

Hallwood Group Inc  
Form 10-Q  
November 13, 2009

**Table of Contents**

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
FORM 10-Q**

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

**For the quarterly period ended September 30, 2009**

**OR**

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

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission file number: 1-8303**

**The Hallwood Group Incorporated**

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of incorporation or organization)

**51-0261339**

(I.R.S. Employer Identification No.)

**3710 Rawlins, Suite 1500, Dallas, Texas**

(Address of principal executive offices)

**75219**

(Zip Code)

**214-528-5588**

(Registrant's telephone number, including area code)

**Not Applicable**

(Former name, former address and former fiscal year, if changed since last report)

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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

(Do not check if a smaller reporting company)

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

Yes  No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

**Class**

**Outstanding at October 31, 2009**

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Common Stock, \$0.10 par value per share

1,525,166 shares

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**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES  
TABLE OF CONTENTS**

| <b>ITEM NO.</b>   | <b>PAGE</b> |
|---|-------------|
| <b><u>PART I FINANCIAL INFORMATION</u></b>  |             |
| 1 Financial Statements (Unaudited):   |             |
| <u>Condensed Consolidated Balance Sheets as of September 30, 2009 and December 31, 2008</u>   | 3           |
| <u>Condensed Consolidated Statements of Operations for the Nine Months Ended September 30, 2009 and 2008</u>                            | 4           |
| <u>Condensed Consolidated Statements of Operations for the Three Months Ended September 30, 2009 and 2008</u>                           | 5           |
| <u>Condensed Consolidated Statements of Comprehensive Income for the Three Months and Nine Months Ended September 30, 2009 and 2008</u> | 6           |
| <u>Condensed Consolidated Statement of Changes in Stockholders' Equity for the Nine Months Ended September 30, 2009</u>                 | 7           |
| <u>Condensed Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2009 and 2008</u>                            | 8           |
| <u>Notes to Condensed Consolidated Financial Statements</u>   | 9           |
| <u>2 Management's Discussion and Analysis of Financial Condition and Results of Operations</u>  | 25          |
| <u>4T Controls and Procedures</u>   | 36          |
| <b><u>PART II OTHER INFORMATION</u></b>   |             |
| <u>1 thru 6 Other Information</u>   | 37          |
| <u>Signature Page</u>   | 38          |
| <u>Index to Exhibits</u>  | 39          |
| <u>EX-10.26</u>   |             |
| <u>EX-31.1</u>  |             |
| <u>EX-31.2</u>  |             |
| <u>EX-32.1</u>  |             |

**Table of Contents**

**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
(dollars in thousands)  
(unaudited)

|  | <b>September<br/>30,<br/>2009</b> | <b>December<br/>31,<br/>2008</b> |
|--|-----------------------------------|----------------------------------|
| <b>ASSETS</b>  |                                   |                                  |
| <b>Current Assets</b>  |                                   |                                  |
| Cash and cash equivalents  | \$ 9,068                          | \$ 6,016                         |
| Accounts receivable, net   |                                   |                                  |
| Due from factors   | 31,484                            | 15,385                           |
| Trade and other  | 5,743                             | 6,338                            |
| Related parties  | 84                                | 32                               |
| Inventories, net   | 22,834                            | 21,774                           |
| Prepays, deposits and other assets                               | 447                               | 728                              |
| Deferred income tax, net   |                                   | 3,097                            |
|  | 69,660                            | 53,370                           |
| <b>Noncurrent Assets</b>   |                                   |                                  |
| Property, plant and equipment, net                               | 14,711                            | 15,145                           |
| Other assets   | 149                               | 159                              |
| Deferred income tax, net   |                                   | 721                              |
| Investments in Hallwood Energy, net                              |                                   |                                  |
|  | 14,860                            | 16,025                           |
| <b>Total Assets</b>  | <b>\$ 84,520</b>                  | <b>\$ 69,395</b>                 |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>                       |                                   |                                  |
| <b>Current Liabilities</b>                                       |                                   |                                  |
| Accounts payable   | \$ 15,162                         | \$ 10,658                        |
| Accrued expenses and other current liabilities                   | 5,676                             | 5,594                            |
| Payable additional investment in Hallwood Energy                 | 3,201                             | 3,201                            |
| Income taxes payable   | 1,246                             | 243                              |
| Redeemable preferred stock                                       | 1,000                             |                                  |
| Deferred income tax, net   | 99                                |                                  |
| Current portion of loans payable                                 |                                   | 27                               |
|  | 26,384                            | 19,723                           |
| <b>Noncurrent Liabilities</b> Long term portion of loans payable | 9,003                             | 10,411                           |
| Deferred income tax, net   | 281                               |                                  |
| Redeemable preferred stock                                       |                                   | 1,000                            |

|  |           |           |
|--|-----------|-----------|
|  | 9,284     | 11,411    |
| <b>Total Liabilities</b>   | 35,668    | 31,134    |
| <b>Stockholders Equity</b>   |           |           |
| Common stock, issued 2,396,105 shares for both periods; outstanding<br>1,525,166 shares for both periods | 240       | 240       |
| Additional paid-in capital   | 51,425    | 51,425    |
| Retained earnings  | 10,591    |           |
| Treasury stock, 870,939 shares for both periods; at cost   | (13,404)  | (13,404)  |
| <b>Total Stockholders Equity</b>   | 48,852    | 38,261    |
| <b>Total Liabilities and Stockholders Equity</b>   | \$ 84,520 | \$ 69,395 |

See accompanying notes to condensed consolidated financial statements.

Page 3

---

**Table of Contents**

**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
(in thousands, except per share amounts)  
(unaudited)

|   | <b>Nine Months Ended<br/>September 30,</b> |                 |
|---|--|-----------------|
|   | <b>2009</b>                                | <b>2008</b>     |
| <b>Revenues</b>                                 |  |                 |
| Textile products sales                          | \$ 128,166                                 | \$ 126,689      |
| <b>Expenses</b>                                 |  |                 |
| Textile products cost of sales                  | 93,322                                     | 94,234          |
| Administrative and selling expenses             | 17,988                                     | 16,726          |
|   | 111,310                                    | 110,960         |
| Operating income                                | 16,856                                     | 15,729          |
| <b>Other Income (Loss)</b>                      |  |                 |
| Interest expense                                | (171)                                      | (567)           |
| Interest and other income                       | 33   | 72              |
| Equity loss from investments in Hallwood Energy |  | (12,120)        |
|   | (138)                                      | (12,615)        |
| Income before income taxes                      | 16,718                                     | 3,114           |
| Income tax expense                              | 6,127                                      | 1,623           |
| <b>Net Income</b>                               | <b>\$ 10,591</b>                           | <b>\$ 1,491</b> |
| <b>Net Income Per Common Share</b>              |  |                 |
| Basic   | \$ 6.94                                    | \$ 0.98         |
| Diluted   | \$ 6.94                                    | \$ 0.98         |
| <b>Weighted Average Shares Outstanding</b>      |  |                 |
| Basic   | 1,525                                      | 1,521           |
| Diluted   | 1,525                                      | 1,523           |

See accompanying notes to condensed consolidated financial statements.





**Table of Contents**

**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
(in thousands, except per share amounts)  
(unaudited)

|   | <b>Three Months Ended<br/>September 30,</b> |                 |
|---|---|-----------------|
|   | <b>2009</b>                                 | <b>2008</b>     |
| <b>Revenues</b>                                 |   |                 |
| Textile products sales                          | \$ 44,182                                   | \$ 35,568       |
| <b>Expenses</b>                                 |   |                 |
| Textile products cost of sales                  | 31,816                                      | 27,715          |
| Administrative and selling expenses             | 6,121                                       | 5,960           |
|   | 37,937                                      | 33,675          |
| Operating income                                | 6,245                                       | 1,893           |
| <b>Other Income (Loss)</b>                      |   |                 |
| Interest expense                                | (44)  | (139)           |
| Interest and other income                       | 16  | 30              |
| Equity loss from investments in Hallwood Energy | (28)  | (109)           |
| Income before income taxes                      | 6,217                                       | 1,784           |
| Income tax expense                              | 2,149                                       | 529             |
| <b>Net Income</b>                               | <b>\$ 4,068</b>                             | <b>\$ 1,255</b> |
| <b>Net Income Per Common Share</b>              |   |                 |
| Basic   | \$ 2.67                                     | \$ 0.83         |
| Diluted   | \$ 2.67                                     | \$ 0.82         |
| <b>Weighted Average Shares Outstanding</b>      |   |                 |
| Basic   | 1,525                                       | 1,521           |
| Diluted   | 1,525                                       | 1,523           |

See accompanying notes to condensed consolidated financial statements.



**Table of Contents**

**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**  
(in thousands)  
(unaudited)

|                             | <b>Three Months Ended</b> |                 | <b>Nine Months Ended</b> |                 |
|-----------------------------|---------------------------|-----------------|--------------------------|-----------------|
|                             | <b>September 30,</b>      |                 | <b>September 30,</b>     |                 |
|                             | <b>2009</b>               | <b>2008</b>     | <b>2009</b>              | <b>2008</b>     |
| <b>Net Income</b>           | \$ 4,068                  | \$ 1,255        | \$ 10,591                | \$ 1,491        |
| Other Comprehensive Income  |                           |                 |                          |                 |
| None                        |                           |                 |                          |                 |
| <b>Comprehensive Income</b> | <b>\$ 4,068</b>           | <b>\$ 1,255</b> | <b>\$ 10,591</b>         | <b>\$ 1,491</b> |

See accompanying notes to condensed consolidated financial statements.

Page 6

---

Table of Contents

**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS EQUITY**  
(in thousands)  
(unaudited)

|  | Common Stock<br>Par |        | Additional<br>Paid-In | Retained  | Treasury Stock |            | Total<br>Stockholders |
|--|---------------------|--------|-----------------------|-----------|----------------|------------|-----------------------|
|  | Shares              | Value  | Capital               | Earnings  | Shares         | Cost       | Equity                |
| <b>Balance, January 1,<br/>2009</b>    | 2,396               | \$ 240 | \$ 51,425             | \$        | 871            | \$(13,404) | \$ 38,261             |
| Net income                             |                     |        |                       | 10,591    |                |            | 10,591                |
| <b>Balance,<br/>September 30, 2009</b> | 2,396               | \$ 240 | \$ 51,425             | \$ 10,591 | 871            | \$(13,404) | \$ 48,852             |

See accompanying notes to condensed consolidated financial statements.

Page 7

---

**Table of Contents**

**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(in thousands)  
(unaudited)

|   | <b>Nine Months Ended</b> |                 |
|---|--------------------------|-----------------|
|   | <b>September 30,</b>     |                 |
|   | <b>2009</b>              | <b>2008</b>     |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>                                       |                          |                 |
| Net income  | \$ 10,591                | \$ 1,491        |
| Adjustments to reconcile net income to net cash provided by operating activities: |                          |                 |
| Deferred tax expense  | 4,198                    | 438             |
| Depreciation and amortization   | 1,712                    | 1,684           |
| Equity loss from investments in Hallwood Energy                                   |                          | 12,120          |
| Changes in assets and liabilities:  |                          |                 |
| (Increase) decrease in accounts receivable  | (15,556)                 | 1,886           |
| Increase (decrease) in accounts payable   | 4,804                    | 792             |
| (Increase) decrease in inventories  | (1,060)                  | (110)           |
| Net change in income taxes receivable/payable                                     | 1,003                    | 569             |
| Net change in other assets and liabilities  | 291                      | 499             |
| Increase (decrease) in accrued expenses and other current liabilities             | 82                       | (76)            |
| <br>  |                          |                 |
| Net cash provided by operating activities   | 6,065                    | 19,293          |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>                                       |                          |                 |
| Investments in property, plant and equipment, net                                 | (1,578)                  | (2,239)         |
| Investments in Hallwood Energy  |                          | (13,919)        |
| <br>  |                          |                 |
| Net cash used in investing activities   | (1,578)                  | (16,158)        |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>                                       |                          |                 |
| Repayment of other bank borrowings and loans payable                              | (1,435)                  | (7,084)         |
| Proceeds from revolving credit facilities, net                                    |                          |                 |
| <br>  |                          |                 |
| Net cash used in financing activities   | (1,435)                  | (7,084)         |
| <br>  |                          |                 |
| <b>INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>                           | <b>3,052</b>             | <b>(3,949)</b>  |
| <br>  |                          |                 |
| <b>CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD</b>                             | <b>6,016</b>             | <b>7,260</b>    |
| <br>  |                          |                 |
| <b>CASH AND CASH EQUIVALENTS, END OF PERIOD</b>                                   | <b>\$ 9,068</b>          | <b>\$ 3,311</b> |

See accompanying notes to condensed consolidated financial statements.



**Table of Contents**

**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Nine Months Ended September 30, 2009 and 2008**  
**(unaudited)**

**Note 1 Interim Condensed Consolidated Financial Statements, Organization, Policies and New Accounting Pronouncements**

*Interim Condensed Consolidated Financial Statements.* The interim condensed consolidated financial statements of The Hallwood Group Incorporated and its subsidiaries (the Company) (NYSE Amex: HWG), a Delaware corporation, have been prepared in accordance with the instructions to Form 10-Q and do not include all of the information and disclosures required by accounting principles generally accepted in the United States of America. Although condensed, in the opinion of management, all adjustments considered necessary for a fair presentation have been included. These condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and related disclosures thereto included in Form 10-K for the year ended December 31, 2008.

*Organization.* The Company operates as a holding company. The principal remaining business is in the textile products industry, following the bankruptcy reorganization of its former Hallwood Energy affiliate.

*Textile Products.* Textile products operations are conducted through the Company's wholly owned subsidiary, Brookwood Companies Incorporated ( Brookwood ). Brookwood is an integrated textile firm that develops and produces innovative fabrics and related products through specialized finishing, treating and coating processes. Brookwood has three subsidiaries:

Kenyon Industries, Inc. ( Kenyon ). Kenyon, located in Rhode Island, uses the latest technologies and processes in dyeing, finishing, coating and printing of woven synthetic products. Kenyon provides quality finishing services for fabrics used in a variety of markets, such as military, luggage and knapsacks, flag and banner, apparel, industrial and sailcloth.

