

HALLMARK FINANCIAL SERVICES INC  
Form 10-Q  
November 12, 2009

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

Commission file number 001-11252

Hallmark Financial Services, Inc.  
(Exact name of registrant as specified in its charter)

Nevada  
(State or other jurisdiction of  
Incorporation or organization)

87-0447375  
(I.R.S. Employer  
Identification No.)

777 Main Street, Suite 1000, Fort Worth, Texas  
(Address of principal executive offices)

76102  
(Zip Code)

Registrant's telephone number, including area code: (817) 348-1600

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 (§232.405 of this chapter) 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.

Large accelerated filer  Accelerated filer   
Non-accelerated filer  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: Common Stock, par value \$.18 per share – 20,113,670 shares outstanding as of November 12, 2009.



PART I  
FINANCIAL INFORMATION

Item 1. Financial Statements

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Hallmark Financial Services, Inc. and Subsidiaries  
Consolidated Balance Sheets  
(\$ in thousands)

	September 30 2009 (unaudited)	December 31 2008
<b>ASSETS</b>		
Investments:		
Debt securities, available-for-sale, at fair value	\$ 295,452	\$ 268,513
Equity securities, available-for-sale, at fair value	40,959	25,003
<b>Total investments</b>	<b>336,411</b>	<b>293,516</b>
Cash and cash equivalents	84,422	59,134
Restricted cash and cash equivalents	5,918	8,033
Premiums receivable	48,794	44,032
Accounts receivable	3,729	4,531
Receivable for securities	181	1,031
Prepaid reinsurance premiums	11,198	1,349
Reinsurance recoverable	11,695	8,218
Deferred policy acquisition costs	22,629	19,524
Excess of cost over fair value of net assets acquired	41,080	41,080
Intangible assets, net	29,789	28,969
Current federal income tax recoverable	1,080	696
Deferred federal income taxes	-	6,696
Prepaid expenses	816	1,007
Other assets	18,264	20,582
<b>Total assets</b>	<b>\$ 616,006</b>	<b>\$ 538,398</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Liabilities:		
Notes payable	\$ 59,502	\$ 60,919
Reserves for unpaid losses and loss adjustment expenses	180,179	156,363
Unearned premiums	130,467	102,192
Unearned revenue	266	2,037
Reinsurance balances payable	2,680	-
Accrued agent profit sharing	1,908	2,151
Accrued ceding commission payable	8,600	8,605
Pension liability	4,427	4,309
Deferred federal income taxes	92	-
Payable for securities	688	3,606
Accounts payable and other accrued expenses	9,148	18,067
<b>Total liabilities</b>	<b>397,957</b>	<b>358,249</b>
Commitments and Contingencies (Note 15)		

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Redeemable non-controlling interest	1,011	737
Stockholders' equity:		
Common stock, \$.18 par value (authorized 33,333,333 shares in 2009 and 2008; issued 20,871,498 shares in 2009 and 20,841,782 shares in 2008)	3,757	3,751
Capital in excess of par value	121,261	119,928
Retained earnings	89,186	72,242
Accumulated other comprehensive income (loss)	8,161	(16,432)
Treasury stock, at cost (757,828 shares in 2009 and 7,828 in 2008)	(5,327)	(77)
Total stockholders' equity	217,038	179,412
	\$ 616,006	\$ 538,398

The accompanying notes are an integral part  
of the consolidated financial statements

Hallmark Financial Services, Inc. and Subsidiaries  
Consolidated Statements of Operations  
(Unaudited)  
(\$ in thousands, except per share amounts)

	Three Months Ended September 30		Nine Months Ended September 30	
	2009	2008	2009	2008
Gross premiums written	\$ 74,013	\$ 59,005	\$ 220,545	\$ 186,357
Ceded premiums written	(11,222)	(2,493)	(16,714)	(6,503)
Net premiums written	62,791	56,512	203,831	179,854
Change in unearned premiums	1,447	2,416	(17,844)	(1,918)
Net premiums earned	64,238	58,928	185,987	177,936
Investment income, net of expenses	3,467	4,100	11,203	11,682
Net realized gains (losses)	597	(2,496)	1,116	(1,405)
Finance charges	1,525	1,307	4,324	3,894
Commission and fees	2,018	3,127	10,834	16,280
Processing and service fees	7	20	33	98
Other income	51	3	60	9
Total revenues	71,903	64,989	213,557	208,494
Losses and loss adjustment expenses	40,579	38,981	115,552	110,514
Other operating expenses	23,428	24,041	71,056	71,114
Interest expense	1,147	1,186	3,456	3,557
Amortization of intangible assets	916	620	2,412	1,766
Total expenses	66,070	64,828	192,476	186,951
Income before tax	5,833	161	21,081	21,543
Income tax expense (benefit)	1,585	(485)	5,766	6,222
Net income	4,248	646	15,315	15,321
Less: Net income attributable to non-controlling interest	34	15	36	15
Net income attributable to Hallmark Financial Services, Inc.	\$ 4,214	\$ 631	\$ 15,279	\$ 15,306
Net income per share attributable to Hallmark Financial Services, Inc. common stockholders:				
Basic	\$ 0.20	\$ 0.03	\$ 0.73	\$ 0.74
Diluted	\$ 0.20	\$ 0.03	\$ 0.73	\$ 0.73

The accompanying notes are an integral part  
of the consolidated financial statements



Hallmark Financial Services, Inc. and Subsidiaries  
Consolidated Statements of Stockholders' Equity and Comprehensive Income (Loss)  
(Unaudited)  
(\$ in thousands)

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2009	2008	2009	2008
<b>Common Stock</b>				
Balance, beginning of period	\$ 3,757	\$ 3,747	\$ 3,751	\$ 3,740
Issuance of common stock upon option exercises	-	-	6	7
Balance, end of period	3,757	3,747	3,757	3,747
<b>Additional Paid-In Capital</b>				
Balance, beginning of period	120,736	119,369	119,928	118,459
Accretion of redeemable noncontrolling interest	(87)	(25)	(259)	(25)
Equity based compensation	612	305	1,488	1,078
Exercise of stock options	-	-	104	137
Balance, end of period	121,261	119,649	121,261	119,649
<b>Retained Earnings</b>				
Balance, beginning of period	84,972	74,018	72,242	59,343
Adjustment to opening balance, net of tax (note 2)	-	-	1,665	-
Adjusted balance, beginning of period	84,972	74,018	73,907	59,343
Net income attributable to Hallmark Financial Services, Inc.	4,214	631	15,279	15,306
Balance, end of period	89,186	74,649	89,186	74,649
<b>Accumulated Other Comprehensive Income (Loss)</b>				
Balance, beginning of period	836	(4,756)	(16,432)	(1,844)
Adjustment to opening balance, net of tax (note 2)	-	-	(1,665)	-
Adjusted balance, beginning of period	836	(4,756)	(18,097)	(1,844)
Additional minimum pension liability, net of tax	80	10	239	31
Net unrealized holding gains (losses) arising during period	7,881	(2,982)	27,197	(4,340)
Reclassification adjustment for losses included in net income	(636)	(734)	(1,178)	(2,309)
Balance, end of period	8,161	(8,462)	8,161	(8,462)
<b>Treasury Stock</b>				
Balance, beginning of period	(77)	(77)	(77)	(77)
Acquisition of treasury shares	(5,250)	-	(5,250)	-
Balance, end of period	(5,327)	(77)	(5,327)	(77)
<b>Total Stockholders' Equity</b>	<b>\$ 217,038</b>	<b>\$ 189,506</b>	<b>\$ 217,038</b>	<b>\$ 189,506</b>
<b>Net income</b>	<b>\$ 4,248</b>	<b>\$ 646</b>	<b>\$ 15,315</b>	<b>\$ 15,321</b>

