johnson, received several inquiries about leasing the preserve for oil/gas exploration. TNCT management decided to allow seismic operations (to determine mineral potential) on the Preserve after discussing the subject within TNCT and with TNCT Advisory Board members. Robert Potts, both the TNCT Director and South Central Division Vice President at the time, strongly believed that the prairie chicken's survival depended on its ability to coexist with oil production. To Mr. Potts this endeavor was exactly what TNC senior management was championing as compatible economic development of conservation land.

Seismic Permit

Before proceeding with gas/oil exploration on the preserve, TNCT hired an outside gas/oil attorney, Mike McReynolds, from the Kleberg Law Firm in San Antonio, TX and met with U.S.

Fish and Wildlife Service (USFWS) representatives. TNC's regional attorney (in the Durham, NC office) and General Counsel were also consulted during this process. In June 1998 Mr. McReynolds drew up a seismic permit between TNCT, Galveston Bay Resources (GBR), and Aspect Management Corporation (Aspect), two of the companies that had been pursuing TNCT, allowing gas/oil exploration on the preserve subject to a number of restrictions and conditions that the USFWS and TNCT incorporated in the permit. The permit, which gave GBR the right to perform a 3-D seismic survey on 2,104 acres of the preserve with an option to lease, was signed in July 1998 by Mr. Potts and representatives from the two gas/oil companies. At signing, TNCT received \$315,600 and an additional \$25,000 to cover the legal and USFWS consultation costs associated with writing the permit.

When TNCT was considering executing the seismic permit, a title opinion of the Preserve was prepared by an attorney for one of the oil/gas companies. TNCT learned that the north 1,047 acres of the property was encumbered by a 1/8th non participating royalty interest owned by RSF and numerous other entities (NPRIs). TNC, as the holder of executive mineral rights to the Preserve, was the only entity that could make decisions regarding gas and oil exploration on the property. However, if exploration was successful, royalties paid out from producing wells on the north 1,047 acres would be split: 25% to RSF, 25% to the other NPRI owners, and 50% to TNC. TNCT did not commission a survey to establish the boundaries between the encumbered and unencumbered acreage until October 2001, well after litigation began.

After the survey was completed, TNCT received an eight millimeter tape containing the raw seismic data and a Prospect Summary which depicted graphically the results of the exploration. Because TNCT did not have the equipment to read the tape or the knowledge to interpret the Prospect Summary, it enlisted the help of Tom Rollins, an honorary member of its Board of Trustees and a retired geological engineer for Shell Oil.

The seismic data was encouraging, showing potential reservoirs of hydrocarbons on both the north and south tracts of the Preserve; GBR and Aspect pursued the option granted in the seismic permit to lease the Preserve for drilling.

Gas/Oil Leases

Many of the decisions that TNCT made regarding the final gas/oil lease documents resonated during the litigation proceedings:

Pooling Agreement:

In February 1999, TNCT was in negotiations with Mr. "Butch" Ballow to acquire 434 acres of his Cross Media property which adjoined the Preserve to the west. TNCT wanted the land to enhance the prairie chicken habitat and was willing to exchange some of the Preserve mineral rights for Mr. Ballow's acreage. The seismic data indicated that mineral reservoirs extended to the Cross Media property. Attempting to encompass the best land surface that would contribute hydrocarbons to a producing well, in March 1999 the lessee oil/gas companies proposed a pooling agreement which included 137 acres

* In November 1998, GBR entered into a Farmout Letter Agreement with Aspect under which Aspect earned interest in the Preserve leases. Aspect agreed to pay all costs of exploring and developing gas and oil on the tracts. Aspect later assigned part of its interests under the agreement to the other lessee defendants in the litigation: Esenjay Exploration, Helmerich&Payne, and Frontier Natural Gas.

from the south lease, 71 acres from the north lease, and 112 acres from the Cross Media tract. Royalty payments from a producing well subject to the pooling agreement would be shared between TNCT, Mr. Ballow, RSF and the other NPRIs. Because Mr. Ballow would not part with his 434 acres unless TNCT paid a sum far in excess of its value, TNCT refused to sign the pooling agreement.