Brookwood Laminating Inc. ( Brookwood Laminating ). Brookwood Laminating, located in Connecticut, uses the latest in processing technology to provide quality laminating services for fabrics used in military clothing and equipment, sailcloth, medical equipment, industrial applications and consumer apparel. Up to five layers of textile materials can be processed using both wet and dry lamination techniques.

Strategic Technical Alliance, LLC ( STA ). STA is part of the Brookwood marketing group and markets advanced breathable, waterproof laminate and other fabrics primarily for military applications. The STA entity, in name only, is being phased out in 2009. The change will have no effect on STA's customers, suppliers, Brookwood, or the consolidated operations of Brookwood.

Textile products operations account for all of the Company's operating revenues. See Note 3 for additional information on Brookwood.

*Energy.* The Company's investment in the energy segment was conducted through Hallwood Energy, L.P. ( Hallwood Energy ). The Company accounted for the investment in Hallwood Energy using the equity method of accounting, recording its pro rata share of Hallwood Energy's net income (loss), partners' capital transactions and comprehensive income (loss).

Hallwood Energy was a privately held independent oil and gas limited partnership and operated as an upstream energy company engaged in the acquisition, development, exploration, production, and sale of hydrocarbons, with a primary focus on natural gas assets.

*Bankruptcy Filing by Hallwood Energy.* On March 1, 2009, Hallwood Energy, L.P., Hallwood Energy Management, LLC (the general partner of Hallwood Energy, HEM), and Hallwood Energy's subsidiaries, filed petitions for relief under Chapter 11 of the United States Bankruptcy Code. The cases were adjudicated in the United States Bankruptcy Court for the Northern District of Texas, Dallas Division, in *In re Hallwood Energy, L.P., et al Case No. 09-31253*. The Company was only an investor in and creditor of Hallwood Energy. The bankruptcy filing did not include the Company or any other of its assets.

On June 29, 2009, the Bankruptcy Court granted a motion by Hall Phoenix/Inwood, Ltd. ( HPI ), the secured lender to Hallwood Energy, to partially lift the automatic stay applicable in bankruptcy proceedings, permitting HPI, among other things, to enter upon and take possession of substantially all of Hallwood Energy s assets and operations.

On October 19, 2009, the Bankruptcy Court confirmed the plan of reorganization proposed by HPI that, among other things, extinguished Hallwood Energy s general partnership and limited partnership interests, including those held by the Company. As a



**Table of Contents**

**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Nine Months Ended September 30, 2009 and 2008**  
**(unaudited)**

result of these developments, the Company does not anticipate that it will recover any of its investments in Hallwood Energy. The carrying value of the Company's investment in Hallwood Energy has been reflected as zero since December 31, 2007.

See Note 4 for additional information on Hallwood Energy.

*Consolidation Policy.* The Company's Brookwood subsidiary operates on a 5-4-4 accounting cycle with its months always ending on a Saturday for accounting purposes, while the parent company, The Hallwood Group Incorporated, operates on a traditional fiscal month accounting cycle. For purposes of the year-end financial statements the Brookwood cycle always ends on December 31, however, quarterly interim financial statements may not correspond to the fiscal quarter-end. The Company's condensed consolidated financial statements as of September 30, 2009 and 2008 include Brookwood's operations through September 27, 2009 and September 28, 2008, respectively. Estimated operating results of Brookwood for the intervening periods to September 30, 2009 and 2008, respectively, are provided below (in thousands):

|                                     | <b>Amounts in Intervening Periods</b> |                      |
|-------------------------------------|---------------------------------------|----------------------|
|                                     | <b>2009</b>                           | <b>2008</b>          |
|                                     | <b>(three</b>                         | <b>(two business</b> |
|                                     | <b>business</b>                       | <b>days)</b>         |
|                                     | <b>days)</b>                          | <b>days)</b>         |
| Textile products sales              | \$ 823                                | \$ 444               |
| Textile products costs of sales     | 604                                   | 342                  |
| Administrative and selling expenses | 293                                   | 212                  |

*Subsequent Events.* The Company recognizes the effects of events or transactions that occur after the balance sheet date but before financial statements are issued, referred to as subsequent events, if there is evidence that conditions related to the subsequent event existed at the balance sheet date, including the impact of such events on management's estimates and assumptions used in preparing the financial statements. Other significant subsequent events that are not recognized in the financial statements, if any, are disclosed in the notes to the Company's consolidated financial statements. Subsequent events have been evaluated through November 13, 2009, the date these condensed consolidated financial statements were filed with the Securities and Exchange Commission.

*New Accounting Pronouncements.* In May 2009, the Financial Accounting Standards Board (FASB) issued SFAS No. 165, (FASB ASC Topic 855) *Subsequent Events*, which was effective for interim or annual periods ending after June 15, 2009. FASB ASC Topic 855 establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued by public entities. It mirrors the longstanding existing guidance for subsequent events that was promulgated by the American Institute of Certified Public Accountants. FASB ASC Topic 855 also requires the Company to disclose the date through which subsequent events have been evaluated and the basis for that date. The Company adopted FASB ASC Topic 855 for the quarter ended June 30, 2009.

In June 2009, the FASB issued SFAS No. 166 (FASB ASC Topic 860) *Accounting for Transfers of Financial Assets* an amendment of FASB Statement No. 140, that relates to accounting for transfers of financial assets. FASB ASC Topic 860 improves the information that a reporting entity provides in its financial reports about a transfer of financial assets; the effects of a transfer on its financial position, financial performance and cash flows; and a continuing interest in transferred financial assets. In addition, this guidance amends various ASC concepts with respect to accounting for transfers and servicing of financial assets and extinguishments of liabilities, including removing the concept of qualified special purpose entities. FASB ASC Topic 860 is effective for interim and annual reporting periods that begin after November 15, 2009. FASB ASC Topic 860 must be applied to transfers occurring

on or after the effective date. The Company is still analyzing the effects of adoption of FASB ASC Topic 860.

In June 2009, the FASB issued SFAS No. 168, (FASB ASC Topic 105) *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles* . FASB ASC Topic 105 establishes the FASB Accounting Standards Codification Principles (Codification) as the source of authoritative accounting principles recognized by the FASB to be applied in the preparation of financial statements in conformity with GAAP. FASB ASC Topic 105 explicitly recognizes rules and interpretive releases of the SEC under federal securities laws as authoritative GAAP for SEC registrants. The Company adopted FASB ASC Topic 105 for the quarter ended September 30, 2009. The FASB codification does not change the Company's application of U.S. GAAP, and therefore the adoption only affects the way authoritative accounting literature is referred to in the notes to the Company's consolidated financial statements.

Table of Contents

**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Nine Months Ended September 30, 2009 and 2008**  
**(unaudited)**

**Note 2 Inventories**

All inventories relate to Brookwood. Inventories as of the balance sheet dates were as follows (in thousands):

|                            | <b>September<br/>30,<br/>2009</b> | <b>December<br/>31,<br/>2008</b> |
|----------------------------|-----------------------------------|----------------------------------|
| Raw materials              | \$ 5,632                          | \$ 6,215                         |
| Work in progress           | 9,579                             | 6,427                            |
| Finished goods             | 9,078                             | 10,203                           |
|                            | 24,289                            | 22,845                           |
| Less: Obsolescence reserve | (1,455)                           | (1,071)                          |
| <br>Total                  | <br>\$ 22,834                     | <br>\$ 21,774                    |

**Note 3 Operations of Brookwood Companies Incorporated**

*Receivables.* Brookwood maintains factoring agreements with several factors, which provide that receivables resulting from credit sales to customers, excluding the U.S. Government, may be sold to the factor, subject to a commission and the factor's prior approval.

Brookwood continues to monitor its factors and the effects the current economic situation may have upon their ability to fulfill their obligations to Brookwood in a timely manner. The parent company of one of Brookwood's factors, CIT Group Inc. (CIT), previously announced it had liquidity issues and filed for bankruptcy on October 31, 2009. Brookwood has taken steps to protect its interests with CIT and expanded its relationships with other factors. Additionally, Brookwood has amended its factor agreement with CIT that, among other things, allows CIT to be a Brookwood receivables management agent in connection with post-September 30, 2009 receivables and further clarifies Brookwood's ownership of the receivables. As of November 13, 2009, all of Brookwood's factors were complying with payment terms in accordance with factor agreements, although such terms from the other factors have resulted in timing differences that have increased Brookwood's end-of-month receivables balances.

The accounts receivable due from factor balance at September 30, 2009 includes approximately \$4,800,000 related to fabric sold to a Brookwood customer that supplies the U.S. military for which payment has been delayed due to a pending compliance issue (see also Note 11). Brookwood is in the process of structuring resolution of the issue and believes it is likely to have partial resolution in the 2009 fourth quarter with complete resolution in 2010. The Company does not believe resolution of the issue will have a material adverse effect on its financial condition, results of operations or cash flows.

*Sales Concentration.* Brookwood has several customers who accounted for more than 10% of Brookwood's sales in the 2009 and 2008 periods. Sales to one Brookwood customer, Tennier Industries, Inc. (Tennier), accounted for more than 10% of Brookwood's sales during both the 2009 and 2008 periods. Its relationship with Tennier is ongoing. Sales to Tennier, which are included in military sales, were \$16,933,000 and \$40,298,000 in the 2009 third quarter and nine month periods, respectively, compared to \$8,593,000 and \$38,573,000 in 2008. Sales to Tennier represented 38.3% and 24.2% of Brookwood's net sales in the 2009 and 2008 third quarters, respectively, and 31.4% and 30.4% in the 2009 and 2008 nine month periods, respectively. Sales to another customer, ORC Industries, Inc. (ORC), accounted for more than 10% of Brookwood's sales in 2009 and 2008. Its relationship with ORC is ongoing. Sales to ORC, which are included in military sales, were \$3,926,000 and \$18,925,000 in the 2009 third quarter and nine month periods, respectively, compared to \$4,093,000 and \$13,375,000 in 2008. Sales to ORC represented 8.9% and 11.5% of

Brookwood's net sales in the 2009 and 2008 third quarters, respectively, and 14.8% and 10.6% in the 2009 and 2008 nine month periods, respectively. Sales to another customer accounted for more than 10% of sales for 2008 only. Brookwood's relationship with the customer is ongoing. Sales to that customer, which are also included in the military sales, were \$1,956,000 and \$8,116,000 in the 2009 third quarter and nine month periods, compared to \$4,439,000 and \$15,208,000 in the 2008 third quarter and nine month periods, which represented 4.4% and 12.5% of Brookwood sales in the third quarters in 2009 and 2008, and 6.3% and 12.0% in the 2009 and 2008 nine month periods, respectively.

Military sales accounted for \$32,415,000 and \$92,845,000 in the 2009 third quarter and nine month periods, respectively, compared to \$21,194,000 and \$81,148,000 in 2008. The military sales represented 73.4% and 59.6% of Brookwood's net sales in the 2009 and 2008 third quarters, respectively, and 72.4% and 64.1% in the 2009 and 2008 nine month periods, respectively.

**Table of Contents**

**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Nine Months Ended September 30, 2009 and 2008**  
**(unaudited)**

*Stockholders' Equity.* The Company is the holder of all of Brookwood's outstanding \$13,500,000 Series A, \$13.50 annual dividend per share, redeemable preferred stock and all of its 10,000,000 outstanding shares of common stock. The preferred stock has a liquidation preference of \$13,500,000 plus accrued but unpaid dividends. At September 30, 2009, cumulative dividends in arrears on the preferred stock amounted to approximately \$456,000.

*2005 Long-Term Incentive Plan for Brookwood.* In December 2005, the Company adopted The Hallwood Group Incorporated 2005 Long-Term Incentive Plan for Brookwood Companies Incorporated (the 2005 Long-Term Incentive Plan for Brookwood) to encourage employees of Brookwood to increase the value of Brookwood and to be employed by Brookwood. The terms of the incentive plan provide for a total award amount to participants equal to 15% of the fair market value of consideration received by the Company in a change of control transaction, as defined, in excess of the sum of the liquidation preference plus accrued unpaid dividends on the Brookwood preferred stock (approximately \$13,956,000 at September 30, 2009). The base amount will fluctuate in accordance with a formula that increases by the amount of the annual dividend on the preferred stock, currently \$1,823,000, and decreases by the amount of the actual preferred dividends paid by Brookwood to the Company. However, if the Company's board of directors determines that certain specified Brookwood officers, or other persons performing similar functions do not have, prior to the change of control transaction, in the aggregate an equity or debt interest of at least two percent in the entity with whom the change of control transaction is completed, then the minimum amount to be awarded under the plan shall be \$2,000,000. In addition, the Company agreed that, if members of Brookwood's senior management do not have, prior to a change of control transaction in the aggregate an equity or debt interest of at least two percent in the entity with whom the change of control transaction is completed (exclusive of any such interest any such individual receives with respect to his or her employment following the change of control transaction), then the Company will be obligated to pay an additional \$2,600,000.

**Note 4 Investments in Hallwood Energy, L.P.**

Investments in Hallwood Energy as of the balance sheet dates were as follows (in thousands):

| Description                             | As of September<br>30,2009      |           | Amount at                |                         | Loss for the<br>nine months<br>ended |             |
|---|---------------------------------|-----------|--------------------------|-------------------------|--------------------------------------|-------------|
|   | Percent<br>of<br>Class<br>Owned | Cost      | September<br>30,<br>2009 | December<br>31,<br>2008 | September 30,<br>2009                | 2008        |
| - Class A limited partner interest      | 25(a)                           | \$ 50,384 | \$                       | \$                      | \$                                   | \$          |
| - Class C limited partner interest      | 13(b)                           | 11,084    |                          |                         |                                      |             |
| - General partner interest              | 50                              | 13        |                          |                         |                                      |             |
| - First Convertible Note                | 17                              | 5,000     |                          |                         |                                      |             |
| - Second Convertible Note               |                                 |           |                          |                         |                                      |             |
| Cash investment                         | 96                              | 9,300     |                          |                         |                                      | (8,920)     |
| Less: portion invested by third parties |                                 | (380)     |                          |                         |                                      |             |
| Commitment to invest additional funds   |                                 | 3,200     |                          |                         |                                      | (3,200)     |
| Total                                   |                                 | \$ 78,601 | \$                       | \$                      | \$                                   | \$ (12,120) |

(a)

18% after  
consideration of  
profit interests

- (b) Convertible into  
a Class A  
limited partner  
interest

Prior to the approval of Hallwood Energy's plan of reorganization in Bankruptcy Court (discussed below), the Company accounted for the investment in Hallwood Energy using the equity method of accounting and recorded its pro rata share of Hallwood Energy's net income (loss) and partner capital transactions, as appropriate. In connection with Hallwood Energy's bankruptcy reorganization, the Company's partnership interests in Hallwood Energy were extinguished and the Company no longer accounts for the investment in Hallwood Energy using the equity method of accounting. Additionally, any right of recovery for the convertible note interests has been subordinated in favor of Hall Phoenix/Inwood, Ltd., ( "HPI" ), the secured lender to Hallwood Energy.