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Additional minimum pension liability, net of tax	80	10	239	31
Net unrealized holding gains (losses) arising during period	7,881	(2,982)	27,197	(4,340)
Reclassification adjustment for losses included in net income	(636)	(734)	(1,178)	(2,309)
Comprehensive income (loss)	11,573	(3,060)	41,573	8,703
Less: Comprehensive income attributable to non-controlling interest	34	15	36	15
Comprehensive income (loss) attributable to Hallmark Financial Services, Inc.	\$ 11,539	\$ (3,075)	\$ 41,537	\$ 8,688

The accompanying notes are an integral part  
of the consolidated financial statements

Hallmark Financial Services, Inc. and Subsidiaries  
Consolidated Statements of Cash Flows  
(Unaudited)  
(\$ in thousands)

	Nine Months Ended September 30	
	2009	2008
<b>Cash flows from operating activities:</b>		
Net income	\$ 15,315	\$ 15,321
<b>Adjustments to reconcile net income to cash provided by operating activities:</b>		
Depreciation and amortization expense	2,979	2,311
Deferred federal income tax benefit	(1,117)	(1,849)
Realized (gains) losses on investments	(1,116)	1,405
Change in prepaid reinsurance premiums	(5,036)	(1,694)
Change in premiums receivable	(4,787)	(1,026)
Change in accounts receivable	815	(24)
Change in deferred policy acquisition costs	(3,105)	(392)
Change in reserves for unpaid losses and loss adjustment expenses	15,252	29,950
Change in unearned premiums	23,462	2,295
Change in unearned revenue	(1,771)	(823)
Change in accrued agent profit sharing	(243)	(909)
Change in reinsurance recoverable	5,087	(6,573)
Change in reinsurance payable	2,680	-
Change in current federal income tax recoverable	(384)	(2,451)
Change in accrued ceding commission payable	(5)	94
Change in all other liabilities	(8,094)	(2,599)
Change in all other assets	5,763	4,122
<b>Net cash provided by operating activities</b>	<b>45,695</b>	<b>37,158</b>
<b>Cash flows from investing activities:</b>		
Purchases of property and equipment	(907)	(477)
Decrease in restricted cash and cash equivalents	3,470	7,080
Purchases of debt and equity securities	(74,430)	(642,260)
Maturities, sales and redemptions of investment securities	65,283	500,516
Payment for acquisition of subsidiaries	(7,246)	(14,799)
<b>Net cash used in investing activities</b>	<b>(13,830)</b>	<b>(149,940)</b>
<b>Cash flows from financing activities:</b>		
Proceeds from exercise of employee stock options	110	143
Net borrowings (repayments) of notes payable	(1,417)	946
Distribution (to) from non-controlling interest	(20)	-
Purchase of treasury shares	(5,250)	-
Repayment of structured settlement	-	(10,000)
<b>Net cash used in financing activities</b>	<b>(6,577)</b>	<b>(8,911)</b>

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Increase (decrease) in cash and cash equivalents	25,288	(121,693)
Cash and cash equivalents at beginning of period	59,134	145,884
Cash and cash equivalents at end of period	\$ 84,422	\$ 24,191

Supplemental cash flow information:

Interest paid	\$ 3,494	\$ 3,576
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Taxes paid	\$ 7,267	\$ 10,521
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Supplemental schedule of non-cash investing activities:

Change in receivable for securities related to investment disposals settled after the balance sheet date	\$ 850	\$ 27,395
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Change in payable for securities related to investment purchases settled after the balance sheet date	\$ (2,918)	\$ (85,897)
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The accompanying notes are an integral part  
of the consolidated financial statements

Hallmark Financial Services, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements (Unaudited)

1. General

Hallmark Financial Services, Inc. (“Hallmark” and, together with subsidiaries, “we,” “us” or “our”) is an insurance holding company which, through its subsidiaries, engages in the sale of property/casualty insurance products to businesses and individuals. Our business involves marketing, distributing, underwriting and servicing commercial insurance, personal insurance and general aviation insurance, as well as providing other insurance related services. Our business is geographically concentrated in the south central and northwest regions of the United States, except for our general aviation business and the excess commercial automobile and commercial umbrella risks produced by our Heath XS Operating Unit which are written on a national basis.

We pursue our business activities through subsidiaries whose operations are organized into five operating units which are supported by four of our insurance company subsidiaries. Our AHIS Operating Unit handles standard lines commercial insurance products and services and is comprised of American Hallmark Insurance Services, Inc. and Effective Claims Management, Inc. Our TGA Operating Unit handles primarily excess and surplus lines commercial insurance products and services and is comprised of TGA Insurance Managers, Inc., Pan American Acceptance Corporation (“PAAC”) and TGA Special Risk, Inc. Our Aerospace Operating Unit handles general aviation insurance products and services and is comprised of Aerospace Insurance Managers, Inc., Aerospace Special Risk, Inc. and Aerospace Claims Management Group, Inc. Our Heath XS Operating Unit handles excess commercial automobile and commercial umbrella risks on both an admitted and non-admitted basis and is comprised of Heath XS, LLC and Hardscrabble Data Solutions, LLC. Our Personal Lines Operating Unit handles non-standard personal automobile insurance and complementary personal insurance products and services and is comprised of American Hallmark General Agency, Inc. and Hallmark Claims Services, Inc., both of which do business as Hallmark Insurance Company.

These five operating units are segregated into three reportable industry segments for financial accounting purposes. The Standard Commercial Segment presently consists solely of the AHIS Operating Unit and the Personal Segment presently consists solely of our Personal Lines Operating Unit. The Specialty Commercial Segment includes our TGA Operating Unit, Aerospace Operating Unit, and Heath XS Operating Unit.

2. Basis of Presentation

Our unaudited consolidated financial statements included herein have been prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) and include our accounts and the accounts of our subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation. Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to rules and regulations of the Securities and Exchange Commission (“SEC”) for interim financial reporting. These unaudited consolidated financial statements should be read in conjunction with our audited consolidated financial statements for the year ended December 31, 2008 included in our Annual Report on Form 10-K filed with the SEC.

The interim financial data as of September 30, 2009 and 2008 is unaudited. However, in the opinion of management, the interim data includes all adjustments, consisting only of normal recurring adjustments, necessary for a fair statement of the results for the interim periods. The results of operations for the period ended September 30, 2009 are not necessarily indicative of the operating results to be expected for the full year.

#### Redeemable non-controlling interest

We are accreting the redeemable non-controlling interest to its redemption value from the date of issuance to the earliest determinable redemption date, August 29, 2012, using the interest method. Changes in redemption value are considered a change in accounting estimate. We follow the two class method of computing earnings per share. We treat only the portion of the periodic adjustment to the redeemable non-controlling interest carrying amount that reflects a redemption in excess of fair value as being akin to an actual dividend. (See Note 3, "Business Combinations.")