One Lease/Two Leases:

Mr. McReynolds was tasked with drawing up the gas/oil exploration lease agreements. Since the seismic permit had encompassed 2,104 acres of the Preserve, Mr. McReynolds' original lease agreement covered the same acreage. However, because RSF's and the other NPRIs' interests in the north acreage, he included a non communitization clause allowing that if oil/gas was discovered on the southern acres, RSF and the other NPRIs would not participate in any royalty payments from production. Three days before the lease was finalized, a representative from one of the gas/oil companies faxed a legal article to Mr. McReynolds at Mr. Johnson's request. The article indicated that non communitization clauses may not be enforceable. After discussions with TNCT, Mr. McReynolds drew up two, essentially identical leases, one for the north 1,047 acres and one for south 1,057 acres. Both leases, allowing gas/oil exploration on the Preserve, incorporated significant land surface use recommendations, restrictions, and requirements suggested by USFWS to protect the prairie chickens. The leases were signed on March 11, 1999 by Mr. Potts and a GBR representative. TNCT received a bonus payment of \$315,600 from the lessees at signing.

TNCT #1

The first well, TNCT #1, was a directional well, drilled from a surface location on the south tract 2,232 feet from the north tract boundary, but with a bottom hole location only 592 feet from that boundary. Although the well was started during the "drilling window" (a time period specified in the lease and based on the breeding patterns of the prairie chickens during which drilling was allowed), it was not completed until November 1999. TNCT #1 started production in January 2000 and continues to produce gas and moderate amounts of oil. By Texas standards TNCT #1 is an extremely productive well which has netted TNCT approximately \$8.8 million in royalty payments to date.

Unbeknownst to TNCT, the reservoir from which TNCT #1 was producing spanned the north lease line and was draining hydrocarbons from the north lease. Thus, a portion of the royalties TNCT received rightfully belonged to RSF and the other NPRIs.

All of TNCT's significant decisions relating to the reservoir into which TNCT #1 was drilled were based on TNCT's erroneous assumption that the north and south mineral reservoirs were separated by a fault that essentially paralleled the lease line. The assumption that TNCT #1, could not be draining minerals from the north lease because of the fault was based solely on the advice of Mr. Rollins. Mr. Rollins, who testified that he believed that the lease line ran just south of the main fault, cannot support that belief with any scientific or engineering data. Although the seismic data depicted potential reservoirs of hydrocarbons and fault lines separating the reservoirs, no survey or map indicated the location of the lease lines. However, the lessees provided TNCT with several maps that showed the TNCT #1 bottom hole only 592 feet from the north lease line (an approximation Aspect determined by using a "directional

survey" when it drilled the well). That proximity, which triggered an offset well/drainage protection clause in the leases which required a 675 foot separation from other lease boundaries, should have instigated an inquiry about drainage. However, in spite of evidence to the contrary, no one at TNCT questioned Mr. Rollins' belief.

TNCT #2 and TNC #3

By March, 2000, GBR began to consider drilling a second well located on the north tract. Drilling of the second well was problematic for TNCT because of concerns about the prairie chickens whose prime habitat was on the north acreage. At a May 2000 TNCT senior staff meeting to discuss the adverse effects on the birds of the drilling, Matt Williams, Preserve Manager, outlined a number of incidents including gas pipeline leaks, wildfires on the Preserve caused by oil/gas company personnel, and saltwater and hydrocarbon spills that had occurred during exploration, drilling, and production of TNCT #1. Mr. Johnson believed that the delays in completing TNCT #1 adversely affected the safety of captive prairie chickens whose release on the Preserve was likewise delayed. In May, 2000, Mr. Johnson wrote a letter to the attorney, Mr. McReynolds, seeking a legal opinion as to whether TNCT could prevent the lessees from drilling on the north tract. In his letter, Mr. Johnson expressed the same concerns about the negative impact of drilling on the prairie chicken population that had been discussed at the staff meeting. Mr. Johnson also stated his concern that if TNCT prevented drilling on the north tract out of concern for the birds, it would be denying RSF and the other NPRI's their share of potential royalties. Mr. McReynolds' response dated May 4, 2000, indicates that while TNCT could insist on scrupulous compliance with the substantial surface protection provisions in the lease, it could not prevent drilling on the north tract. Additionally, Mr. McReynolds wrote that as long as TNCT was not favoring itself over RSF/NPRI's in its exercise of executive power over the minerals on the north lease (i.e., was not obtaining for itself some mineral benefit that was denied RSF and the others) TNCT could place surface benefits above mineral benefits in its dealings with the lessees.