Hallwood Energy was a privately held independent oil and gas limited partnership and operated as an upstream energy company engaged in the acquisition, development, exploration, production, and sale of hydrocarbons, with a primary focus on

**Table of Contents**

**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Nine Months Ended September 30, 2009 and 2008**  
**(unaudited)**

natural gas assets. Certain of the Company's officers and directors were investors in Hallwood Energy. In addition, one officer of the Company held a profit interest in Hallwood Energy that was also extinguished in the bankruptcy.

*Bankruptcy Filing by Hallwood Energy.* On March 1, 2009, Hallwood Energy, HEM (the general partner of Hallwood Energy) and Hallwood Energy's subsidiaries, filed petitions for relief under Chapter 11 of the United States Bankruptcy Code. The cases were adjudicated in the United States Bankruptcy Court for the Northern District of Texas, Dallas Division, in *In re Hallwood Energy, L.P., et al Case No. 09-31253*. The Company was only an investor in and creditor of Hallwood Energy. The bankruptcy filing did not include the Company or any other of its assets.

On June 29, 2009, the Bankruptcy Court granted a motion by HPI to partially lift the automatic stay applicable in bankruptcy proceedings, permitting HPI, among other things, to enter upon and take possession of substantially all of Hallwood Energy's assets and operations.

On October 19, 2009, the Bankruptcy Court confirmed the plan of reorganization proposed by HPI that, among other things, extinguished Hallwood Energy's general partnership and limited partnership interests, including those held by the Company. As a result of these developments, the Company does not anticipate that it will recover any of its investments in Hallwood Energy. The carrying value of the Company's investment in Hallwood Energy has been reflected as zero since December 31, 2007.

Hallwood Energy's previously filed adversary proceeding against the Company requesting that the Company fund \$3,200,000 under the Equity Support Agreement (discussed below and in Note 11) between Hallwood Energy and the Company remains outstanding. In addition, the Bankruptcy Court had previously granted the motions of HPI and of FEI Shale, L.P. ( FEI ), a subsidiary of Talisman Energy, Inc., to intervene as plaintiffs in the proceeding. HPI and FEI contend that the Company's failure to fund \$3,200,000 under an Equity Support Agreement damaged Hallwood Energy in an amount in excess of \$3,200,000 and have asserted compensatory and exemplary damages. HPI filed a motion for summary judgment on its claims and a hearing on this motion was held on July 17, 2009. The Court has not yet entered a ruling on the motion.

On August 3, 2009, the Company was served with a complaint in *Hall Phoenix/Inwood Ltd. and Hall Performance Energy Partners 4, Ltd. v. The Hallwood Group Incorporated, et al.* filed in the 298<sup>th</sup> District of Texas, No. 09-09551. The other defendants include Anthony J. Gumbiner, the Chairman and Chief Executive Officer of the Company, Bill Guzzetti, the President of the Company, certain affiliates of Mr. Gumbiner and certain officers of Hallwood Energy. The complaint alleges that the defendants defrauded plaintiffs in connection with plaintiffs acquiring interests in and providing loans to Hallwood Energy and seeks unspecified actual and exemplary damages.

In addition, the confirmed plan of reorganization in the Hallwood Energy bankruptcy proceeding provides that a creditors' trust created by the plan will pursue various claims against the Company and its officers, directors and affiliates and Hallwood Energy's officers and directors. Attorneys for HPI have also delivered a letter on behalf of HPI and certain affiliates alleging claims against the Company and its officers, directors and affiliates and Hallwood Energy's officers and directors for, among other things, breach of contract, breach of fiduciary duties, neglect, negligence, and various alleged misleading statements, omissions and misrepresentations. HPI and certain of its affiliates have asserted that its damages exceed \$200,000,000. The Company believes that the allegations and claims are without merit and intends to defend the lawsuit and any future claims vigorously.

*Equity Losses.* Under U.S. generally accepted accounting principles, the general rule for recording equity losses ordinarily indicates that the investor shall discontinue applying the equity method when the investment has been reduced to zero and shall not provide for additional losses unless the investor provides or commits to provide additional funds in the investee, has guaranteed obligations of the investee, or is otherwise committed to provide further financial support to the investee.

In connection with the then ongoing efforts to complete the Talisman Energy Transaction (discussed below), the Company loaned Hallwood Energy \$2,961,000 in May 2008. Concurrent with the completion of the Talisman Energy Transaction in June 2008, the Company entered into an Equity Support Agreement (the Equity Support Agreement )

with Hallwood Energy under which the Company committed under certain conditions to contribute equity or debt capital to Hallwood Energy to maintain a reasonable liquidity position for Hallwood Energy or prevent or cure any default under Hallwood Energy's credit facilities with respect to interest payments, up to a maximum amount of \$12,500,000. The Company contributed \$2,039,000 at the completion date (for a total amount of \$5,000,000) to Hallwood Energy and committed to provide an additional amount of up to \$7,500,000 in certain circumstances, all of which were issued under the terms of the Second Convertible Note (discussed below). Due to the



**Table of Contents**

**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Nine Months Ended September 30, 2009 and 2008**  
**(unaudited)**

uncertainties in May 2008 related to the completion of the Talisman Energy Transaction and the Company's additional investments, if any, the Company recorded an equity loss for the 2008 first quarter to the extent of the \$2,961,000 loan.

An obligation and related additional equity loss were recorded in the 2008 second quarter to the extent of the Company's commitment to provide additional financial support to Hallwood Energy pursuant to the Equity Support Agreement, in accordance with generally accepted accounting principles. Subject to certain defenses raised by the Company, the remaining commitment amount under the Equity Support Agreement was \$3,200,000 at September 30, 2009. Hallwood Energy has filed an adversary proceeding against the Company requesting that the Company fund the additional \$3,200,000. The Company has filed an answer to Hallwood Energy's lawsuit and denied liability under the Equity Support Agreement. HPI has filed a motion for summary judgment on its claims and a hearing on this motion was held on July 17, 2009. The Court has not yet entered a ruling on the motion. The Company intends to defend the matter vigorously.

The Company's carrying value of its Hallwood Energy investment, which was zero at December 31, 2008 and 2007, remained at zero as of September 30, 2009.

Pursuant to the plan of reorganization confirmed by the Bankruptcy Court, the Company's ownership interest in Hallwood Energy was extinguished and the Company no longer accounts for the investment in Hallwood Energy using the equity method of accounting.

In addition to the description of Hallwood Energy's activities provided in the Company's 2008 Form 10-K, further information regarding Hallwood Energy is provided below.

*Loan Facilities and Convertible Notes.* At September 30, 2009, Hallwood Energy had two loan facilities and two convertible note issues:

*Senior Secured Credit Facility and Junior Credit Facility.* In April 2007, Hallwood Energy entered into a \$100,000,000 loan facility (the Senior Secured Credit Facility) with HPI, who is an affiliate of one of Hallwood Energy's investors. The outstanding principal balance was \$100,000,000 at September 30, 2009 and December 31, 2008. The Senior Secured Credit Facility, including its amendments, contained various financial covenants, including maximum general and administrative expenses and current and proved collateral coverage ratios and non-financial covenants that restricted Hallwood Energy's activities and contained a make-whole provision.

In January 2008, Hallwood Energy entered into a \$15,000,000 loan facility (the Junior Credit Facility) with HPI and drew the full \$15,000,000 available. Borrowings under the Senior Secured Credit Facility and Junior Credit Facility (collectively referred to as the Secured Credit Facilities) were both secured by Hallwood Energy's oil and gas leases and matured on February 1, 2010. The Junior Credit Facility contained various financial covenants and a make-whole provision, materially consistent with the Senior Secured Credit Facility.

Hallwood Energy was not in compliance with various covenants beginning March 31, 2008, which required waivers and amended loan covenants. At September 30, 2008 and December 31, 2008, Hallwood Energy was not in compliance with the proved collateral coverage ratio under the Secured Credit Facilities. However, pursuant to a forbearance agreement related to the Talisman Energy Transaction, HPI agreed not to exercise its other remedies under the facilities until at least 91 days after the termination of the farmout agreement (discussed below).

To the extent Hallwood Energy was not in default by virtue of pre-March 1, 2009 events, the bankruptcy filing on March 1, 2009 constituted a default under the terms of the Secured Credit Facilities and the forbearance agreement was terminated by its terms upon the bankruptcy filing. However, under the automatic stay

provisions of the Bankruptcy Code, HPI had not been able to foreclose on its collateral. As previously stated, on June 29, 2009, the Bankruptcy Court granted a motion by HPI, to partially lift the automatic stay applicable in bankruptcy proceedings, permitting HPI, among other things, to enter upon and take possession of substantially all of Hallwood Energy's assets and operations.

Hallwood Energy's obligations under the Secured Credit Facilities were the subject of litigation commenced by Hallwood Energy against HPI, as more fully described in the section below entitled *Litigation*.

**Table of Contents**

**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
Nine Months Ended September 30, 2009 and 2008  
(unaudited)**

*First Convertible Note.* In January 2008, Hallwood Energy entered into a \$30,000,000 convertible subordinated note agreement (the First Convertible Note ). Borrowings bore interest at an annual rate of 16%, payable on a quarterly basis after the completion of a defined equity offering and subject to the prior full payment of borrowings and accrued interest under the Secured Credit Facilities. The First Convertible Note and accrued interest was convertible into Class C interests, or comparable securities, on a dollar for dollar basis. As of September 30, 2009, \$28,839,000 principal amount of the First Convertible Notes were outstanding, of which the Company held \$5,000,000.

*Second Convertible Note.* In May 2008, Hallwood Energy entered into a \$12,500,000 convertible subordinated note agreement (the Second Convertible Note ), which was underwritten by the Company. The Second Convertible Note was issued in connection with the completion of the Talisman Energy Transaction and the related Equity Support Agreement. The Second Convertible Note contained terms comparable to the First Convertible Note. During June and July 2008, the Company sold \$380,000 of the Second Convertible Note to other investors in Hallwood Energy. As of September 30, 2009, \$9,300,000 principal amount of the Second Convertible Notes were outstanding, of which \$8,920,000 was held by the Company and \$380,000 was held by other Hallwood Energy investors.

Pursuant to the plan of reorganization approved by the Bankruptcy Court, the holders of the First Convertible Notes and Second Convertible Notes are treated as a subordinated creditor class with its rights to recovery subordinated to HPI. The Company does not anticipate any recovery from its convertible note holdings.

*Limited Partnership Interests.* At September 30, 2009, there were three classes of limited partnership interests held in Hallwood Energy:

Class C interests bore a 16% priority return which compounded monthly. The priority return would have become payable when, as and if declared by the general partner of Hallwood Energy. The Class C interests would have received priority on any distributions of cash or sales proceeds from a terminating capital transaction, as defined. The Class C capital contributions totaled approximately \$84,422,000 at September 30, 2009.

Class A interests bore certain voting rights and with the general partner would have received 100% of the distributions of available cash and net proceeds from a terminating capital transaction, as defined, subsequent to the payment of all unpaid Class C priority return and of all Class C capital contributions until the unrecovered capital accounts of each Class A partner interest was reduced to zero, and thereafter would have shared in all future distributions of available cash and net proceeds from terminating capital transactions with the holders of the Class B interests.

Class B interests represented vested net profit interests awarded to key individuals by Hallwood Energy. At September 30, 2009 and December 31, 2008, outstanding Class B interests had rights to receive 20.0% of distributions of defined available cash and net proceeds from a terminating capital transaction after the unpaid Class C priority return and capital contributions and the unreturned Class A and general partner capital contributions were reduced to zero.

Pursuant to the plan of reorganization approved by the Bankruptcy Court, the Class A, B and C limited partnership interests and the general partnership interests were extinguished upon confirmation of the plan by the Bankruptcy Court.

*Talisman Energy Transaction.* In June 2008, Hallwood Energy raised additional capital by entering into an agreement for the sale and farmout to FEI Shale, L.P. ( FEI ), a subsidiary of Talisman Energy, Inc., of an undivided interest in up to 33.33% of Hallwood Energy's interest in substantially all its assets for a series of payments of up to \$125,000,000 (an initial payment of \$60,000,000 and the option to pay up to the additional \$65,000,000), and entered

into an agreement to provide consulting services to the purchaser for one year (the Talisman Energy Transaction ). FEI prepaid the consulting services agreement which required two man-weeks per month of service from two senior executives. The revenues from this agreement were recognized as earned over the course of the twelve month period. In October 2008, FEI elected to make a second payment of \$30,000,000 to Hallwood Energy. In February 2009, FEI elected to make a partial funding in the amount of \$15,000,000 related to its third payment.

In connection with the Talisman Energy Transaction, the Company loaned \$2,961,000 to Hallwood Energy in May 2008. Contemporaneously with the signing of the sale and farmout agreement, the Company entered into the Equity Support Agreement with Hallwood Energy. The loan of \$2,961,000 in May 2008 and an additional loan to Hallwood Energy in June 2008 of \$2,039,000 (for a total of \$5,000,000) were treated as contributions toward the maximum amount. In September 2008, the Company loaned an additional \$4,300,000 to Hallwood Energy under the Equity Support Agreement. Funds advanced to

**Table of Contents**

**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Nine Months Ended September 30, 2009 and 2008**  
**(unaudited)**

Hallwood Energy pursuant to the Equity Support Agreement were issued under terms of the Second Convertible Note. Subject to certain defenses raised by the Company, the remaining commitment amount under the Equity Support Agreement was \$3,200,000 at September 30, 2009.