#### Reclassification

Certain previously reported amounts have been reclassified in order to conform to our current year presentation. Such reclassification had no effect on net income or stockholders' equity.

#### Income taxes

Income taxes are accounted for under the asset and liability method. At December 31, 2008, we had recorded a valuation allowance of \$4.5 million primarily attributable to capital losses from investments, impairments and unrealized losses in excess of gains. The valuation allowance was decreased by \$4.5 million during the nine months ended September 30, 2009, due to changes in unrealized and realized gains and losses on investments. The changes in valuation allowance attributable to continuing operations and to accumulated comprehensive income were approximately \$0.5 million and \$4.0 million, respectively, for the nine months ended September 30, 2009.

#### Use of Estimates in the Preparation of the Financial Statements

Our preparation of financial statements in conformity with GAAP requires us to make estimates and assumptions that affect our reported amounts of assets and liabilities and our disclosure of contingent assets and liabilities at the date of our consolidated financial statements, as well as our reported amounts of revenues and expenses during the reporting period. Actual results could differ materially from those estimates.

#### Fair Value of Financial Instruments

Fair value estimates are made at a point in time, based on relevant market data as well as the best information available about the financial instruments. Fair value estimates for financial instruments for which no or limited observable market data is available are based on judgments regarding current economic conditions, credit and interest rate risk. These estimates involve significant uncertainties and judgments and cannot be determined with precision. As a result, such calculated fair value estimates may not be realizable in a current sale or immediate settlement of the instrument. In addition, changes in the underlying assumptions used in the fair value measurement technique, including discount rate and estimates of future cash flows, could significantly affect these fair value estimates.

Investment Securities: Fair values for debt securities and equity securities are obtained from an independent pricing service or based on quoted market prices. (See Notes 4 and 5.)

Cash and Cash Equivalents: The carrying amounts reported in the balance sheet for these instruments approximate their fair values.

Restricted Cash and Cash Equivalents : The carrying amount for restricted cash reported in the balance sheet approximates the fair value.

Notes Payable: The carrying value of our bank credit facility of \$2.8 million approximates the fair value based on the current interest rate. Our trust preferred securities have a carried value of \$56.7 million and a fair value of \$51.5 million as of September 30, 2009. The fair value of our trust preferred securities is based on discounted cash flows using a current yield to maturity of 8.5% based on similar issues to discount future cash flows.

For accrued investment income, amounts recoverable from reinsurers, federal income tax recoverable and other liabilities, the carrying amounts approximate fair value because of the short maturity of such financial instruments.

#### Recently Issued Accounting Standards

In June 2009, the Financial Accounting Standards Board (“FASB”) issued Statement of Financial Accounting Standards No. 168, “The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles” — a replacement of FASB Statement No. 162 (the “Codification”). The Codification reorganized existing U.S. accounting and reporting standards issued by the FASB and other related private sector standard setters into a single source of authoritative accounting principles arranged by topic. The Codification supersedes all existing U.S. accounting standards. All other accounting literature not included in the Codification (other than SEC guidance for publicly-traded companies) is considered non-authoritative. The Codification was effective on a prospective basis for interim and annual reporting periods ending after September 15, 2009. The adoption of the Codification changed our references to U.S. GAAP accounting standards but did not impact our results of operations, financial position or liquidity.

In September 2006, FASB issued Statement of Financial Accounting Standards No. 157, “Fair Value Measurements,” which was codified in the FASB Accounting Standards Codification (“ASC”) Topic 820, “Fair Value Measurements and Disclosures (“FASB ASC 820”). FASB ASC 820 establishes a separate framework for determining fair values of assets and liabilities that are required by other authoritative GAAP pronouncements to be measured at fair value. In addition, FASB ASC 820 incorporates and clarifies the guidance in FASB Concepts Statement 7 regarding the use of present value techniques in measuring fair value. FASB ASC 820 does not require any new fair value measurements. FASB ASC 820 is effective for financial statements issued for fiscal years beginning after November 15, 2007. The adoption of FASB ASC 820 had no impact on our financial statements or results of operations but did require additional disclosures. (See Note 4, “Fair Value.”)

In February 2007, FASB issued Statement of Financial Accounting Standards No. 159, “The Fair Value Option for Financial Assets and Liabilities”, which was codified into FASB ASC Topic 825, “Financial Instruments” (“FASB ASC 825”). FASB ASC 825 permits entities to choose to measure many financial instruments and certain other items at fair value with changes in fair value included in current earnings. The election is made on specified election dates, can be made on an instrument-by-instrument basis, and is irrevocable. FASB ASC 825 is effective for financial statements issued for fiscal years beginning after November 15, 2007. The adoption of FASB ASC 825 had no impact on our financial statements or results of operations as we did not elect to apply FASB ASC 825 to any eligible items.

In December 2007, the FASB issued Revised Statement of Financial Accounting Standards No. 141R, “Business Combinations”, which was codified into FASB ASC Topic 805, “Business Combinations”, (“FASB ASC 805”). FASB ASC 805 provides revised guidance on how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquired entity. In addition, it provides revised guidance on the recognition and measurement of goodwill acquired in the business combination. FASB ASC 805 also provides guidance specific to the recognition, classification, and measurement of assets and liabilities related to insurance and reinsurance contracts acquired in a business combination. FASB ASC 805 applies to business combinations for acquisitions occurring on or after January 1, 2009. The adoption of FASB ASC 805 did not have a material effect on our results of operations or liquidity. However, FASB ASC 805 will impact the accounting for any future acquisitions.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 160, “Noncontrolling Interests in Consolidated Financial Statements—an amendment of Accounting Research Bulletin No. 51”, which was codified into FASB ASC Topic 810, “Noncontrolling Interests” (“FASB ASC 810”). FASB ASC 810 amends Accounting Research Bulletin No. 51 to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. In addition, it clarifies that a noncontrolling interest in a subsidiary is an ownership interest in the consolidated entity that should be reported as a component of equity in the consolidated financial statements. FASB ASC 810 is effective on a prospective basis beginning January 1, 2009, except for the presentation and disclosure requirements which are applied on a retrospective basis for all periods presented. The adoption of FASB ASC 810 did not have a significant impact on our consolidated financial statements.

In April 2009, FASB issued FASB Staff Position No. FAS 157-4, “Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly”, which was codified into FASB ASC Topic 820. FASB ASC 820 provides guidance for estimating fair value when the volume and level of activity for the asset or liability have significantly decreased and identifying circumstances that may indicate that a transaction is not orderly. FASB ASC 820 is effective for interim and annual reporting periods ending after June 15, 2009, and is applied prospectively. The adoption of this guidance did not have a significant impact on our consolidated financial statements.

In April 2009, FASB issued FASB Staff Position No. FAS 115-2 and FAS 124-2, “Recognition and Presentation of Other-Than-Temporary Impairments”, which was codified into FASB ASC Topic 320, “Investment Securities” (“FASB ASC 320”), amending prior other-than-temporary impairment guidance for debt in order to make the guidance more operational and improve the presentation and disclosure of other-than-temporary impairments in the financial statements. FASB ASC 320 does not amend existing recognition and measurement guidance related to other-than-temporary impairments of equity securities. The provisions of FASB ASC 320 are effective for interim periods ending after June 15, 2009. We adopted FASB ASC 320 effective April 1, 2009 which resulted in a cumulative effect adjustment to the beginning balances of retained earnings and accumulated other comprehensive income of approximately \$2.6 million before tax and \$1.7 million net of tax.