The lawyer went on to say that the only caveat to this conclusion arose from the possibility of subsurface drainage. In his letter, Mr. McReynolds suggests that if RSF hired a petroleum engineer to review the leases and received a report that hydrocarbons were being drained from the north lease (where TNCT restricted development) to the south lease (where TNCT had been more accommodating of development), RSF could assert a breach of duty of utmost fair dealing by TNCT. Such allegations, suggested Mr. McReynolds, would be bolstered by the fact that TNCT had a substantial incentive to have the gas/oil produced from a well on the south lease where it did not have to share royalty payments. TNCT ignored this warning because of its belief that the north and south leases were fault separated and thus, drainage could not occur.

After over a year delay, TNCT #2 was drilled from a surface location on the south lease (near TNCT #1's surface location), but with a bottom hole location on the north lease in a truly fault separated reservoir. TNCT participated in the drilling costs to prevent the surface location of the well from being located on the north lease property. In October 2001, TNCT #2 came in a dry hole.

TNCT #3 was drilled in the summer of 2001. The bottom hole location of this well is far south of the lease line. TNCT #3 appears to be in a separate reservoir located entirely on the south lease. As of June 30, 2002, TNCT has received royalty revenue from this well's gas/oil production totaling approximately \$300,000.

Purchase of RSF interests

In early 2000 after TNCT #1 had been producing for several months, Mr. Rollins and Mr. Johnson discussed the possibility of purchasing the non participating royalty interests from RSF. They approached Jack Schneider, a principal in an independent company called Chisos Exploration and a friend of Mr. Rollins, about assisting TNCT in making an offer to RSF. Mr. Schneider determined the value of RSF's interest at \$26,176 and proposed that he approach RSF. Mr. Potts approved the proposal and the price over the phone. Mr. Rollins and Mr. Johnson discussed partnering to purchase the interests of the other NPRI owners, but dropped the idea when Mr. Potts suggested that such an action would constitute a conflict of interest. Both Mr. Potts and Mr. Johnson later testified that the purpose of the offer was to provide greater operational flexibility in dealing with the lessees and to protect the breeding and nesting habitat of the prairie chickens on the lands covered by the north lease. However, Mr. Rollins testified that TNCT wanted to consolidate its interest in the north tract in order to make more money.

In a letter to RSF dated July 14, 2000, Mr. Schneider represented that Chisos Exploration, after a cursory examination of the public records in Galveston County, had learned of RSF's non participating royalty interest in 1,047 acres. The letter further indicates Chisos Exploration's interest in purchasing those mineral rights for \$400 per royalty acre. Mr. Schneider's July 14 letter and subsequent communications with RSF did not disclose that Mr. Schneider was acting as an agent for TNCT, that TNCT #1 had been drilled 592 feet from the lease line and was a strong producer, and/or that drilling on the north acreage was planned for the fall of 2000. Mr. Schneider followed up his offer with a letter dated August 18, 2000 informing RSF that the basis of his offer was a successful gas play six to fourteen miles east of the RSF property. Mr. Rollins testified that that statement was meant to intentionally mislead RSF.

Mr. Schneider's offer letters to RSF were approved by Mr. Johnson and Mr. Rollins. None were reviewed by TNC attorneys or by Mr. Potts.

In their defense, TNCT managers contend that they were assured by both Mr. Rollins and Mr. Schneider that Mr. Schneider's deceptive approach to purchasing RSF's mineral interests was standard industry practice and that the \$26,172 value assigned to that interest was based on the speculative nature of drilling a producing well on the north lease which was subsequently drilled a dry hole.