*Litigation.* For a description of litigation filed against the Company in connection with the Hallwood Energy bankruptcy, see Note 11.

The following table sets forth certain unaudited summarized financial data for Hallwood Energy for 2008 (in thousands):

|   | <b>December 31,<br/>2008</b>                             |   |
|---|--|---|
| <b>Balance Sheet Data</b>                 |  |   |
| Cash and cash equivalents                 |  | \$ 18,706   |
| Oil and gas properties, net               |  | 86,347  |
| Total assets                              |  | 111,100   |
| Notes payable (including make-whole fees) |  | 155,849   |
| Total liabilities                         |  | 195,380   |
| Partners' capital (deficiency)            |  | (84,280)  |
|   | <b>Three Months<br/>Ended<br/>September 30<br/>2008,</b> | <b>Nine Months<br/>Ended<br/>September 30,<br/>2008</b> |
| <b>Statement of Operations Data</b>       |  |   |
| Revenues                                  | \$ 2,215   | \$ 14,819   |
| Expenses                                  | 8,173  | 25,337  |
| Operating loss                            | (5,958)  | (10,518)  |
| Other income (expense)                    | 4,020  | (13,308)  |
| Net loss                                  | \$ (1,938)   | \$ (23,826)   |

The Company has not provided current unaudited summarized financial data for Hallwood Energy for the three month and nine month periods ended September 30, 2009, in consideration of Hallwood Energy's bankruptcy reorganization, the extinguishment of the Company's ownership interests in Hallwood Energy in the plan of reorganization, HPI's possession of substantially all of Hallwood Energy's assets and operations (including all financial records), and the Company's lack of involvement in Hallwood Energy's operations.

Table of Contents

**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Nine Months Ended September 30, 2009 and 2008**  
**(unaudited)**

**Note 5 Loans Payable**

Loans payable, all of which relate to Brookwood, at the balance sheet dates were as follows (in thousands):

|   | September<br>30,<br>2009 | December<br>31,<br>2008 |
|---|--------------------------|-------------------------|
| Working capital revolving credit facility, interest at Libor +1.25 - 1.75% or Prime; due January 2011 | \$ 9,003                 | \$ 10,411               |
| Equipment term loans, interest at various rates; due April 2009                                       |                          | 27                      |
| Total   | 9,003                    | 10,438                  |
| Current portion   |                          | (27)                    |
| Noncurrent portion  | \$ 9,003                 | \$ 10,411               |

*Working Capital Revolving Credit Facility.* The Company's Brookwood subsidiary has a revolving credit facility in an amount up to \$25,000,000 with Key Bank National Association (the Working Capital Revolving Credit Facility). In October 2009, Brookwood entered into an amendment to this facility to extend the term to January 31, 2011, with an increase in the interest rate, at Brookwood's option, of Key Bank's Base Rate, typically Prime Rate, + 1.25% or LIBOR + 2.75%. Previously, the facility had a maturity date of January 31, 2010 and an interest rate, at Brookwood's option, of Prime, or Libor plus 1.25% - 1.75%. The facility's various covenants were continued and include an additional covenant (discussed below). Borrowings are collateralized by accounts receivable, certain finished goods inventory, machinery and equipment and all of the issued and outstanding capital stock of Brookwood and its subsidiaries. The interest rate was a blended rate of 2.08% and 2.30% at September 30, 2009 and December 31, 2008, respectively. The outstanding balance was \$9,003,000 at September 30, 2009 and Brookwood had \$15,876,000 of borrowing availability under this facility, which is net of a standby letter of credit for \$121,000.

*Equipment Term Loans.* In connection with the October 2009 renewal of the Working Capital Revolving Credit Facility, Brookwood's revolving equipment credit facility in an amount up to \$3,000,000 with Key Bank was not renewed. The interest rate for the remaining equipment term loan, which was repaid in April 2009, was 2.26% at December 31, 2008.

*Loan Covenants.* The Working Capital Revolving Credit Facility provides for a maximum total debt to tangible net worth ratio of 1.50 and a covenant that Brookwood shall maintain a quarterly minimum net income of not less than one dollar. With the renewal of the facility, an additional covenant was added that provides for a total funded debt to EBITDA (for the trailing four quarters) ratio of 2.00 to be calculated on a quarterly basis, commencing December 31, 2009. Cash dividends and tax sharing payments to the Company are contingent upon Brookwood's compliance with the covenants contained in the Working Capital Revolving Credit Facility. As of the end of all interim periods in 2009 and 2008 and as of December 31, 2008, Brookwood was in compliance with its loan covenants, although an amendment to the Working Capital Revolving Credit Facility was entered into in June 2008, to allow a \$4,800,000 dividend payment in June 2008, which restricted calendar 2008 total dividends from Brookwood to the Company to \$9,300,000.

*Restricted Net Assets.* Cash dividends and tax sharing payments by Brookwood to the Company are contingent upon compliance with the Key Bank loan covenants. This limitation on the transferability of assets constitutes a restriction of Brookwood's net assets, which were \$42,558,000 and \$32,754,000 as of September 30, 2009 and

December 31, 2008, respectively.

**Note 6 Stockholders Equity**

*Stock Options.* The Company established the 1995 Stock Option Plan for The Hallwood Group Incorporated (the 1995 Plan ), which authorized the granting of nonqualified stock options to employees, directors and consultants of the Company. The 1995 Plan authorized options to purchase up to 244,800 shares of common stock of the Company. The exercise prices of all options granted were at the fair market value of the Company s stock on the date of grant, had an expiration date of ten years from date of grant and were fully vested on the date of grant.

At September 30, 2009, there were no outstanding stock options as the remaining options were exercised in December 2008. The 1995 Plan terminated in June 2005 and no new options can be issued under the 1995 Plan.

**Table of Contents**

**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Nine Months Ended September 30, 2009 and 2008**  
**(unaudited)**

**Note 7 Income Taxes**

Following is a schedule of the income tax expense (benefit) (in thousands):

|           | <b>Three Months Ended</b> |             | <b>Nine Months Ended</b> |             |
|-----------|---------------------------|-------------|--------------------------|-------------|
|           | <b>September 30,</b>      |             | <b>September 30,</b>     |             |
|           | <b>2009</b>               | <b>2008</b> | <b>2009</b>              | <b>2008</b> |
| Federal   |                           |             |                          |             |
| Deferred  | \$ 899                    | \$ 317      | \$ 4,197                 | \$ 438      |
| Current   | 1,198                     | (109)       | 1,260                    | (109)       |
| Sub-total | 2,097                     | 208         | 5,457                    | 329         |
| State     |                           |             |                          |             |
| Deferred  |                           |             |                          |             |
| Current   | 332                       | 321         | 950                      | 1,294       |
| Sub-total | 332                       | 321         | 950                      | 1,294       |
| Foreign   |                           |             |                          |             |
| Current   | (280)                     |             | (280)                    |             |
| Total     | \$ 2,149                  | \$ 529      | \$ 6,127                 | \$ 1,623    |

The net deferred tax asset (liability) was \$(380,000) and \$3,818,000 at September 30, 2009 and December 31, 2008, respectively. The deferred tax liability at September 30, 2009 was comprised of \$380,000 attributable to temporary differences. The deferred tax asset at December 31, 2008 amount was attributable to temporary differences of \$550,000, a federal net operating loss carryforward of \$2,509,000 and \$759,000 of alternative minimum tax credits. The effective federal tax rate in both periods was 34%. State taxes are determined based upon taxable income apportioned to those states in which the Company does business at their respective tax rates.

The current federal income tax payable at September 30, 2009 of \$972,000 represents the estimated current tax due for the nine month period ended September 30, 2009, reduced by various tax loss and credit carryforwards and an estimated tax payment of \$250,000 paid by the Company in March 2009. The Company reported a taxable loss of \$2,325,000 on its federal income tax return for the year ended December 31, 2008 that was filed in September 2009, principally from operating income from Brookwood, offset by the flow-through of partnership losses from its Hallwood Energy investment.



**Table of Contents**

**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Nine Months Ended September 30, 2009 and 2008**  
**(unaudited)**

**Note 8 Supplemental Disclosures to the Condensed Consolidated Statements of Cash Flows**

The following transactions affected recognized assets or liabilities but did not result in cash receipts or cash payments in thousands):

*Supplemental schedule of non-cash investing and financing activities:*

| Description  | Nine Months Ended<br>September 30, |          |
|--|------------------------------------|----------|
|  | 2009                               | 2008     |
| Change in payable additional investment in Hallwood Energy                   | \$                                 | \$ 3,201 |
| Accrued capital expenditures in accounts payable:<br>Amount at end of period | \$ 8                               | \$ 37    |

*Supplemental disclosures of cash payments:*

|                   |        |        |
|-------------------|--------|--------|
| Income taxes paid | \$ 879 | \$ 634 |
| Interest paid     | 152    | 567    |

**Note 9 Computation of Income Per Common Share**

The following table reconciles weighted average shares outstanding from basic to diluted methods (in thousands):

| Description   | Three Months Ended<br>September 30, |          | Nine Months Ended<br>September 30, |          |
|---|-------------------------------------|----------|------------------------------------|----------|
|   | 2009                                | 2008     | 2009                               | 2008     |
| <b>Weighted Average Shares Outstanding</b>                |                                     |          |                                    |          |
| Basic   | 1,525                               | 1,521    | 1,525                              | 1,521    |
| Potential shares from assumed exercise of stock options   |                                     | 5        |                                    | 5        |
| Potential repurchase of shares from stock option proceeds |                                     | (3)      |                                    | (3)      |
| Diluted   | 1,525                               | 1,523    | 1,525                              | 1,523    |
| <b>Net Income</b>   |                                     |          |                                    |          |
| Basic and diluted   | \$ 4,068                            | \$ 1,255 | \$ 10,591                          | \$ 1,491 |

No shares were excluded from the calculation of diluted earnings per share for the nine months ended September 30, 2009 and 2008 or the three months ended September 30, 2009 and 2008.

**Note 10 Related Party Transactions**

*Hallwood Investments Limited.* The Company has entered into a financial consulting contract with Hallwood Investments Limited ( HIL ), a corporation associated with Mr. Anthony J. Gumbiner, the Company's chairman and principal stockholder. The contract provides for HIL to furnish and perform international consulting and advisory services to the Company and its subsidiaries, including strategic planning and merger activities, for annual compensation of \$996,000. The annual amount is payable in monthly installments. The contract automatically renews for one-year periods if not terminated by the parties beforehand. Additionally, HIL and Mr. Gumbiner are also eligible

for bonuses from the Company or its subsidiaries, subject to approval by the Company's or its subsidiaries' board of directors. The Company also reimburses HIL for reasonable expenses in providing office space and

**Table of Contents**

**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Nine Months Ended September 30, 2009 and 2008**  
**(unaudited)**

administrative services and for travel and related expenses principally to and from the Company's corporate office and Brookwood's facilities and health insurance premiums.

A summary of the fees and expenses related to HIL and Mr. Gumbiner are detailed below (in thousands):

|  | <b>Three Months Ended</b> |               | <b>Nine Months Ended</b> |                 |
|--|---------------------------|---------------|--------------------------|-----------------|
|  | <b>September 30,</b>      |               | <b>September 30,</b>     |                 |
|  | <b>2009</b>               | <b>2008</b>   | <b>2009</b>              | <b>2008</b>     |
| Consulting fees                          | \$ 249                    | \$ 249        | \$ 747                   | \$ 747          |
| Office space and administrative services | 24                        | 52            | 160                      | 204             |
| Travel and other expenses                | 85                        | 39            | 147                      | 75              |
| <b>Total</b>                             | <b>\$ 358</b>             | <b>\$ 340</b> | <b>\$ 1,054</b>          | <b>\$ 1,026</b> |

In addition, from time to time, HIL and Mr. Gumbiner have performed services for certain affiliated entities that are not subsidiaries of the Company, for which they receive consulting fees, bonuses, stock options, profit interests or other forms of compensation and expenses. The Company recognizes a proportionate share of such compensation and expenses, based upon its ownership percentage in the affiliated entities, through the utilization of the equity method of accounting. In the three months and nine months ended September 30, 2008 Mr. Gumbiner received a consulting fee from only one affiliate, Hallwood Energy, of approximately \$50,000 and \$150,000, respectively. Mr. Gumbiner received no compensation from Hallwood Energy during 2009.

In January 2008, Hallwood Family BVI, L.P. ( HFBL ), a partnership affiliated with Mr. Gumbiner, loaned \$5,000,000 to Hallwood Energy in connection with Hallwood Energy's \$30,000,000 First Convertible Note. Terms of the First Convertible Note agreement are discussed in Note 4. As of November 1, 2009, HFBL had invested \$19,156,000 in Hallwood Energy, of which \$14,156,000 was in the form of Class C limited partnership interest and \$5,000,000 of its First Convertible Note. Pursuant to Hallwood Energy's bankruptcy plan of reorganization, the Class C partnership interest was extinguished and the convertible notes have been subordinated to recovery in favor of HPI.

During the period, other companies in which Mr. Gumbiner has an indirect financial interest shared common offices, facilities and certain staff in the Company's Dallas office for which these companies reimburse the Company. The Company pays certain common general and administrative expenses and charges the companies an overhead reimbursement fee for the share of the expenses allocable to these companies. For the three months ended September 30, 2009 and 2008, these companies reimbursed the Company \$19,000 and \$38,000, respectively, for such expenses. For the nine months ended September 30, 2009 and 2008, these companies reimbursed the Company \$55,000 and \$118,000, respectively.

*Hallwood Financial Limited.* As further discussed in Note 13, Hallwood Financial Limited, a corporation affiliated with Mr. Gumbiner, announced on April 20, 2009 that it had advised the Board of Directors that it intended to make an offer to acquire all of the outstanding common stock of the Company not already beneficially owned by Hallwood Financial Limited. On June 17, 2009, Hallwood Financial Limited announced that it had determined that it would not proceed with the offer.