In April 2009, FASB issued FASB Staff Position No. FAS 107-1 and APB Opinion No. 28-1, “Interim Disclosures about Fair Value of Financial Instruments”, which was codified into FASB ASC 825. FASB ASC 825 requires disclosures about fair value of financial instruments for interim reporting periods as well as in annual financial statements. This guidance is effective for interim periods ending after June 15, 2009 but did not impact our consolidated financial statements. However, additional footnote disclosures to our interim and annual financial statements were required.

In May 2009, FASB issued Statement of Financial Accounting Standard No. 165, "Subsequent Events", which was codified into FASB ASC Topic 855, "Subsequent Events" ("FASB ASC 855"), which provides authoritative accounting literature for a topic previously addressed only in the auditing literature (AICPA AU Section 560, Subsequent Events). The provisions of FASB ASC 855 are effective for interim financial periods ending after June 15, 2009. The adoption of FASB ASC 855 did not have a significant impact on our consolidated financial statements.

In June 2009, FASB issued Statement of Financial Accounting Standards No. 167, "Amendments to FASB Interpretation No. 46(R)" ("SFAS 167"), which has not yet been codified in the Codification. SFAS 167 addresses the effects of eliminating the qualifying special-purpose entity concept and responds to concerns about the application of certain key provisions of FASB Interpretation No. 46(R), "Consolidation of Variable Interest Entities", including concerns over the transparency of enterprises' involvement with variable interest entities. SFAS 167 is effective for calendar year end companies beginning on January 1, 2010 with earlier application prohibited. We do not expect the impact of adopting SFAS 167 to have a material impact on our consolidated financial statements.

### 3. Business Combinations

We account for business combinations using the purchase method of accounting. The cost of an acquired entity is allocated to the assets acquired (including identified intangible assets) and liabilities assumed based on their estimated fair values. The excess of the cost of an acquired entity over the net amounts assigned to assets acquired and liabilities assumed is an asset referred to as "Excess of cost over fair value of net assets acquired." Indirect and general expenses related to business combinations are expensed as incurred.

Effective August 29, 2008, we acquired 80% of the issued and outstanding membership interests in the subsidiaries now comprising the Heath XS Operating Unit for consideration of \$15.0 million. In connection with the acquisition of membership interests in the subsidiaries comprising the Heath XS Operating Unit, we executed an operating agreement for each subsidiary. The operating agreements grant us the right to purchase the remaining 20% membership interests in the subsidiaries comprising the Heath XS Operating Unit and grant to an affiliate of the seller the right to require us to purchase such remaining membership interests (the "Put/Call Option"). The Put/Call Option becomes exercisable by either us or the affiliate of the seller upon the earlier of August 29, 2012, the termination of the employment of the seller by the Heath XS Operating Unit or a change of control of Hallmark. If the Put/Call Option is exercised, we will have the right or obligation to purchase the remaining 20% membership interests in the Heath XS Operating Unit for an amount equal to nine times the average Pre-Tax Income (as defined in the operating agreements) for the previous 12 fiscal quarters. We estimate the ultimate redemption value of the Put/Call Option to be \$2.0 million at September 30, 2009.

The fair value of the amortizable intangible assets acquired and respective amortization periods are as follows (\$ in thousands):

Tradename	\$	757	15 years
Non-compete agreement	\$	526	6 years
Agency relationships	\$	6,385	15 years

The Heath XS Operating Unit is an underwriting organization that produces lower hazard, middle market, excess commercial automobile and commercial umbrella insurance policies on both an admitted and non-admitted basis through a network of independent wholesale agencies throughout the United States.

Effective June 5, 2009, we acquired all of the issued and outstanding shares of CYR Insurance Management Company (“CYR”). CYR has as its primary asset a management agreement with State and County Mutual Fire Insurance Company (subsequently renamed Hallmark County Mutual Insurance Company, “HCM”) which provides for CYR to have management and control of HCM. We acquired all of the issued and outstanding shares of CYR for consideration of a base purchase price of \$4.0 million paid at closing plus an override commission in an amount equal to 1% of the net premiums and net policy fees of HCM for the years 2010 and 2011 subject to a maximum of \$1.25 million. The override commission will be paid monthly as the subject premiums and policy fees are written. The fair value of the management agreement acquired is \$3.2 million and will be amortized over 4 years. HCM is used to front certain lines of business in our Specialty Commercial and Personal Segments in Texas where we previously produced policies for third party county mutual insurance companies and reinsured 100% for a fronting fee.

#### 4. Fair Value

FASB ASC 820 defines fair value, establishes a consistent framework for measuring fair value and expands disclosure requirements about fair value measurements. FASB ASC 820, among other things, requires us to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. In addition, FASB ASC 820 precludes the use of block discounts when measuring the fair value of instruments traded in an active market, which were previously applied to large holdings of publicly traded equity securities.

Effective January 1, 2008, we determine the fair value of our financial instruments based on the fair value hierarchy established in FASB ASC 820. In accordance with FASB ASC 820, we utilize the following fair value hierarchy:

- Level 1: quoted prices in active markets for identical assets;
- Level 2: inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, inputs of identical assets for less active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the instrument; and
- Level 3: inputs to the valuation methodology that are unobservable for the asset or liability.

This hierarchy requires the use of observable market data when available.

Under FASB ASC 820, we determine fair value based on the price that would be received for an asset or paid to transfer a liability in an orderly transaction between market participants on the measurement date. It is our policy to maximize the use of observable inputs and minimize the use of unobservable inputs when developing fair value measurements, in accordance with the fair value hierarchy described above. Fair value measurements for assets and liabilities where there exists limited or no observable market data are calculated based upon our pricing policy, the economic and competitive environment, the characteristics of the asset or liability and other factors as appropriate. These estimated fair values may not be realized upon actual sale or immediate settlement of the asset or liability.

Where quoted prices are available on active exchanges for identical instruments, investment securities are classified within Level 1 of the valuation hierarchy. Level 1 investment securities include common and preferred stock. If quoted prices are not available from active exchanges for identical instruments, then fair values are estimated using quoted prices from less active markets, quoted prices of securities with similar characteristics or by pricing models utilizing other significant observable inputs. Examples of such instruments, which would generally be classified within Level 2 of the valuation hierarchy, include corporate bonds, municipal bonds and U.S. Treasury securities. In cases where there is limited activity or less transparency around inputs to the valuation, investment securities are classified within Level 3 of the valuation hierarchy. Level 3 investments are valued based on the best available data in order to approximate fair value. This data may be internally developed and consider risk premiums that a market participant would require. Investment securities classified within Level 3 include other less liquid investment securities.

The following table presents for each of the fair value hierarchy levels, our assets that are measured at fair value on a recurring basis at September 30, 2009 (in thousands).