TNCT was unsuccessful in its bid to purchase RSF's mineral interests. None of the other NPRIs were approached about selling their interest. RSF subsequently approached Aspect and solicited an offer for its mineral interests; Aspect offered \$100,000 which RSF also rejected.

Litigation

Mr. Schneider's July 14, 2000 offer letter alerted RSF to its ownership of the non participating royalty interest on the 1,047 acres of the Preserve which it had reserved for itself when it (as original owner of the acreage) deeded the north tract to the Superior Oil Company in 1947. In the process of performing due diligence before accepting or rejecting TNCT's offer, RSF researched the deeds and hired an investigative geologist and Texas-based attorneys.

On June 1, 2001 without prior notice, RSF sued TNCT and the oil/gas company lessees alleging that TNCT breached certain duties owed to RSF in connection with the leases on the Preserve, and that the lessees knowingly participated in TNCT's actions. TNCT's exposure in the lawsuit is greatly influenced by its many actions, although innocent and/or uninformed, that nonetheless, appear sinister in litigation. The lawsuit alleged that every action TNCT took as executive rights holder in managing the mineral estate of the Preserve was knowingly taken to deny RSF its benefit as a non participating royalty interest owner.

RSF's allegations included that TNCT: (1) failed to disclose its knowledge that TNCT #1 was draining hydrocarbons from the north lease or to require that the lessees drill an offset well to mitigate the drainage; (2) hindered and delayed drilling a well on the north lease in bad faith; and, (3) conspired with others to buy RSF's royalty interest at a price less than its worth. Specifically:

TNCT # 1 drained hydrocarbons:

RSF argued that others in TNCT should have known or discovered, independent of Mr. Rollins' unsupported assertions, that a significant portion of the TNCT #1 reservoir was north of the lease line. TNCT should have known as early as March 1999 that the north lease contained productive acreage because the pooling agreement proposed by the lessees included north and south lease acreage. Additionally, several maps provided to TNCT show the bottom hole location of TNCT #1 to be only 592 feet from the north lease, a distance that triggered drainage mitigation clauses in the leases. RSF further suggested that TNCT's decision to draw up two leases rather than one was the beginning of a sinister, deliberate, and greedy plot to cheat the RSF and the other NPRIs of their royalty interests. TNCT decided to divide the lease at a time when it knew (or should have known) the lease bisected the main reservoir. Although TNCT is innocent of the allegations, its failure to question Mr. Rollins' assertions that the leases were fault-separated and its subsequent actions based on that assertion, its failure to survey the lease lines, and its failure to heed the warnings of its oil and gas attorney, Mr. McReynolds, who alerted TNCT to the drainage issues in a May 2000 letter, would likely have been viewed by a jury as unreasonable behavior for an executive rights holder.

TNCT hindered drilling TNCT #2:

The lawsuit alleged that TNCT did not want to share any royalties with RSF and the other NPRI's, and, therefore, took actions that delayed drilling of TNCT #2.

TNCT offered to purchase RSF's royalty interest:

The lawsuit's allegation that a former TNC employee (Mr. Johnson left TNC employ in February 2001) conspired with others to buy RSF's royalty interest at a fraction of its value would be difficult to overcome. TNCT's initial communication with RSF in the guise of a letter from Chisos Exploration was admittedly calculated to mislead RSF. Ultimately, RSF did not sell its interest and, therefore, suffered no damages as result of the offer. However, TNCT's action in regards to the purchase attempt directly affected TNCT's credibility on other issues.

TNCT's outside attorneys advised management that TNCT's claims that its focus was on the prairie chickens and that it was not knowledgeable about the gas/oil industry would be

challenged in a court room. RSF could claim that TNCT: (1) used the services of an experienced geologist to evaluate the seismic data; (2) retained an experienced gas and oil attorney to draft the leases and to consult as issues arose; (3) had access to other Board of Trustee members with extensive knowledge of oil and gas issues; (4) had key employees who were lawyers; and (5) demanded and received extensive documentation of all phases of the seismic and drilling operations.

Settlement

When the suit was initially filed in June 2001, TNCT was still convinced that the hydrocarbon reservoirs on the north and south leases were fault separated and that all of its actions on the Preserve had been predicated on protecting the birds. Only after it completed the survey of the lease line in October 2001, did TNCT realize that the RSF claims would resonate with a jury.