*Hallwood Energy.* Prior to July 31, 2009, Hallwood Energy shared common offices, facilities and certain staff in the Company's Dallas office and Hallwood Energy was obligated to reimburse the Company for its allocable share of the expenses and certain direct expenses. For the three months ended September 30, 2009 and 2008, Hallwood Energy's share of such expenses was \$9,000 and \$113,000, respectively. For the nine months ended September 30, 2009 and 2008, Hallwood Energy's share of such expenses was \$124,000 and \$317,000, respectively. At

September 30, 2009, the amount due from Hallwood Energy was \$37,000. Hallwood Energy completed its move from the office space by July 31, 2009 and is no longer sharing such expenses.

**Table of Contents**

**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Nine Months Ended September 30, 2009 and 2008**  
**(unaudited)**

**Note 11 Litigation, Contingencies and Commitments**

Reference is made to Note 16 to the consolidated financial statements contained in Form 10-K for the year ended December 31, 2008.

*Litigation.* From time to time, the Company, its subsidiaries, certain of its affiliates and others have been named as defendants in lawsuits relating to various transactions in which it or its affiliated entities participated. Although the Company does not believe that the results of any of these matters are likely to have a material adverse effect on its financial condition, results of operation or cash flows, it is possible that any of the matters could result in material liability to the Company. In addition, the Company has spent and will likely continue to spend significant amounts in professional fees in connection with these matters. The Company expenses professional fees associated with litigation matters as incurred.

In July 2007, Nextec Applications, Inc. filed *Nextec Applications, Inc. v. Brookwood Companies Incorporated and The Hallwood Group Incorporated* in the United States District Court for the Southern District of New York (SDNY No. CV 07-6901) claiming that the defendants infringed five United States patents pertaining to internally-coated webs: U.S. Patent No. 5,418,051; 5,856,245; 5,869,172; 6,071,602 and 6,129,978. On October 3, 2007, the U.S. District Court dismissed The Hallwood Group Incorporated from the lawsuit. Brookwood timely answered the lawsuit. Nextec sought leave of Court to add two additional patents to the lawsuit: U.S. Patent No. 5,954,902 and 6,289,841. The Court granted leave to Nextec, and Nextec filed its amended complaint September 19, 2008. The Court has scheduled a hearing in January 2010 on motions for summary judgment submitted by both parties on various issues. Brookwood intends to vigorously defend all claims. Brookwood believes it possesses valid defenses, however due to the nature of litigation, the ultimate outcome of this case is indeterminable at this time.

In April 2009, a claim was filed against, but not served on, the Company, each of its directors and Hallwood Financial Limited in the state district court in Dallas County, Texas by a purported stockholder of the Company on behalf of the stockholders of the Company other than Hallwood Financial Limited. The plaintiff alleges that in connection with the announcement by Hallwood Financial Limited that it intended to commence an offer to acquire the remaining outstanding shares of the Company's common stock not beneficially owned by Hallwood Financial Limited, each of the directors breached their fiduciary duties to the minority stockholders, and that the Company and Hallwood Financial Limited aided and abetted that breach. The plaintiff is also seeking to enjoin the proposed offer. The case is styled as *Gottlieb v. The Hallwood Group, Inc.*, et al, No. 9-05042, 134<sup>th</sup> Judicial District, Dallas County, Texas. The Company believes the claim is premature and without merit. The Company intends to contest this matter vigorously. On June 17, 2009, Hallwood Financial Limited announced that it had determined that it would not proceed with the offer.

In connection with the Acquisition and Farmout Agreement entered into between Hallwood Energy and FEI, in June 2008, the Company and Hallwood Energy entered into an Equity Support Agreement dated June 9, 2008, under which the Company agreed, under certain conditions, to contribute to Hallwood Energy up to \$12,500,000, in consideration for which the Company would receive equity or debt securities of Hallwood Energy. As of February 25, 2009 the Company had contributed \$9,300,000 to Hallwood Energy pursuant to the Equity Support Agreement. On that date, Hallwood Energy requested that the Company fund the additional \$3,200,000, which the Company has not done. As previously discussed, on March 1, 2009, Hallwood Energy, HEM and Hallwood Energy's subsidiaries filed petitions for relief under Chapter 11 of the United States Bankruptcy Code. On March 30, 2009, Hallwood Energy filed an adversary proceeding against the Company requesting that the Company fund the additional \$3,200,000. The case is *Hallwood Energy, L.P. v. The Hallwood Group Incorporated*, Adversary No. 09-03082, in the United States Bankruptcy Court for the Northern District of Texas, Dallas Division. On April 29, 2009, the Company filed an answer to Hallwood Energy's lawsuit and denied liability under the Equity Support Agreement. HPI has filed a motion for summary judgment on its claims and a hearing on this motion was held on July 17, 2009. The Court has not yet entered a ruling on the motion. The Company intends to defend the matter vigorously.

HPI and FEI were granted permission to intervene in the lawsuit and filed their respective complaints in intervention. Among the arguments advanced in the complaints is that the Company's failure to fund \$3,200,000 under the Equity Support Agreement damaged Hallwood Energy in an amount in excess of \$3,200,000. In its complaint, HPI contends that the additional damage is at least \$20,000,000 because it alleges that the failure of the Company to fund the \$3,200,000 caused FEI to not fund \$20,000,000 due under the Farmout Agreement between Hallwood Energy and FEI. HPI also asserts that the Company is liable for exemplary damages of \$100,000,000 on account of its failure to fund the last \$3,200,000 under the Equity Support Agreement. FEI's

**Table of Contents**

**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Nine Months Ended September 30, 2009 and 2008**  
**(unaudited)**

complaint in intervention claims that it was denied the benefit of its bargain promised in the Farmout Agreement and alleges consequential damages in excess of the \$3,200,000. The Company has and intends to continue to contest the allegations vigorously.

On August 3, 2009, the Company was served with a complaint in *Hall Phoenix/Inwood Ltd. and Hall Performance Energy Partners 4, Ltd. v. The Hallwood Group Incorporated, et al.* filed in the 298<sup>th</sup> District of Texas, No. 09-09551. The other defendants include Anthony J. Gumbiner, the Chairman and Chief Executive Officer of the Company, Bill Guzzetti, the President of the Company, certain affiliates of Mr. Gumbiner and certain officers of Hallwood Energy. The complaint alleges that the defendants defrauded plaintiffs in connection with plaintiffs acquiring interests in and providing loans to Hallwood Energy and seeks unspecified actual and exemplary damages.

In addition, the confirmed plan of reorganization in the Hallwood Energy bankruptcy proceeding, provides that a creditors trust created by the plan will pursue various claims against the Company and its officers, directors and affiliates and Hallwood Energy's officers and directors. Attorneys for HPI have also delivered a letter on behalf of HPI and certain affiliates alleging claims against the Company and its officers, directors and affiliates and Hallwood Energy's officers and directors for, among other things, breach of contract, breach of fiduciary duties, neglect, negligence, and various alleged misleading statements, omissions and misrepresentations. HPI and certain of its affiliates have asserted that its damages exceed \$200,000,000. The Company believes that the allegations and claims are without merit and intends to defend the lawsuit and any future claims vigorously.

*Hallwood Energy.* On March 1, 2009, Hallwood Energy, HEM (the general partner of Hallwood Energy) and Hallwood Energy's subsidiaries, filed petitions for relief under Chapter 11 of the United States Bankruptcy Code. The cases were adjudicated in the United States Bankruptcy Court for the Northern District of Texas, Dallas Division, in *In re Hallwood Energy, L.P., et al Case No. 09-31253*. The Company was only an investor in and creditor of Hallwood Energy. The bankruptcy filing did not include the Company or any other of its assets. Refer to Note 4 for a further description of the bankruptcy case.

On October 19, 2009, the Bankruptcy Court confirmed the plan of reorganization proposed by HPI that, among other things, extinguished Hallwood Energy's general partnership and limited partnership interests, including those held by the Company. As a result of these developments, the Company does not anticipate that it will recover any of its investments in Hallwood Energy. The carrying value of the Company's investment in Hallwood Energy has been reflected as zero since December 31, 2007.

*Environmental Contingencies.* A number of jurisdictions in which the Company operates have adopted laws and regulations relating to environmental matters. Such laws and regulations may require the Company to secure governmental permits and approvals and undertake measures to comply therewith. Compliance with the requirements imposed may be time-consuming and costly. While environmental considerations, by themselves, have not significantly affected the Company's business to date, it is possible that such considerations may have a significant and adverse impact in the future. The Company actively monitors its environmental compliance and while certain matters currently exist, management is not aware of any compliance issues which will significantly impact the financial position, operations or cash flows of the Company.

In August 2005, the Rhode Island Department of Health (RIDOH) issued a compliance order to Kenyon, alleging that Kenyon is a non-community water system and ordering Kenyon to comply with the RIDOH program for public water supply systems. Kenyon contested the compliance order and an administrative hearing was held in November 2005. No decision was ever rendered by RIDOH. However, by letter dated July 23, 2008, the United States Environmental Protection Agency (EPA) advised Kenyon that it is the EPA's position that the Kenyon facility is a Public Water System and subject to regulation under the Safe Drinking Water Act. As a result, in January 2009, Kenyon entered into a Consent Order with RIDOH agreeing to apply for a public water license and submit plans to comply with the aforementioned regulations. Conformance with the Consent Order will require the Company to revamp Kenyon's water supply system at an anticipated minimum cost of \$100,000.

In June 2007, the Rhode Island Department of Environmental Management ( RIDEM ) issued a Notice of Alleged Violation ( NOV ) to Kenyon, alleging that Kenyon violated certain provisions of its wastewater discharge permit and seeking an administrative penalty of \$79,000. Kenyon filed an Answer and Request for Hearing in which it disputed certain allegations in the NOV and the amount of the penalty. An informal meeting was held with RIDEM in August 2007. Following settlement negotiations, a Consent Agreement was executed in June 2008. The Consent Agreement required the Company to pay a \$5,000 fine and perform two Supplemental Environmental Projects ( SEPs ) at a total cost of \$161,000. As of March 2009, one SEP had been completed. The Company is presently awaiting RIDEM approval of the engineering plans for the second SEP. Once the approval is received, the second SEP will be performed. The Company anticipates that the second SEP will be completed during 2010.



**Table of Contents**

**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Nine Months Ended September 30, 2009 and 2008**  
**(unaudited)**

*Other Contingencies.* In May 2009, one of Brookwood's suppliers advised Brookwood that shipments to Brookwood during the period from September 2008 to April 2009 of a quantity of greige fabric from the supplier incorporated fiber in some yarn from their vendor that was not of domestic origin. The fabric in question was ordered to fill contracts in support of the United States military and was required to be domestic. Brookwood's suppliers have advised that the greige fabric containing the non-compliant yarn was supplied inadvertently to Brookwood in limited quantity. Brookwood has determined that this yarn affects two of their greige products. Brookwood has advised its affected customers and the United States military of this circumstance. Brookwood has resolved the issue with respect to one of the products and remains in the process of determining the effect, if any, of the second product.

**Note 12 Segments and Related Information**

The following represents the Company's reportable segment operations for the three months and nine months ended September 30, 2009 and 2008, respectively (in thousands):

|  | <b>Textile<br/>Products</b> | <b>Energy</b> | <b>Other</b> | <b>Consolidated</b> |
|--|-----------------------------|---------------|--------------|---------------------|
| <b>Three months ended September 30, 2009</b> |                             |               |              |                     |
| Total revenue from external sources          | \$ 44,182                   |               |              | \$ 44,182           |
| Operating income (loss)                      | \$ 8,125                    | \$            | \$ (1,880)   | \$ 6,245            |
| Other income (loss), net                     | (44)                        |               | 16           | (28)                |
| Income (loss) before income taxes            | \$ 8,081                    | \$            | \$ (1,864)   | \$ 6,217            |
| <b>Three months ended September 30, 2008</b> |                             |               |              |                     |
| Total revenue from external sources          | \$ 35,568                   |               |              | \$ 35,568           |
| Operating income (loss)                      | \$ 3,401                    | \$            | \$ (1,508)   | \$ 1,893            |
| Other income (loss), net                     | (139)                       |               | 30           | (109)               |
| Income (loss) before income taxes            | \$ 3,262                    | \$            | \$ (1,478)   | \$ 1,784            |
| <b>Nine months ended September 30, 2009</b>  |                             |               |              |                     |
| Total revenue from external sources          | \$ 128,166                  |               |              | \$ 128,166          |
| Operating income (loss)                      | \$ 21,723                   | \$            | \$ (4,867)   | \$ 16,856           |
| Other income (loss), net                     | (171)                       |               | 33           | (138)               |
| Income (loss) before income taxes            | \$ 21,552                   | \$            | \$ (4,834)   | \$ 16,718           |
| <b>Nine months ended September 30, 2008</b>  |                             |               |              |                     |

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|                                     |            |             |            |            |
|-------------------------------------|------------|-------------|------------|------------|
| Total revenue from external sources | \$ 126,689 |             |            | \$ 126,689 |
| Operating income (loss)             | \$ 19,542  | \$          | \$ (3,813) | \$ 15,729  |
| Other income (loss), net            | (567)      | (12,120)    | 72         | (12,615)   |
| Income (loss) before income taxes   | \$ 18,975  | \$ (12,120) | \$ (3,741) | \$ 3,114   |

No differences have occurred in the basis or methodologies used in the preparation of this interim segment information from those used in the December 31, 2008 annual report. The total assets for the Company's operating segments have not materially changed since the December 31, 2008 annual report.

Page 23

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**Table of Contents**

**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Nine Months Ended September 30, 2009 and 2008**  
**(unaudited)**

On April 20, 2009, Hallwood Financial Limited ( Hallwood Financial ), a corporation affiliated with Mr. Anthony J. Gumbiner, a director, Chairman of the Board of Directors and Chief Executive Officer of the Company, which currently owns 65.7% of the outstanding common stock of the Company, announced that it had advised the Board of Directors of the Company that it intended to make an offer to acquire all of the outstanding shares of common stock of the Company not already beneficially owned by Hallwood Financial (approximately 523,591 shares). In its announcement, Hallwood Financial indicated that it intended to offer \$12.00 per share in cash for each share of common stock not already owned by Hallwood Financial.

On June 17, 2009, Hallwood Financial announced that it had determined that it would not proceed with the offer.

**Note 14 Subsequent Events**

In completing the condensed consolidated financial statements and related notes thereto for the nine months ended September 30, 2009, the Company considered two subsequent events:

On October 19, 2009, the Bankruptcy Court confirmed the plan of reorganization for Hallwood Energy that, among other things, extinguished Hallwood Energy's general partnership and limited partnership interests, including those held by the Company.