	Quoted Prices in Active Markets for Identical Assets (Level 1)		Other Observable Inputs (Level 2)		Unobservable Inputs (Level 3)	Total		
U.S. Treasury securities and obligations of U.S. government	\$	-	\$	6,169	\$	-	\$	6,169
Corporate debt securities		-		91,427		-		91,427
Municipal bonds		-		168,261		28,882		197,143
Asset backed		-		713		-		713
Total debt securities		-		266,570		28,882		295,452
Financial services		28,356		-		-		28,356
All other		12,603		-		-		12,603
Total equity securities		40,959		-		-		40,959
Total debt and equity securities	\$	40,959	\$	266,570	\$	28,882	\$	336,411

Due to significant unobservable inputs into the valuation model for certain municipal bonds in illiquid markets, we classified these as level 3 in the fair value hierarchy. We used an income approach in order to derive an estimated fair value of such securities, which included inputs such as expected holding period, benchmark swap rate, benchmark discount rate and a discount rate premium for illiquidity.



The following table summarizes the changes in fair value for all financial assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) during the nine months ended September 30, 2009 (in thousands).

Beginning balance as of January 1, 2009	\$ 46,104
Net purchases, issuances, sales and settlements	(16,450)
Total realized/unrealized gains included in net income	-
Net gains included in other comprehensive income	(772)
Transfers in and/or out of Level 3	-
Ending balance as of September 30, 2009	\$ 28,882

## 5. Investments

We complete a detailed analysis each quarter to assess whether any decline in the fair value of any investment below cost is deemed other-than-temporary. All securities with an unrealized loss are reviewed. We recognize an impairment loss when an investment's value declines below cost, adjusted for accretion, amortization and previous other-than-temporary impairments and it is determined that the decline is other-than-temporary.

**Equity Investments:** Some of the factors considered in evaluating whether a decline in fair value for an equity investment is other-than-temporary include: (1) our ability and intent to retain the investment for a period of time sufficient to allow for an anticipated recovery in value; (2) the recoverability of cost; (3) the length of time and extent to which the fair value has been less than cost; and (4) the financial condition and near-term and long-term prospects for the issuer, including the relevant industry conditions and trends, and implications of rating agency actions and offering prices. When it is determined that an equity investment is other-than-temporarily impaired, the security is written down to fair value, and the amount of the impairment is included in earnings as a realized investment loss. The fair value then becomes the new cost basis of the investment, and any subsequent recoveries in fair value are recognized at disposition. We recognize a realized loss when impairment is deemed to be other-than-temporary even if a decision to sell an equity investment has not been made. When we decide to sell a temporarily impaired available-for-sale equity investment and we do not expect the fair value of the equity investment to fully recover prior to the expected time of sale, the investment is deemed to be other-than-temporarily impaired in the period in which the decision to sell is made.

**Fixed Maturity Investments:** We assess whether we intend to sell, or it is more likely than not that we will be required to sell, a fixed maturity investment before recovery of its amortized cost basis less any current period credit losses. For fixed maturity investments that are considered other-than-temporarily impaired and that we do not intend to sell and will not be required to sell, we separate the amount of the impairment into the amount that is credit related (credit loss component) and the amount due to all other factors. The credit loss component is recognized in earnings and is the difference between the investment's amortized cost basis and the present value of its expected future cash flows. The remaining difference between the investment's fair value and the present value of future expected cash flows is recognized in other comprehensive income.

Major categories of recognized gains (losses) on investments are summarized as follows (in thousands):

	Three Months Ended September 30		Nine Months Ended September 30	
	2009	2008	2009	2008
U.S. Treasury securities and obligations of U.S. government	\$ -	\$ -	\$ -	\$ 1,217
Corporate debt securities	239	-	1,269	-
Municipal bonds	-	27	(48)	204
Equity securities-financial services	58	102	115	142
Equity securities- all other	300	527	318	746
Net realized gain	597	656	1,654	2,309
Other-than-temporary impairments	-	(3,152)	(538)	(3,714)
Gain (loss) on investments	\$ 597	\$ (2,496)	\$ 1,116	\$ (1,405)

We realized gross gains on investments of \$0.7 million and \$0.7 million during the three months ended September 30, 2009 and 2008, respectively, and \$2.0 million and \$2.8 million for the nine months ended September 30, 2009 and 2008, respectively. We realized gross losses on investments of \$0.1 million and \$3.2 million during the three months ended September 30, 2009 and 2008, respectively, and \$0.9 million and \$4.2 million for the nine months ended September 30, 2009 and 2008, respectively. We recorded proceeds from the sale of investment securities of \$25.3 million and \$86.9 million during the three months ended September 30, 2009 and 2008, respectively, and \$66.2 million and \$475.4 million for the nine months ended September 30, 2009 and 2008, respectively. Realized investment gains and losses are recognized in operations on the specific identification method.

The amortized cost and estimated fair value of investments in debt and equity securities (in thousands) by category is as follows:

As of September 30, 2009	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Treasury securities and obligations of U.S. government	\$ 6,104	\$ 65	\$ -	\$ 6,169
Corporate debt securities	87,349	6,488	(2,410)	91,427
Municipal bonds	197,746	2,793	(3,396)	197,143
Asset backed	699	14	-	713
<b>Total debt securities</b>	<b>291,898</b>	<b>9,360</b>	<b>(5,806)</b>	<b>295,452</b>
Financial services	21,770	6,598	(12)	28,356
All other	9,294	3,644	(335)	12,603
<b>Total equity securities</b>	<b>31,064</b>	<b>10,242</b>	<b>(347)</b>	<b>40,959</b>
<b>Total debt and equity securities</b>	<b>\$ 322,962</b>	<b>\$ 19,602</b>	<b>\$ (6,153)</b>	<b>\$ 336,411</b>
As of December 31, 2008				
U.S. Treasury securities and obligations of U.S. government	\$ 3,996	\$ 179	\$ -	\$ 4,175
Corporate debt securities	67,157	395	(7,005)	60,547
Municipal bonds	211,083	631	(7,923)	203,791
<b>Total debt securities</b>	<b>282,236</b>	<b>1,205</b>	<b>(14,928)</b>	<b>268,513</b>
Financial services	24,761	332	(3,618)	21,475
All other	4,292	29	(793)	3,528
<b>Total equity securities</b>	<b>29,053</b>	<b>361</b>	<b>(4,411)</b>	<b>25,003</b>
<b>Total debt and equity securities</b>	<b>\$ 311,289</b>	<b>\$ 1,566</b>	<b>\$ (19,339)</b>	<b>\$ 293,516</b>

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The following schedules summarize the gross unrealized losses showing the length of time that investments have been continuously in an unrealized loss position as of September 30, 2009 and December 31, 2008 (in thousands):

	As of September 30, 2009					
	12 months or less		Longer than 12 months		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Corporate debt securities	\$ 14,081	\$ (1,527)	\$ 9,169	\$ (883)	\$ 23,250	\$ (2,410)
Municipal bonds	33,282	(1,995)	41,220	(1,401)	74,502	(3,396)
Total debt securities	47,363	(3,522)	50,389	(2,284)	97,752	(5,806)
Financial services	1,638	(12)	-	-	1,638	(12)
All other	2,362	(335)	-	-	2,362	(335)
Total equity securities	4,000	(347)	-	-	4,000	(347)
Total debt and equity securities	\$ 51,363	\$ (3,869)	\$ 50,389	\$ (2,284)	\$ 101,752	\$ (6,153)