Both Mr. Potts and Steve McCormick, TNC President, visited the President of RSF to explain that TNCT's actions had been based on false assumptions and its interest in the birds, not on sinister motives to cheat RSF of its royalty rights. All efforts to settle the lawsuit, including an all day mediation attempt in July 2002 failed. Finally, in August 2002, all parties to the lawsuit agreed to a settlement amount to be paid to RSF in part by the lessees, TNCT, and TNC's insurance company. A motion to dismiss the case was filed on August 30, 2002.

AFTERMATH

TNC is well versed in the risks of buying land and operating with government funding, traditional methods of achieving its mission. The Conservancy's Policies and Procedures address these risks. TNC's sterling reputation is in part a result of its adherence to its mission, its policies and procedures, and its core values. However, the Conservancy is also an entrepreneurial organization whose senior staff are now urged to explore a new mix of strategies to achieve mission, including methods of compatible economic development. TNCT's attempt to balance the welfare of the prairie chickens with gas/oil exploration at the Galveston Bay Prairie Preserve seems to be a picture postcard strategy of the new Conservancy. However, were the events that transpired at the Preserve to become public knowledge, the Conservancy's good reputation could be badly damaged.

In the aftermath of the TNCT litigation, TNC senior management needs to evaluate the policies and procedures that it has in place (or does not have in place) that would/could mitigate the risk of future occurrences such as this one and discuss what limits, if any, enterprising managers should face when they explore new methods of achieving the mission. If TNC does not evaluate the lessons learned from TNCT's ordeal, and share those lessons with others in the Conservancy, it will face risks similar to those posed by TNCT's actions again.

Policies and Procedures

TNCT did not violate any of TNC's current Policies and Procedures in its gas/oil exploration and drilling on the Preserve. Mr. Potts, as TNCT Director, had signatory authority to enter into real estate transactions that did not exceed \$500,000. The gas/oil leases were real estate transactions that required no outlay of TNC funds, but instead included cash bonuses at signing. The offer to

purchase RSF's mineral interests, an event that could be interpreted as a real estate transaction, totaled only \$26,000.

Although not required, TNC managers are asked to seek legal advice when they consider any real estate transaction. Mr. Potts talked to a TNC's regional attorney and General Counsel before agreeing to the seismic exploration on the Preserve. In accordance with TNC Standard Operating Procedures (SOP), Mr. Potts hired an outside attorney with expertise in gas/oil operations to draft all of the legal documents between TNCT and the lessees. The seismic permit and the leases were reviewed by TNC attorneys. As required by another SOP, TNCT immediately contacted its Regional Attorney when the lawsuit was filed. Litigation proceedings were managed by internal legal staff and by outside attorneys recommended by TNC's insurance company.

One SOP specifically allows compatible human use at conservation sites as long as certain criteria are met.* Although gas/oil exploration on the Preserve arguably may not have met all of the criteria, the SOP allows for approval of an activity that does not meet the criteria by the Division Vice President. In his dual role as TNCT Director and Divisional Vice President, Mr. Potts was vested with the authority to approve compatible economic development at the Preserve. Mr. Potts approved the activity after serious discussions with his Advisory Board, his Board of Trustees, and his senior staff.

As TNC contemplates expanding conservation strategies to accomplish Conservation by Design, senior management will have to revisit the Conservancy's Policies and Procedures to ensure that they are adequate to address the current business climate. Obviously, Mr. Potts' role as both State Program Director and Division Vice President was an inherent conflict of interest that prevented proper oversight of the proposed economic activities at the Preserve. Under TNC's new organizational structure, approval for compatible human use of conservation land must vest at a higher level than Division Vice Presidents.

The risks inherent in engaging in businesses with which TNC has little expertise must be addressed in TNC's Policies and Procedures. Gas/oil exploration, eco-tourism, cattle grazing, and timbering operations are all activities which are already in place or are being contemplated on TNC conservation land. TNC staff are expert in none of these endeavors. Assigning decreased levels of signatory authority and increased levels of consultation should be contemplated for entering into unfamiliar operations.