On October 23, 2009, Brookwood entered into an amendment to the Working Capital Revolving Credit Facility with Key Bank that, among other things, extends the loan term from January 31, 2010 to January 31, 2011.

**Table of Contents**

**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**

**Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

**Overview**

*General.* The Company operates as a holding company. The principal remaining business is in the textile products industry, following the bankruptcy reorganization of its former Hallwood Energy affiliate.

*Textile Products.* In 2008 and 2009, the Company derived all of its operating revenues from the textile activities of its Brookwood Companies Incorporated ( Brookwood ) subsidiary; consequently, the Company's success is highly dependent upon Brookwood's success. Brookwood's success will be influenced in varying degrees by its ability to continue sales to existing customers, cost and availability of supplies, Brookwood's response to competition, its ability to generate new markets and products and the effect of global trade regulation. Although the Company's textile activities have generated positive cash flows in recent years, there is no assurance that this trend will continue.

While Brookwood has enjoyed substantial growth in its military business, there is no assurance that this trend will continue. Brookwood's sales to the customers from whom it derives its military business have been volatile and difficult to predict, a trend the Company believes will continue. In recent years, orders from the military for goods generally were significantly affected by the increased activity of the U.S. military. If this activity does not continue or declines, then orders from the military generally, including orders for Brookwood's products, may be similarly affected. Military sales of \$32,415,000 and \$92,845,000 for the 2009 third quarter and nine month periods, respectively, were 52.9% and 14.4% higher than the comparable periods in 2008 of \$21,194,000 and \$81,148,000.

From time to time, the military limits orders for existing products and adopts revised specifications for new products to replace the products for which Brookwood's customers have been suppliers. The U.S. government released orders in recent years that include Brookwood's products, which resulted in a substantial increase in military sales over prior periods. Changes in specifications or orders present a potential opportunity for additional sales; however, it is a continuing challenge to adjust to changing specifications and production requirements. Brookwood has regularly conducted research and development on various processes and products intended to comply with the revised specifications and participates in the bidding process for new military products. However, to the extent Brookwood's products are not included in future purchases by the U.S. government for any reason, Brookwood's sales could be adversely affected. A provision of U.S. federal law, known as the Berry Amendment, generally requires the Department of Defense to give preference in procurement to domestically produced products, including textiles. Brookwood's sales of products to the U.S. military market is highly dependent upon the continuing application and enforcement of the Berry Amendment by the U.S. government. In addition, the U.S. government is releasing contracts for shorter periods than in the past. The Company acknowledges the unpredictability in revenues and margins due to military sales and is unable at this time to predict future sales trends.

Unstable global nylon and chemical pricing and volatile domestic energy costs, coupled with a varying product mix, have continued to cause fluctuations in Brookwood's margins, a trend that will potentially continue.

Brookwood continues to identify new market niches intended to replace sales lost to imports. In addition to its existing products and proprietary technologies, Brookwood has been developing advanced breathable, waterproof laminates and other materials, which have been well received by its customers. Continued development of these fabrics for military, industrial and consumer applications is a key element of Brookwood's business plan. The ongoing success of Brookwood is contingent on its ability to maintain its level of military business and adapt to the global textile industry. There can be no assurance that the positive results of the past can be sustained or that competitors will not aggressively seek to replace products developed by Brookwood.

The U.S. textile industry has been and continues to be negatively impacted by existing worldwide trade practices, including the North American Free Trade Agreement ( NAFTA ), the Central American Free Trade Agreement ( CAFTA ), anti-dumping and duty enforcement activities by the U.S. Government and by the value of the U.S. dollar in relation to other currencies. The establishment of the World Trade Organization ( WTO ) in 1995 has generally resulted in the phase out of quotas on textiles and apparel, effective January 1, 2005. Brookwood does not believe these developments will have a material impact on its business.

Under NAFTA and CAFTA there are no textile and apparel quotas between the U. S. and the other parties for products that meet certain origin criteria. Tariffs among the countries are either already zero or are being phased out. Although these actions have the effect of exposing Brookwood's market to the lower price structures of the other countries and, therefore, continuing to increase competitive pressures, management is not able to predict their specific impact.

**Table of Contents****THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES****Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

The Company does not guarantee the Brookwood bank facility and is not obligated to contribute additional capital. Conversely, Brookwood does not guarantee debts of the Company or any of the Company's subsidiaries and is not obligated to contribute additional capital to the Company beyond dividend payments and the tax sharing agreement.

*Energy.* Hallwood Energy was a privately held independent oil and gas limited partnership and operated as an upstream energy company engaged in the acquisition, development, exploration, production, and sale of hydrocarbons, with a primary focus on natural gas assets.

On March 1, 2009, Hallwood Energy, HEM (the general partner of Hallwood Energy) and Hallwood Energy's subsidiaries, filed petitions for relief under Chapter 11 of the United States Bankruptcy Code. The cases were adjudicated in the United States Bankruptcy Court for the Northern District of Texas, Dallas Division, in *In re Hallwood Energy, L.P., et al Case No. 09-31253*. The Company was only an investor in and creditor of Hallwood Energy. The bankruptcy filing did not include the Company or any other of its assets. On October 16, 2009, the Bankruptcy Court confirmed the plan of reorganization proposed by HPI. For a further discussion of the bankruptcy case, refer to the section entitled *Investments in Hallwood Energy Bankruptcy Filing by Hallwood Energy*.

Refer also to the section *Investments in Hallwood Energy* for a further description of the Company's energy investments.

**Presentation**

The Company intends the discussion of its financial condition and results of operations that follows to provide information that will assist in understanding its financial statements, the changes in certain key items in those financial statements from year to year, and the primary factors that accounted for those changes, as well as how certain accounting principles, policies and estimates affect its financial statements.

**Results of Operations**

The Company reported net income for the 2009 third quarter of \$4,068,000, compared to net income of \$1,255,000 in 2008. Revenue for the 2009 third quarter was \$44,182,000, compared to \$35,568,000 in 2008.

Net income for the 2009 nine month period was \$10,591,000, compared to net income of \$1,491,000 in 2008. Revenue for the 2009 nine month period was \$128,166,000, compared to \$126,689,000 in 2008.

**Revenues**

Textile products sales of \$44,182,000 increased by \$8,614,000, or 24.2%, in the 2009 third quarter, compared to \$35,568,000 in 2008. Sales for the 2009 nine month period increased by \$1,477,000, or 1.2%, to \$128,166,000, compared to \$126,689,000 in 2008. The increases in the 2009 periods were principally due to an increase in sales of specialty fabric to military contractors, partially offset by a decrease in the commercial market segment, as well as sail cloth, flag and other customer products affected by the current economic downturn. Military sales accounted for \$32,415,000 and \$92,845,000 in the 2009 third quarter and nine month periods, respectively, compared to \$21,194,000 and \$81,148,000 in 2008. The military sales represented 73.4% and 59.6% of Brookwood's net sales in the 2009 and 2008 third quarters, respectively, and 72.4% and 64.1% in the 2009 and 2008 nine month periods, respectively.

*Sales Concentration.* Brookwood has several customers who accounted for more than 10% of Brookwood's sales in the 2009 and 2008 periods. Sales to one Brookwood customer, Tennier Industries, Inc. (Tennier), accounted for more than 10% of Brookwood's sales during both the 2009 and 2008 periods. Its relationship with Tennier is ongoing. Sales to Tennier, which are included in military sales, were \$16,933,000 and \$40,298,000 in the 2009 third quarter and nine month periods, respectively, compared to \$8,593,000 and \$38,573,000 in 2008. Sales to Tennier represented 38.3% and 24.2% of Brookwood's net sales in the 2009 and 2008 third quarters, respectively, and 31.4% and 30.4% in the 2009 and 2008 nine month periods, respectively. Sales to another customer, ORC Industries, Inc. (ORC), accounted for more than 10% of Brookwood's sales in 2009 and 2008. Its relationship with ORC is ongoing. Sales to ORC, which are included in military sales, were \$3,926,000 and \$18,925,000 in the 2009 third quarter and nine month periods, respectively, compared to \$4,093,000 and \$13,375,000 in 2008. Sales to ORC represented 8.9% and 11.5% of Brookwood's net sales in the 2009 and 2008 third quarters, respectively, and 14.8% and 10.6% in the 2009 and 2008

nine month periods, respectively. Sales to another customer accounted for more than 10% of sales for 2008 only. Brookwood's relationship with the customer is ongoing. Sales to that customer, which are also included in the military sales, were \$1,956,000 and

**Table of Contents****THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES****Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

\$8,116,000 in the 2009 third quarter and nine month periods, compared to \$4,439,000 and \$15,208,000 in the 2008 third quarter and nine month periods, which represented 4.4% and 12.5% of Brookwood sales in the third quarters in 2009 and 2008, and 6.3% and 12.0% in the 2009 and 2008 nine month periods, respectively.

**Expenses**

Textile products cost of sales of \$31,816,000 for the 2009 third quarter increased by \$4,101,000, or 14.8%, compared to \$27,715,000 in 2008. For the nine month periods, textile products cost of sales of \$93,322,000 for 2009 decreased by \$912,000, or 1.0%, compared to \$94,234,000 in 2008. The 2009 changes principally resulted from fluctuating sales volume, changes in product mix and reduced energy costs, which decreased 37.0% and 29.5% in the 2009 third quarter and nine month periods compared to the 2008 periods. Cost of sales includes all costs associated with the manufacturing process, including but not limited to, materials, labor, utilities, depreciation on manufacturing equipment and all costs associated with the purchase, receipt and transportation of goods and materials to Brookwood facilities, including inbound freight, purchasing and receiving costs, inspection costs, internal transfer costs and other costs of the distribution network and associated manufacturer's rebates. Brookwood believes that the reporting and composition of cost of sales and gross margin is comparable with similar companies in the textile converting and finishing industry.

The gross profit margin for the 2009 third quarter, 28.0% versus 22.1%, and for the 2009 nine month period, 27.2% versus 25.6%, increased over the comparable prior periods. Increases in the gross profit margin are attributed to higher sales volumes, changes in product mix, energy savings and manufacturing efficiencies such as reductions to material working loss.

Administrative and selling expenses were comprised of the following (in thousands):

|                  | <b>Three Months Ended</b> |                 | <b>Nine Months Ended</b> |                  |
|------------------|---------------------------|-----------------|--------------------------|------------------|
|                  | <b>September 30,</b>      |                 | <b>September 30,</b>     |                  |
|                  | <b>2009</b>               | <b>2008</b>     | <b>2009</b>              | <b>2008</b>      |
| Textile products | \$ 4,241                  | \$ 4,452        | \$ 13,121                | \$ 12,913        |
| Corporate        | 1,880                     | 1,508           | 4,867                    | 3,813            |
| <b>Total</b>     | <b>\$ 6,121</b>           | <b>\$ 5,960</b> | <b>\$ 17,988</b>         | <b>\$ 16,726</b> |

Textile products administrative and selling expenses of \$4,241,000 for the 2009 third quarter decreased by \$211,000, or 4.7%, from 2008. For the nine months, textile products administrative and selling expenses increased by \$208,000, or 1.6%, compared to 2008. The decrease for the 2009 third quarter from the 2008 quarter was primarily attributable to a decrease in bad debt expense of \$134,000. The increase for the 2009 nine month period was primarily attributable to an increase of \$486,000 in professional services, principally legal fees, offset by a reduction of \$212,000 related to performance and other related payroll costs. The textile products administrative and selling expenses included items such as payroll, professional fees, sales commissions, factor commissions, marketing, rent, insurance, travel and royalties. Brookwood conducts research and development activities related to the exploration, development and production of innovative products and technologies. Research and development costs were approximately \$161,000 and \$574,000 for the three months and nine months ended September 30, 2009 and \$210,000 and \$668,000 for the three months and nine months ended September 30, 2008, respectively.

Corporate administrative expenses increased \$372,000, or 24.7%, for the 2009 third quarter, compared to 2008. For the nine months, corporate expenses increased \$1,054,000, or 27.6%, compared to 2008. The increases were principally attributable to higher professional fees of \$614,000 and \$1,582,000 for the 2009 three month and nine month periods, respectively, including costs related to the Hallwood Energy bankruptcy, the special committee's activities in considering the offer by the chairman and principal stockholder to acquire the Company's outstanding



common stock that has been canceled and accounting and tax services. The increases were partially offset by decreased employee related expenses of \$83,000 and \$233,000 for the 2009 three month and nine month periods, respectively, due to a reduction in staff.

**Table of Contents****THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES****Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS****Other Income (Loss)**

Equity loss from the Company's investments in Hallwood Energy, attributable to the Company's share of loss in Hallwood Energy, to the extent of its investment and commitment to provide additional financial support to Hallwood Energy, was zero in both the 2009 and 2008 third quarters. The equity loss for the 2009 nine month period was zero, compared to a loss of \$12,120,000 in 2008. In consideration of Hallwood Energy's bankruptcy proceedings, the extinguishment of the Company's ownership interest in Hallwood Energy in the approved plan of reorganization, the previously recorded reduction in the carrying value of the Hallwood Energy investment to zero and possession by Hall Phoenix/Inwood, Ltd. (HPI), the secured lender to Hallwood Energy, of substantially all of Hallwood Energy's assets and operations (including all financial records), the Company is unable to provide operating data for Hallwood Energy for the three month and nine month periods ended September 30, 2009. In the 2008 third quarter, Hallwood Energy reported a loss of \$1,938,000, which included an impairment of its oil and gas properties of \$3,742,000, interest expense of \$858,000 (including an offset of \$6,374,000 attributable to the make-whole fee) and other income of \$3,227,000, which principally related to the contract services agreement with Talisman. For the 2008 nine month period, Hallwood Energy reported a loss of \$23,826,000. The Company recorded equity losses in the 2008 periods to the extent of loans it made to Hallwood Energy in 2008 of \$8,919,000 and a commitment under certain conditions to invest additional funds in accordance with the Equity Support Agreement up to \$3,201,000 and maintained the carrying value of its investment in Hallwood Energy at zero.