	As of December 31, 2008					
	12 months or less		Longer than 12 months		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Corporate debt securities	\$ 34,314	\$ (5,175)	\$ 9,786	\$ (1,830)	\$ 44,100	\$ (7,005)
Municipal bonds	106,175	(7,258)	10,295	(665)	116,470	(7,923)
Total debt securities	140,489	(12,433)	20,081	(2,495)	160,570	(14,928)
Financial services	7,110	(3,618)	-	-	7,110	(3,618)
All other	1,822	(793)	-	-	1,822	(793)
Equity securities	8,932	(4,411)	-	-	8,932	(4,411)
Total debt and equity securities	\$ 149,421	\$ (16,844)	\$ 20,081	\$ (2,495)	\$ 169,502	\$ (19,339)

At September 30, 2009, the gross unrealized losses more than twelve months old were attributable to 39 bond positions. At December 31, 2008, the gross unrealized losses more than twelve months old were attributable to 15 bond positions. We consider these losses as a temporary decline in value as they are predominately on bonds that we do not intend to sell and do not believe we will be required to sell prior to recovery of our amortized cost basis. We see no other indications that the decline in values of these securities is other-than-temporary.

Based on evidence gathered through our normal credit evaluation process, we presently expect that all debt securities held in our investment portfolio will be paid in accordance with their contractual terms. Nonetheless, it is at least reasonably possible that the performance of certain issuers of these debt securities will be worse than currently expected resulting in additional future write-downs within our portfolio of debt securities.



Also, as a result of the challenging market conditions, we expect the volatility in the valuation of our equity securities to continue in the foreseeable future. This volatility may lead to additional impairments on our equity securities portfolio or changes regarding retention strategies for certain equity securities.

The amortized cost and estimated fair value of debt securities at September 30, 2009 by contractual maturity are as follows. Expected maturities may differ from contractual maturities because certain borrowers may have the right to call or prepay obligations with or without penalties.

	Amortized Cost	Fair Value
	(in thousands)	
Due in one year or less	\$ 36,343	\$ 37,237
Due after one year through five years	126,983	132,249
Due after five years through ten years	52,526	51,749
Due after ten years	75,347	73,504
Asset backed	699	713
	\$ 291,898	\$ 295,452

Activity related to the credit component recognized in earnings on debt securities held by us for which a portion of other-than-temporary impairment was recognized in other comprehensive income for the nine months ended September 30, 2009 is as follows (in thousands):

Balance, January 1, 2009	\$ -
Credit component of other-than-temporary impairment not reclassified to OCI in conjunction with the cumulative effect transition adjustment (1)	1,168
Additions for the credit component on debt securities in which other-than-temporary impairment was not previously recognized	-
Balance, September 30, 2009	\$ 1,168

(1) As of April 1, 2009, the Company had securities with \$3.7 million of other-than-temporary impairment previously recognized in earnings of which \$1.1 million represented the credit component and \$2.6 million represented the noncredit component which was reclassified back to accumulated other comprehensive income through a cumulative-effect adjustment.

Accumulated other comprehensive income includes \$0.7 million, net of tax, of noncredit related impairments as of September 30, 2009.

## 6. Pledged Investments

We have certain of our securities pledged for the benefit of various state insurance departments and reinsurers. These securities are included with our available-for-sale debt securities because we have the ability to trade these securities. We retain the interest earned on these securities. These securities had a carrying value of \$22.5 million at September 30, 2009 and a carrying value of \$26.4 million at December 31, 2008.

## 7. Share-Based Payment Arrangements

Our 2005 Long Term Incentive Plan ("2005 LTIP") is a stock compensation plan for key employees and non-employee directors that was initially approved by the shareholders on May 26, 2005. There are 2,000,000 shares authorized for issuance under the 2005 LTIP. Our 1994 Key Employee Long Term Incentive Plan (the "1994 Employee Plan") and 1994 Non-Employee Director Stock Option Plan (the "1994 Director Plan") both expired in 2004 but have unexercised options outstanding.

As of September 30, 2009, there were incentive stock options to purchase 1,262,499 shares of our common stock outstanding and non-qualified stock options to purchase 320,000 shares of our common stock outstanding under the 2005 LTIP, leaving 417,501 shares reserved for future issuance. As of September 30, 2009, there were incentive stock options to purchase 3,833 shares outstanding under the 1994 Employee Plan and non-qualified stock options to purchase 20,834 shares outstanding under the 1994 Director Plan. In addition, as of September 30, 2009, there were outstanding non-qualified stock options to purchase 8,333 shares of our common stock granted to certain non-employee directors outside the 1994 Director Plan in lieu of fees for service on our board of directors in 1999. The exercise price of all such outstanding stock options is equal to the fair market value of our common stock on the date of grant.

Options granted under the 1994 Employee Plan prior to October 31, 2003, vest 40% six months from the date of grant and an additional 20% on each of the first three anniversary dates of the grant and terminate ten years from the date of grant. Incentive stock options granted under the 2005 LTIP prior to 2009 and the 1994 Employee Plan after October 31, 2003, vest 10%, 20%, 30% and 40% on the first, second, third and fourth anniversary dates of the grant, respectively, and terminate five to ten years from the date of grant. Incentive stock options granted in 2009 under the 2005 LTIP vest in equal annual increments on each of the first seven anniversary dates and terminate ten years from the date of grant. Non-qualified stock options granted under the 2005 LTIP vest 100% six months after the date of grant and terminate ten years from the date of grant. All non-qualified stock options granted under the 1994 Director Plan vested 40% six months from the date of grant and an additional 10% on each of the first six anniversary dates of the grant and terminate ten years from the date of grant. The options granted to non-employee directors outside the 1994 Director Plan fully vested six months after the date of grant and terminate ten years from the date of grant.

A summary of the status of our stock options as of and changes during the year-to-date ended September 30, 2009 is presented below:

	Number of Shares	Average Exercise Price	Contractual Term (Years)	Intrinsic Value (\$000)
Outstanding at January 1, 2009	1,052,298	\$ 11.12		
Granted	595,000	\$ 6.62		
Exercised	(29,716)	\$ 3.66		
Forfeited or expired	(2,083)	\$ 2.63		
Outstanding at September 30, 2009	1,615,499	\$ 9.61	8.2	\$ 1,083
Exercisable at September 30, 2009	415,833	\$ 10.36	6.7	\$ 230

The following table details the intrinsic value of options exercised, total cost of share-based payments charged against income before income tax benefit and the amount of related income tax benefit recognized in income for the periods indicated (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
Intrinsic value of options exercised	\$ -	\$ -	\$ 107	\$ 337
Cost of share-based payments (non-cash)	\$ 612	\$ 305	\$ 1,488	\$ 1,078
Income tax benefit of share-based payments recognized in income	\$ 118	\$ 15	\$ 231	\$ 20

As of September 30, 2009 there was \$2.7 million of total unrecognized compensation cost related to non-vested share-based compensation arrangements granted under our plans, of which \$0.3 million is expected to be recognized during the remainder of 2009, \$1.0 million is expected to be recognized in 2010, \$0.7 million is expected to be recognized in 2011, \$0.3 million is expected to be recognized in 2012, \$0.1 million is expected to be recognized each year from 2013 through 2016.