Consultation

TNC must establish clear lines of consultation and accountability as it moves forward in the new organizational imperative.

Although testimony indicates that TNCT managers consulted with its Board of Trustees about gas/oil exploration on the Preserve, at least one TNCT employee questioned the level of the Board's involvement. Mr. Potts indicated that the Trustees were kept fully informed, but

* The SOP states that the Conservancy may engage in compatible human use at conservation sites: 1) as a strategy to reduce or eliminate threats to conservation targets; 2) when the use is designed primarily to mimic or restore essential ecological processes; 3) when the use is designed to meet other programmatic goals; and, 4) when in all times the use is consistent with corporate values.

minutes from the Trustee meetings during the three plus years that the events transpired contain little mention of discussions about the Preserve. When a presentation about the pooling agreement was made to TNCT's Conservation and Finance Committees of the Board of Trustees in May 1999, the discussion centered around revenue loss issues rather than shared reservoirs and drainage issues. TNCT's Board of Trustees, which included several oil/gas executives, may have offered differing advice from the former Trustee, Mr. Rollins, who was serving as TNCT's expert, had they been more fully engaged in events at the Preserve. At the very least, concentrated discussions may have pinpointed omissions, such as the failure to survey the lease boundaries.

Alternatively, TNC should not solely defer to its volunteer Boards for business advice. In unfamiliar businesses, TNC needs to engage consultants who have current experience in the areas of business operations it is pursuing. Mr. Potts suggests that TNC should not rely on pro bono advice, but should hire experts to advise and consult. The one expert TNCT did engage, its outside oil and gas attorney, was the only person who warned TNCT of the perils of subsurface oil drainage in the early stages of production.

Mr. Potts dual role in the South Central Division did not afford him the luxury of time. In his testimony, he indicated that he deferred much of the decision making at the Preserve to Mr. Johnson and Mr. Rollins. In fact, he indicates in his deposition that he was unaware of many of the details that were cited in the litigation as evidence of TNCT's duplicity and/or had come by the information second hand. He did not even review the correspondence between Chisos and RSF which ultimately precipitated TNCT's legal difficulties. Thus, lack of oversight within TNCT may have contributed to some of its faulty decision making.

TNC's President did not learn about the litigation and the events leading up to it until the spring of 2002, almost a year after the lawsuit was filed. His eventual involvement is credited with preserving a TNC relationship with RSF and with hastening an amicable settlement. The President should remain informed about all activities that pose reputational risks to TNC. TNC also needs to establish some thresh hold at which the President is informed about pending litigation.

Discretionary Revenue

TNCT earned over \$9 million in royalties from the gas/oil operations on the Preserve. It received an additional \$700,000 for signing the seismic permits and leases. Approximately \$7 million of those funds remained recorded as assets (thus, unspent) in various TNCT operating, land, and endowment general ledger centers as of June 30, 2002. TNCT anticipates further royalty revenues from its ongoing gas/oil operations and could agree to further exploration on the Preserve that would have the potential for additional revenues.

In the future, TNC leadership must be made aware of sustainable, compatible economic activities that generate an agreed upon thresh hold level of discretionary income, and should have some voice in how that money is used.

Core Values

TNCT's patently deceptive offer to purchase RSF's royalty interests in the north lease precipitated the litigation and made suspect all of TNCT's other honest, but uninformed, actions

regarding the gas/oil exploration and drilling on the Preserve. Referring to the offer, TNCT's outside litigation attorney advised TNCT that "the harm of this evidence is simply the fact that it will color how the jury will view TNCT's conduct and credibility in general." TNCT's current Director believes that when TNCT "...got into oil and gas, we conducted ourselves aggressively and lost our values." TNCT's failure to act with "integrity beyond reproach" is the gravest mistake that it made.

The further TNC moves from its core competencies, the more risk the organization will assume. Criticism by other conservation leaders of TNC's current willingness to forge closer ties with industry was outlined in a recent LA Times article. One environmental leader is quoted as saying, "...it's possible to compromise your ideology, your reputation, by making too risky choices." TNC must hold its employees accountable for the choices they make and values they disregard.