Interest expense was \$44,000 and \$171,000 in the 2009 third quarter and nine month periods, respectively, compared to \$139,000 and \$567,000 in the 2008 periods. Interest expense principally relates to Brookwood's Key Bank revolving credit facility. The decreases in interest expense were due to a decline in the average outstanding loan amount and lower average interest rates (2.08% and 4.95% at September 30, 2009 and 2008, respectively).

Interest and other income was \$16,000 and \$33,000 in the 2009 third quarter and nine month periods, respectively, compared to \$30,000 and \$72,000 in 2008. The 2009 decreases were principally due to reduced interest income earned on lower balances of cash and cash equivalents and lower interest rates.

**Income Taxes**

Following is a schedule of income tax expense (in thousands):

|           | <b>Three Months Ended</b> |             | <b>Nine Months Ended</b> |             |
|-----------|---------------------------|-------------|--------------------------|-------------|
|           | <b>September 30,</b>      |             | <b>September 30,</b>     |             |
|           | <b>2009</b>               | <b>2008</b> | <b>2009</b>              | <b>2008</b> |
| Federal   |                           |             |                          |             |
| Deferred  | \$ 899                    | \$ 317      | \$ 4,197                 | \$ 438      |
| Current   | 1,198                     | (109)       | 1,260                    | (109)       |
| Sub-total | 2,097                     | 208         | 5,457                    | 329         |
| State     |                           |             |                          |             |
| Deferred  |                           |             |                          |             |
| Current   | 332                       | 321         | 950                      | 1,294       |
| Sub-total | 332                       | 321         | 950                      | 1,294       |
| Foreign   |                           |             |                          |             |
| Current   | (280)                     |             | (280)                    |             |

|       |          |        |          |          |
|-------|----------|--------|----------|----------|
| Total | \$ 2,149 | \$ 529 | \$ 6,127 | \$ 1,623 |
|-------|----------|--------|----------|----------|

At September 30, 2009, the net deferred tax liability was attributable to temporary differences. The effective federal tax rate in both periods was 34%, while state taxes are determined based upon taxable income apportioned to those states in which the Company does business at their respective tax rates.

**Investments in Hallwood Energy**

At September 30, 2009 and December 31, 2008, the Company had invested \$61,481,000 in Hallwood Energy, which represented approximately 22% of the blended Class A and Class C limited partner interests (18% after consideration of profit interests). In addition, the Company loaned Hallwood Energy \$13,920,000 in the form of convertible notes issued by Hallwood

**Table of Contents****THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES****Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

Energy. Prior to the approval of Hallwood Energy's plan of reorganization in Bankruptcy Court (discussed below), the Company accounted for the investment in Hallwood Energy using the equity method of accounting and recorded its pro rata share of Hallwood Energy's net income (loss) and partners' capital transactions, as appropriate. In connection with Hallwood Energy's bankruptcy reorganization, the Company's ownership interest in Hallwood Energy was extinguished and the Company no longer accounts for the investment in Hallwood Energy using the equity method of accounting.

Certain of the Company's officers and directors were investors in Hallwood Energy. In addition, one officer of the Company held a profit interest in Hallwood Energy that was also extinguished in the bankruptcy.

*Bankruptcy Filing by Hallwood Energy.* On March 1, 2009, Hallwood Energy, HEM (the general partner of Hallwood Energy) and Hallwood Energy's subsidiaries, filed petitions for relief under Chapter 11 of the United States Bankruptcy Code. The cases were adjudicated in the United States Bankruptcy Court for the Northern District of Texas, Dallas Division, in *In re Hallwood Energy, L.P., et al Case No. 09-31253*. The Company was only an investor in and creditor of Hallwood Energy. The bankruptcy filing did not include the Company or any other of its assets.

On June 29, 2009, the Bankruptcy Court granted a motion by HPI to partially lift the automatic stay applicable in bankruptcy proceedings, permitting HPI, among other things, to enter upon and take possession of substantially all of Hallwood Energy's assets and operations.

On October 19, 2009, the Bankruptcy Court confirmed the plan of reorganization proposed by HPI that, among other things, extinguished Hallwood Energy's general partnership and limited partnership interests, including those held by the Company. As a result of these developments, the Company does not anticipate that it will recover any of its investments in Hallwood Energy. The carrying value of the Company's investment in Hallwood Energy has been reflected as zero since December 31, 2007.

Hallwood Energy's previously filed adversary proceeding against the Company requesting that the Company fund \$3,200,000 under the Equity Support Agreement (discussed below) between Hallwood Energy and the Company remains outstanding. In addition, the Bankruptcy Court had previously granted the motions of HPI and of FEI Shale, L.P. (FEI), a subsidiary of Talisman Energy, Inc., to intervene as plaintiffs in the proceeding. HPI and FEI contend that the Company's failure to fund \$3,200,000 under an Equity Support Agreement damaged Hallwood Energy in an amount excess of \$3,200,000 and have asserted compensatory and exemplary damages. HPI filed a motion for summary judgment on its claims and a hearing on this motion was held on July 17, 2009. The Court has not yet entered a ruling on the motion.

On August 3, 2009, the Company was served with a complaint in *Hall Phoenix/Inwood Ltd. and Hall Performance Energy Partners 4, Ltd. v. The Hallwood Group Incorporated, et al.* filed in the 298<sup>th</sup> District of Texas, No. 09-09551. The other defendants include Anthony J. Gumbiner, the Chairman and Chief Executive Officer of the Company, Bill Guzzetti, the President of the Company, certain affiliates of Mr. Gumbiner and certain officers of Hallwood Energy. The complaint alleges that the defendants defrauded plaintiffs in connection with plaintiffs acquiring interests in and providing loans to Hallwood Energy and seeks unspecified actual and exemplary damages.

In addition, the confirmed plan of reorganization in the Hallwood Energy bankruptcy proceeding, provides that a creditors' trust created by the plan will pursue various claims against the Company and its officers, directors and affiliates and Hallwood Energy's officers and directors. Attorneys for HPI have also delivered a letter on behalf of HPI and certain affiliates alleging claims against the Company and its officers, directors and affiliates and Hallwood Energy's officers and directors for, among other things, breach of contract, breach of fiduciary duties, neglect, negligence, and various alleged misleading statements, omissions and misrepresentations. HPI and certain of its affiliates have asserted that its damages exceed \$200,000,000. The Company believes that the allegations and claims are without merit and intends to defend the lawsuit and any future claims vigorously.

*Equity Losses.* Under U.S. generally accepted accounting principles, the general rule for recording equity losses ordinarily indicates that the investor shall discontinue applying the equity method when the investment has been reduced to zero and shall not provide for additional losses unless the investor provides or commits to provide

additional funds in the investee, has guaranteed obligations of the investee, or is otherwise committed to provide further financial support to the investee.

In connection with the then ongoing efforts to complete the Talisman Energy Transaction referred to in Note 4 to the condensed consolidated financial statements, the Company loaned Hallwood Energy \$2,961,000 in May 2008. Concurrent with the completion of the Talisman Energy Transaction in June 2008, the Company entered into an Equity Support Agreement (the Equity Support Agreement ) with Hallwood Energy under which the Company committed under certain conditions to contribute equity or debt

**Table of Contents**

**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**

**Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

capital to Hallwood Energy to maintain a reasonable liquidity position for Hallwood Energy or prevent or cure any default under Hallwood Energy's credit facilities with respect to interest payments, up to a maximum amount of \$12,500,000. The Company contributed \$2,039,000 at the completion date (for a total amount of \$5,000,000) to Hallwood Energy and committed to provide an additional amount of up to \$7,500,000 in certain circumstances, all of which were issued under the terms of Hallwood Energy's Second Convertible Note. Due to the uncertainties in May 2008 related to the completion of the Talisman Energy Transaction and the Company's additional investments, if any, the Company recorded an equity loss for the 2008 first quarter to the extent of the \$2,961,000 loan.

An obligation and related additional equity loss were recorded in the 2008 second quarter to the extent of the Company's commitment to provide additional financial support to Hallwood Energy pursuant to the Equity Support Agreement, in accordance with generally accepted accounting principles. Subject to certain defenses raised by the Company, the remaining commitment amount under the Equity Support Agreement was \$3,200,000 at September 30, 2009. As further discussed in the litigation section below, Hallwood Energy has filed an adversary proceeding against the Company requesting that the Company fund the additional \$3,200,000.

The Company's carrying value of its Hallwood Energy investment, which was zero at December 31, 2008 and 2007, remained at zero as of September 30, 2009.

Pursuant to the plan of reorganization confirmed by the Bankruptcy Court, the Company's ownership interest in Hallwood Energy was extinguished and the Company no longer accounts for the investment in Hallwood Energy using the equity method of accounting.

*Litigation.* As of February 25, 2009, the Company had contributed \$9,300,000 to Hallwood Energy pursuant to the Equity Support Agreement discussed above. On that date, Hallwood Energy requested that the Company fund the additional \$3,200,000, which the Company has not done. On March 30, 2009, Hallwood Energy filed an adversary proceeding against the Company requesting that the Company fund the additional \$3,200,000. The case is *Hallwood Energy, L.P. v. The Hallwood Group Incorporated*, Adversary No. 09-03082, in the United States Bankruptcy Court for the Northern District of Texas, Dallas Division. On April 29, 2009, the Company filed an answer to Hallwood Energy's lawsuit and denied liability under the Equity Support Agreement. HPI has filed a motion for summary judgment on its claims and a hearing on this motion was held on July 17, 2009. The court has not yet entered a ruling on the motion. The Company intends to defend the matter vigorously.

HPI and FEI were granted permission to intervene in the lawsuit and filed their respective complaints in intervention. Among the arguments advanced in the complaints is that the Company's failure to fund \$3,200,000 under the Equity Support Agreement damaged Hallwood Energy in an amount in excess of \$3,200,000. In its complaint, HPI contends that the additional damage is at least \$20,000,000 because it alleges that the failure of the Company to fund the \$3,200,000 caused FEI to not fund \$20,000,000 due under the Farmout Agreement between Hallwood Energy and FEI. HPI also asserts that the Company is liable for exemplary damages of \$100,000,000 on account of its failure to fund the last \$3,200,000 under the Equity Support Agreement. FEI's complaint in intervention claims that it was denied the benefit of its bargain promised in the Farmout Agreement and alleges consequential damages in excess of the \$3,200,000. The Company intends to contest the allegations vigorously.

**Critical Accounting Policies**

There have been no changes to the critical accounting policies identified and set forth in the Company's Form 10-K for the year ended December 31, 2008.

**Table of Contents**

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**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES****Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS****Related Party Transactions**

*Hallwood Investments Limited.* The Company has entered into a financial consulting contract with Hallwood Investments Limited ( HIL ), a corporation associated with Mr. Anthony J. Gumbiner, the Company's chairman and principal stockholder. The contract provides for HIL to furnish and perform international consulting and advisory services to the Company and its subsidiaries, including strategic planning and merger activities, for annual compensation of \$996,000. The annual amount is payable in monthly installments. The contract automatically renews for one-year periods if not terminated by the parties beforehand. Additionally, HIL and Mr. Gumbiner are also eligible for bonuses from the Company or its subsidiaries, subject to approval by the Company's or its subsidiaries' board of directors. The Company also reimburses HIL for reasonable expenses in providing office space and administrative services and for travel and related expenses principally to and from the Company's corporate office and Brookwood's facilities and health insurance premiums.

A summary of the fees and expenses related to HIL and Mr. Gumbiner are detailed below (in thousands):

|  | <b>Three Months Ended</b> |               | <b>Nine Months Ended</b> |                 |
|--|---------------------------|---------------|--------------------------|-----------------|
|  | <b>September 30,</b>      |               | <b>September 30,</b>     |                 |
|  | <b>2009</b>               | <b>2008</b>   | <b>2009</b>              | <b>2008</b>     |
| Consulting fees                          | \$ 249                    | \$ 249        | \$ 747                   | \$ 747          |
| Office space and administrative services | 24                        | 52            | 160                      | 204             |
| Travel and other expenses                | 85                        | 39            | 147                      | 75              |
| <b>Total</b>                             | <b>\$ 358</b>             | <b>\$ 340</b> | <b>\$ 1,054</b>          | <b>\$ 1,026</b> |

In addition, from time to time, HIL and Mr. Gumbiner have performed services for certain affiliated entities that are not subsidiaries of the Company, for which they receive consulting fees, bonuses, stock options, profit interests or other forms of compensation and expenses. The Company recognizes a proportionate share of such compensation and expenses, based upon its ownership percentage in the affiliated entities, through the utilization of the equity method of accounting. In the three months and nine months ended September 30, 2008 Mr. Gumbiner received a consulting fee from only one affiliate, Hallwood Energy, of approximately \$50,000 and \$150,000, respectively. Mr. Gumbiner received no compensation from Hallwood Energy during 2009.

In January 2008, Hallwood Family BVI, L.P. ( HFBL ), a partnership affiliated with Mr. Gumbiner, loaned \$5,000,000 to Hallwood Energy in connection with Hallwood Energy's \$30,000,000 First Convertible Note. Terms of the First Convertible Note agreement are discussed in the section entitled *Investments in Hallwood Energy*. As of November 1, 2009, HFBL had invested \$19,156,000 in Hallwood Energy, of which \$14,156,000 was in the form of Class C limited partnership interest and \$5,000,000 of its First Convertible Note. Pursuant to Hallwood Energy's bankruptcy plan or reorganization, the Class C partnership interest was extinguished and the convertible notes have been subordinated to recovery in favor of HPI.

During the period, other companies in which Mr. Gumbiner has an indirect financial interest shared common offices, facilities and certain staff in the Company's Dallas office for which these companies reimburse the Company. The Company pays certain common general and administrative expenses and charges the companies an overhead reimbursement fee for the share of the expenses allocable to these companies. For the three months ended September 30, 2009 and 2008, these companies reimbursed the Company \$19,000 and \$38,000, respectively, for such expenses. For the nine months ended September 30, 2009 and 2008, these companies reimbursed the Company \$55,000 and \$118,000, respectively.

*Hallwood Financial Limited.* As further discussed below, Hallwood Financial Limited, a corporation affiliated with Mr. Gumbiner, announced on April 20, 2009 that it had advised the Board of Directors that it intended to make an offer to acquire all of the outstanding common stock of the Company not already beneficially owned by Hallwood Financial Limited. On June 17, 2009, Hallwood Financial Limited announced that it had determined that it would not proceed with the offer.