The fair value of each stock option granted is estimated on the date of grant using the Black-Scholes option pricing model. Expected volatilities are based on the historical volatility of similar companies' common stock for a period equal to the expected term. The risk free interest rates for periods within the contractual term of the options are based on rates for U.S. Treasury Notes with maturity dates corresponding to the options' expected lives on the dates of grant. Expected term is determined base on the simplified method as we do not have sufficient historical exercise data to provide a basis for estimating the expected term.

The following table details the weighted average grant date fair value and related assumptions for the periods indicated. No options were granted in the third quarter of 2009 or 2008.

	Nine Months Ended	
	September 30, 2009	September 30, 2008
Grant date fair value per share	\$ 2.84	\$ 4.74
Expected term (in years)	6.2	6.4
Expected volatility	40.0%	35.0%
Risk free interest rate	2.5%	3.4%

#### 8. Segment Information

The following is business segment information for the three and nine months ended September 30, 2009 and 2008 (in thousands):

	Three Months Ended		Nine Months Ended	
	September 30, 2009	September 30, 2008	September 30, 2009	September 30, 2008
<b>Revenues:</b>				
Standard Commercial Segment	\$ 19,569	\$ 20,280	\$ 57,783	\$ 64,617
Specialty Commercial Segment	32,346	30,245	97,601	94,617
Personal Segment	18,735	16,053	54,971	48,277
Corporate	1,253	(1,589)	3,202	983
Consolidated	\$ 71,903	\$ 64,989	\$ 213,557	\$ 208,494
<b>Pre-tax income (loss), net of non-controlling interest:</b>				
Standard Commercial Segment	\$ 2,164	\$ 887	\$ 5,987	\$ 9,104
Specialty Commercial Segment	3,588	745	14,280	12,601
Personal Segment	2,225	2,544	7,738	7,047
Corporate	(2,178)	(4,030)	(6,960)	(7,224)
Consolidated	\$ 5,799	\$ 146	\$ 21,045	\$ 21,528

The following is additional business segment information as of the dates indicated (in thousands):

	September 30, 2009	December 31, 2008
<b>Assets</b>		
Standard Commercial Segment	\$ 139,923	\$ 146,415
Specialty Commercial Segment	271,301	230,130
Personal Segment	103,113	84,456
Corporate	101,669	77,397
	<b>\$ 616,006</b>	<b>\$ 538,398</b>

## 9. Reinsurance

We reinsure a portion of the risk we underwrite in order to control the exposure to losses and to protect capital resources. We cede to reinsurers a portion of these risks and pay premiums based upon the risk and exposure of the policies subject to such reinsurance. Ceded reinsurance involves credit risk and is generally subject to aggregate loss limits. Although the reinsurer is liable to us to the extent of the reinsurance ceded, we are ultimately liable as the direct insurer on all risks reinsured. Reinsurance recoverables are reported after allowances for uncollectible amounts. We monitor the financial condition of reinsurers on an ongoing basis and review our reinsurance arrangements periodically. Reinsurers are selected based on their financial condition, business practices and the price of their product offerings.

The following table shows earned premiums ceded and reinsurance loss recoveries by period (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
Ceded earned premiums	\$ 7,137	\$ 2,153	\$ 12,331	\$ 6,126
Reinsurance recoveries	\$ 4,166	\$ 8,211	\$ 7,388	\$ 9,474

We presently retain 100% of the risk associated with all policies marketed by our Personal Lines Operating Unit. We currently reinsure the following exposures on business generated by our AHIS Operating Unit, our TGA Operating Unit, our Heath XS Operating Unit, and our Aerospace Operating Unit:

- Property catastrophe. Our property catastrophe reinsurance reduces the financial impact a catastrophe could have on our commercial and personal property insurance lines. Catastrophes might include multiple claims and policyholders. Catastrophes include hurricanes, windstorms, earthquakes, hailstorms, explosions, severe winter weather and fires. Our property catastrophe reinsurance is excess-of-loss reinsurance, which provides us reinsurance coverage for losses in excess of an agreed-upon amount. We utilize catastrophe models to assist in determining appropriate retention and limits to purchase. The terms of our property catastrophe reinsurance are:

- o We retain the first \$3.0 million of property catastrophe losses; and

- o Our reinsurers reimburse us 100% for any loss in excess of our \$3.0 million retention up to \$35.0 million for each catastrophic occurrence, subject to an aggregate limit of \$64.0 million.
- Commercial property. Our commercial property reinsurance is excess-of-loss coverage intended to reduce the financial impact a single-event or catastrophic loss may have on our results. The terms of our commercial property reinsurance are:
  - o We retain the first \$1.0 million of loss for each commercial property risk;
- o Our reinsurers reimburse us for the next \$5.0 million for each commercial property risk, and \$10.0 million for all commercial property risk involved in any one occurrence, in all cases subject to an aggregate limit of \$30.0 million for all commercial property losses occurring during the treaty period; and
- o Individual risk facultative reinsurance is purchased on any commercial property with limits above \$6.0 million.
- Commercial casualty. Our commercial casualty reinsurance is excess-of-loss coverage intended to reduce the financial impact a single-event loss may have on our results. The terms of our commercial casualty reinsurance are:
  - o We retain the first \$1.0 million of any commercial liability risk; and
  - o Our reinsurers reimburse us for the next \$5.0 million for each commercial liability risk.
- Aviation. We purchase reinsurance specific to the aviation risks underwritten by our Aerospace Operating Unit. This reinsurance provides aircraft hull and liability coverage and airport liability coverage on a per occurrence basis on the following terms:
  - o We retain the first \$350,000 of each aircraft hull or liability loss or airport liability loss;
- o Our reinsurers reimburse us for the next \$2.15 million of each combined aircraft hull and liability loss and for the next \$650,000 of each airport liability loss; and
- o Other risks with liability limits greater than \$1.0 million are placed in a quota share treaty where we retain 20% of incurred losses.
- Heath XS. Effective July 1, 2009, in states where we are admitted, we directly insure policies written by our Heath XS Operating Unit and reinsure a portion of the risk with third party carriers. In states where we are not admitted, our Heath XS Operating Unit writes policies under fronting arrangements pursuant to which we assume all of the risk and then retrocede a portion of the risk to third party reinsurers. We reinsure or retrocede 79% of the risk on policies written by our Heath XS Operating Unit. Through June 30, 2009, our Heath XS Operating Unit wrote policies under a fronting arrangement pursuant to which we assumed 35% of the risk.
- Hallmark County Mutual. HCM is used to front certain lines of business in our Specialty Commercial and Personal Segments in Texas where we previously produced policies for third party county mutual insurance companies and reinsured 100% for a fronting fee. In addition HCM is used to front business produced by unaffiliated third parties. HCM does not retain any business.

## 10. Notes Payable

On June 21, 2005, an unconsolidated trust subsidiary completed a private placement of \$30.0 million of 30-year floating rate trust preferred securities. Simultaneously, we borrowed \$30.9 million from the trust subsidiary and contributed \$30.0 million to one of our insurance company subsidiaries in order to increase policyholder surplus. The note bears an initial interest rate of 7.725% until June 15, 2015, at which time interest will adjust quarterly to the three-month LIBOR rate plus 3.25 percentage points. Under the terms of the note, we pay interest only each quarter and the principal of the note at maturity. As of September 30, 2009, the note balance was \$30.9 million.