*Hallwood Energy.* Prior to July 31, 2009, Hallwood Energy shared common offices, facilities and certain staff in the Company's Dallas office and Hallwood Energy was obligated to reimburse the Company for its allocable share of the expenses and certain direct expenses. For the three months ended September 30, 2009 and 2008, Hallwood Energy's share of such expenses was \$9,000 and \$113,000, respectively. For the nine months ended September 30, 2009 and 2008, Hallwood Energy's share of such expenses was \$124,000 and \$317,000, respectively. At September 30, 2009, the amount due from Hallwood Energy was \$37,000. Hallwood Energy completed its move from the office space by July 31, 2009 and is no longer sharing such expenses.



**Table of Contents****THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES****Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS****Contractual Obligations and Commercial Commitments**

The Company and its subsidiaries have entered into various contractual obligations and commercial commitments in the ordinary course of conducting its business operations, which are provided below as of September 30, 2009 (in thousands):

|                                | 2009*  | Payments Due During the Year Ending December 31, |          |        |        |            | Total     |
|--------------------------------|--------|--|----------|--------|--------|------------|-----------|
|                                |        | 2010   | 2011     | 2012   | 2013   | Thereafter |           |
| <b>Contractual Obligations</b> |        |  |          |        |        |            |           |
| Long term debt                 | \$     | \$   | \$ 9,003 | \$     | \$     | \$         | \$ 9,003  |
| Redeemable preferred stock     |        | 1,000  |          |        |        |            | 1,000     |
| Operating leases               | 253    | 867  | 580      | 520    | 364    | 940        | 3,524     |
| <b>Total</b>                   | \$ 253 | \$ 1,867   | \$ 9,583 | \$ 520 | \$ 364 | \$ 940     | \$ 13,527 |

\* For the three months ending December 31, 2009.

Interest costs associated with the Company's debt, which bears interest at variable rates, are not a material component of the Company's expenses. Estimated interest payments, based on the current principal balances and weighted average interest rates, assuming the renewal of the revolving credit facilities at their loan balances as of September 30, 2009, are \$47,000 for the three months ending December 31, 2009 and \$187,000 for each the years ending December 31, 2010 through December 31, 2013, respectively.

In October 2009, Brookwood Laminating notified the landlord that it is exercising its lease option for the purchase of its Connecticut production facility. The lease option provides for a purchase price of \$3,200,000 and it is anticipated that the purchase will be completed during 2010.

*Employment Contracts.* The Company and its Brookwood subsidiary have compensation agreements with various personnel and consultants. Generally, the agreements extend for one-year terms and are renewable annually.

*2005 Long-Term Incentive Plan for Brookwood.* In December 2005, the Company adopted The Hallwood Group Incorporated 2005 Long-Term Incentive Plan for Brookwood Companies Incorporated ( 2005 Long-Term Incentive Plan for Brookwood ) to encourage employees of Brookwood to increase the value of Brookwood and to continue to be employed by Brookwood. The terms of the incentive plan provide for a total award amount to participants equal to 15% of the fair market value of consideration received by the Company in a change of control transaction, as defined, in excess of the sum of the liquidation preference plus accrued unpaid dividends on the Brookwood preferred stock (approximately \$13,956,000 at September 30, 2009). The base amount will fluctuate in accordance with a formula that increases by the annual amount of the dividend on the preferred stock accrued, currently \$1,823,000, and decreases by the amount of the cash dividends actually paid. However, if the Company's board of directors determines that certain specified Brookwood officers, or other persons performing similar functions do not have, prior to the change of control transaction, in the aggregate an equity or debt interest of at least two percent in the entity with whom the change of control transaction is completed, then the minimum amount to be awarded under the plan shall be \$2,000,000. In addition, the Company agreed that, if members of Brookwood's senior management do not have, prior to a change of control transaction, in the aggregate an equity or debt interest of at least two percent in the entity with

whom the change of control transaction is completed (exclusive of any such interest any such individual receives with respect to his or her employment following the change of control transaction), then the Company will be obligated to pay an additional \$2,600,000.

**Off-Balance Sheet Arrangements**

The Company has no off-balance sheet arrangements.

**Table of Contents****THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES****Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS****Financial Covenants**

The principal ratios, required to be maintained under Brookwood's Working Capital Revolving Credit Facility for the last four quarters are provided below:

| Description                      | Requirement                     | Quarters Ended     |               |                |                   |
|----------------------------------|---------------------------------|--------------------|---------------|----------------|-------------------|
|                                  |                                 | September 30, 2009 | June 30, 2009 | March 31, 2009 | December 31, 2008 |
| Total debt to tangible net worth | must be less than ratio of 1.50 | 0.82               | 0.71          | 0.86           | 0.87              |
| Net income                       | must exceed \$1                 | Yes                | Yes           | Yes            | Yes               |

Brookwood was in compliance with its principal loan covenants under the Working Capital Revolving Credit Facility for the first three quarters in 2009 and for all interim periods in 2008, although an amendment to the Working Capital Revolving Credit Facility was entered into in June 2008 to allow a \$4,800,000 dividend payment in June 2008, which restricted the total calendar 2008 dividends from Brookwood to the Company to \$9,300,000.

In connection with the renewal of the Working Capital Revolving Credit Facility in October 2009, an additional covenant was added that provides for a total funded debt to EBITDA (for the trailing four quarters) ratio of 2:00 to be calculated on a quarterly basis, commencing December 31, 2009.

Cash dividends and tax sharing payments by Brookwood to the Company are contingent upon compliance with the loan covenants in the Working Capital Revolving Credit Facility. This limitation on the transferability of assets constitutes a restriction of Brookwood's net assets, which were \$42,558,000 and \$32,754,000 as of September 30, 2009 and December 31, 2008, respectively.

*Hallwood Energy.* Hallwood Energy was not in compliance with various covenants under its Secured Credit Facilities beginning March 31, 2008, which required waivers and amended loan covenants.

To the extent Hallwood Energy was not in default by virtue of pre-March 1, 2009 events, the bankruptcy filing on March 1, 2009 constituted a default under the terms of the Secured Credit Facilities and the forbearance agreement was terminated by its terms upon the bankruptcy filing.

**Withdrawal of Offer to Acquire All Outstanding Publicly Held Common Shares of Company by Chairman and Principal Stockholder**

On April 20, 2009, Hallwood Financial Limited (Hallwood Financial), a corporation affiliated with Mr. Anthony J. Gumbiner, a director, Chairman of the Board of Directors and Chief Executive Officer of the Company, which currently owns 65.7% of the outstanding common stock of the Company, announced that it had advised the Board of Directors of the Company that it intended to make an offer to acquire all of the outstanding shares of common stock of the Company not already beneficially owned by Hallwood Financial (approximately 523,591 shares). In its announcement, Hallwood Financial indicated that it intended to offer \$12.00 per share in cash for each share of common stock not already owned by Hallwood Financial.

On June 17, 2009, Hallwood Financial announced that it had determined that it would not proceed with the offer.

**Table of Contents****THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES****Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS****Liquidity and Capital Resources**

*General.* The Company principally operates in the textile products segment and, until Hallwood Energy's bankruptcy reorganization, the energy business segment. The Company's cash position increased by \$3,052,000 during the 2009 nine month period to \$9,068,000 as of September 30, 2009. The principal source of cash in the 2009 nine month period was \$6,065,000 provided by operations. The primary uses of cash were \$1,578,000 for property, plant and equipment, principally at Brookwood, and \$1,435,000 for repayment of bank borrowings.

*Textiles.* The Company's textile products segment generates funds from the dyeing, laminating and finishing of fabrics and their sale to customers in the military, consumer, industrial and medical markets. At September 30, 2009, Brookwood had a \$25,000,000 Working Capital Revolving Credit Facility and a \$3,000,000 equipment facility with Key Bank. The facilities had a maturity date of January 2010. In October 2009, Brookwood entered into an amendment to the Working Capital Revolving Credit Facility with Key Bank that maintained the \$25,000,000 loan amount and extended the term to January 31, 2011. The equipment facility was not renewed. At September 30, 2009, Brookwood had approximately \$15,876,000 of unused borrowing capacity on its Working Capital Revolving Credit Facility.

Brookwood paid cash dividends to the Company of \$3,500,000 for the nine months ended September 30, 2009 and \$9,300,000 for all of 2008. In addition, Brookwood made tax sharing payments to the Company of \$4,264,000 for the nine months ended September 30, 2009 and \$7,342,000 for all of 2008 under its tax sharing agreement with the Company. Future cash dividends and tax sharing payments are contingent upon Brookwood's continued compliance with the covenants contained in the Working Capital Revolving Credit Facility. Brookwood's total debt to total tangible net worth ratio of 0.82 at September 30, 2009 was reduced from 0.87 at December 31, 2008, principally due to its profitable operations during the 2009 nine month period relative to the dividends paid, and was substantially below the maximum allowable ratio of 1.50.

Brookwood continuously evaluates opportunities to reduce production costs and expand its manufacturing capacity and portfolio of products. Accordingly, Brookwood incurs capital expenditures to pursue such opportunities, as well as for environmental and safety compliance, building upgrades, energy efficiencies, and various strategic objectives. In the nine months ended September 30, 2009, Brookwood met its capital expenditure and equipment maintenance requirements from its operating cash flows and availability under its Working Capital Revolving Credit Facility. There were no material capital commitments as of September 30, 2009 other than \$3,200,000 for the planned exercise of a lease option for the purchase of Brookwood Laminating's production facility in Connecticut. It is anticipated that the purchase will be completed during 2010.

*Energy.* During 2008, the Company invested \$13,920,000 in Hallwood Energy, as part of a total investment of \$75,401,000. No additional investment was made in Hallwood Energy during 2009.

*Company's Future Liquidity.* The Company's ability to generate cash flow from operations will depend on its future performance and its ability to successfully implement business and growth strategies. The Company's performance will also be affected by the outcome of its litigation matters and prevailing economic conditions. Many of these factors are beyond the Company's control. Considering its current cash position, anticipated cash flow from operations and renewal of the Brookwood Working Capital Revolving Credit Facility, the Company believes it has sufficient funds to meet its liquidity needs.

The Company and its subsidiaries are involved in a number of litigation matters. Although the Company does not believe that the results of any of these matters are likely to have a material adverse effect on its financial condition, results of operations or cash flows, it is possible that any of these matters could result in material liability to the Company. In addition, the Company has spent and will continue to spend significant amounts in professional fees in connection with these matters.

**Table of Contents**

**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**

**Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

**Forward-Looking Statements**

In the interest of providing stockholders with certain information regarding the Company's future plans and operations, certain statements set forth in this Form 10-Q relate to management's future plans, objectives and expectations. Such statements are forward-looking statements. Although any forward-looking statement expressed by or on behalf of the Company is, to the knowledge and in the judgment of the officers and directors, expected to prove true and come to pass, management is not able to predict the future with absolute certainty. Forward-looking statements involve known and unknown risks and uncertainties, which may cause the Company's actual performance and financial results in future periods to differ materially from any projection, estimate or forecasted result. Among others, these risks and uncertainties include those described in the Company's Form 10-K for the year ended December 31, 2008 in Item 1A Risk Factors and Part II Item 1A Risk Factors in this report. These risks and uncertainties are difficult or impossible to predict accurately and many are beyond the control of the Company. Other risks and uncertainties may be described, from time to time, in the Company's periodic reports and filings with the Securities and Exchange Commission.

**Table of Contents**

**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**

**Item 4T. CONTROLS AND PROCEDURES**

*Disclosure Controls and Procedures.* It is the conclusion of the Company's principal executive officer and principal financial officer that the Company's disclosure controls and procedures (as defined in Exchange Act rules 13a-15(e) and 15d-15(e)), based on their evaluation of these controls and procedures as of the end of the period covered by this Form 10-Q, are effective at the reasonable assurance level in ensuring that information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, and that information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the Company's management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure. Management necessarily applied its judgment in assessing the costs and benefits of such controls and procedures, which, by their nature, can provide only reasonable assurance regarding management's control objectives. The design of any system of controls and procedures is based in part upon certain assumptions about the likelihood of future events. There can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions, regardless of how remote.

*Changes in Internal Controls over Financial Reporting.* There were no changes in the Company's internal controls over financial reporting that occurred during the last fiscal quarter that have materially affected, or are reasonably likely to materially affect, these controls.

**Table of Contents**

**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES  
PART II OTHER INFORMATION**

**Item**

1 Legal Proceedings

Reference is made to Note 11 to the Company's condensed consolidated financial statements included within this Form 10-Q.

1A Risk Factors

*Litigation may adversely affect the Company's financial condition, results of operations and cash flows.* The Company and its subsidiaries are involved in a number of litigation matters, as described in Note 4 and Note 11 to the Condensed Consolidated Financial Statements as of and for the nine months ended September 30, 2009 and 2008 included in Part I of this report. Although the Company does not believe that the results of any of these matters are likely to have a material adverse effect on its financial condition, results of operation or cash flows, it is possible that any of the matters could result in material liability to the Company. In addition, the Company has spent and will likely continue to spend significant amounts in professional fees in connection with these matters.

2 Unregistered Sales of Equity Securities and Use of Proceeds None

3 Defaults upon Senior Securities None

4 Submission of Matters to a Vote of Security Holders None

5 Other Information None

6 Exhibits

10.26 Fifth Amendment to Second Amended and Restated Revolving Credit Loan and Security Agreement, dated as of October 23, 2009, by and among Key Bank National Association, Brookwood Companies Incorporated and certain subsidiaries.

31.1 Certification of the Chief Executive Officer, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 Certification of the Chief Financial Officer, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32.1 Certification of Chief Executive Officer and Chief Financial Officer, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

**Table of Contents**

**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES  
SIGNATURE**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

**THE HALLWOOD GROUP  
INCORPORATED**

Dated: November 13, 2009

By: /s/ Richard Kelley  
Richard Kelley, Vice President  
(Duly Authorized Officer and  
Principal Financial and  
Accounting Officer)

Page 38

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**Table of Contents**

**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES  
INDEX TO EXHIBITS**

| <b>Exhibit<br/>Number</b> | <b>Description</b>  |
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