On January 27, 2006, we borrowed \$15.0 million under our revolving credit facility to fund the cash required to close the acquisition of the subsidiaries comprising our TGA Operating Unit. As of September 30, 2009, the balance on the revolving note was \$2.8 million, which currently bears interest at 2.18% per annum. (See Note 11, "Credit Facilities.")

On August 23, 2007, an unconsolidated trust subsidiary completed a private placement of \$25.0 million of 30-year floating rate trust preferred securities. Simultaneously, we borrowed \$25.8 million from the trust subsidiary for working capital and general corporate purposes. The note bears an initial interest rate of 8.28% until September 15, 2017, at which time interest will adjust quarterly to the three-month LIBOR rate plus 2.90 percentage points. Under the terms of the note, we pay interest only each quarter and the principal of the note at maturity. As of September 30, 2009 the note balance was \$25.8 million.

## 11. Credit Facilities

We have a credit facility with The Frost National Bank which was amended and restated on January 27, 2006 to provide a \$20.0 million revolving credit facility with a \$5.0 million letter of credit sub-facility. The credit facility was further amended effective May 31, 2007 to increase the revolving credit facility to \$25.0 million and establish a new \$5.0 million revolving credit sub-facility for the premium finance operations of PAAC. The credit agreement was again amended effective February 20, 2008 to extend the termination to January 27, 2010, revise various affirmative and negative covenants and decrease the interest rate in most instances to the three month Eurodollar rate plus 1.90 percentage points, payable quarterly in arrears. We pay letter of credit fees at the rate of 1.00% per annum. Our obligations under the revolving credit facility are secured by a security interest in the capital stock of all of our subsidiaries, guaranties of all of our subsidiaries and the pledge of all of our non-insurance company assets. The revolving credit facility contains covenants which, among other things, require us to maintain certain financial and operating ratios and restrict certain distributions, transactions and organizational changes. As of September 30, 2009, we were in compliance with all of our covenants. As of September 30, 2009 we had \$2.8 million outstanding under this facility.

## 12. Deferred Policy Acquisition Costs

The following table shows total deferred and amortized policy acquisition cost activity by period (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
Deferred	\$ (7,454)	\$ (13,700)	\$ (38,539)	\$ (41,718)
Amortized	8,257	14,204	35,434	41,326
Net	\$ 803	\$ 504	\$ (3,105)	\$ (392)

## 13. Earnings per Share

The following table sets forth basic and diluted weighted average shares outstanding for the periods indicated (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
Weighted average shares - basic	20,652	20,809	20,790	20,799
Effect of dilutive securities	14	62	32	82
Weighted average shares - assuming dilution	20,666	20,871	20,822	20,881

For the three and nine months ended September 30, 2009 and 2008, 899,166 shares of common stock potentially issuable upon the exercise of employee stock options were excluded from the weighted average number of shares outstanding on a diluted basis because the effect of such options would be anti-dilutive.

## 14. Net Periodic Pension Cost

The following table details the net periodic pension cost incurred by period (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
Interest cost	\$ 160	\$ 167	\$ 482	\$ 501
Amortization of net loss	122	16	366	48
Expected return on plan assets	(121)	(167)	(363)	(502)
Net periodic pension cost	\$ 161	\$ 16	\$ 485	\$ 47

We did not make any contributions to our frozen defined benefit cash balance plan ("Cash Balance Plan") during the three or nine months ended September 30, 2009. We contributed \$414,000 and \$650,000 to the Cash Balance Plan during the three and nine months ended September 30, 2008, respectively. Refer to Note 14 to the consolidated financial statements in our Annual Report on Form 10-K for the year ended December 31, 2008 for more discussion of our retirement plans.

## 15. Contingencies

We are engaged in legal proceedings in the ordinary course of business, none of which, either individually or in the aggregate, are believed likely to have a material adverse effect on our consolidated financial position or results of operations, in the opinion of management. The various legal proceedings to which we are a party are routine in nature and incidental to our business.

We have evaluated subsequent events through November 12, 2009, the date the financial statements were issued.

### Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

The following discussion should be read together with our consolidated financial statements and the notes thereto. This discussion contains forward-looking statements. Please see "Risks Associated with Forward-Looking Statements in this Form 10-Q" for a discussion of some of the uncertainties, risks and assumptions associated with these statements.

#### Introduction

Hallmark Financial Services, Inc. ("Hallmark" and, together with subsidiaries, "we," "us" or "our") is an insurance holding company which, through its subsidiaries, engages in the sale of property/casualty insurance products to businesses and individuals. Our business involves marketing, distributing, underwriting and servicing commercial insurance, personal insurance and general aviation insurance, as well as providing other insurance related services. Our business is geographically concentrated in the south central and northwest regions of the United States, except for our general aviation business and the excess commercial automobile and commercial umbrella risks produced by our Heath XS Operating Unit which are written on a national basis. We pursue our business activities through subsidiaries whose operations are organized into five operating units which are supported by four of our insurance company subsidiaries.

Our non-carrier insurance activities are segregated by operating units into the following reportable segments:

- **Standard Commercial Segment.** Our Standard Commercial Segment includes the standard lines commercial property/casualty insurance products and services handled by our AHIS Operating Unit which is comprised of our American Hallmark Insurance Services, Inc. and Effective Claims Management, Inc. subsidiaries.
- **Specialty Commercial Segment.** Our Specialty Commercial Segment includes the excess and surplus lines commercial property/casualty insurance products and services handled by our TGA Operating Unit, the general aviation insurance products and services handled by our Aerospace Operating Unit, and the excess commercial automobile and commercial umbrella insurance products handled by our Heath XS Operating Unit. Our TGA Operating Unit is comprised of our TGA Insurance Managers, Inc., Pan American Acceptance Corporation ("PAAC") and TGA Special Risk, Inc. subsidiaries. Our Aerospace Operating Unit is comprised of our Aerospace Insurance Managers, Inc., Aerospace Special Risk, Inc. and Aerospace Claims Management Group, Inc. subsidiaries. Our Heath XS Operating Unit is comprised of our Heath XS, LLC and Hardscrabble Data Solutions, LLC subsidiaries.

- **Personal Segment.** Our Personal Segment includes the non-standard personal automobile insurance and complementary personal insurance products and services handled by our Personal Lines Operating Unit which is comprised of American Hallmark General Agency, Inc. and Hallmark Claims Services, Inc., both of which do business as Hallmark Insurance Company.

The retained premium produced by our operating units is supported by the following insurance company subsidiaries:

- American Hallmark Insurance Company of Texas (“AHIC”) presently retains all of the risks on the commercial property/casualty policies marketed within the Standard Commercial Segment and assumes a portion of the risks on the commercial and aviation property/casualty policies marketed within the Specialty Commercial Segment.
- Hallmark Specialty Insurance Company (“HSIC”) presently retains a portion of the risks on the commercial property/casualty policies marketed within the Specialty Commercial Segment.
- Hallmark Insurance Company (“HIC”) presently assumes all of the risks on the personal property/casualty policies marketed by our Personal Lines Operating Unit and assumes a portion of the risks on the aviation property/casualty products marketed within the Specialty Commercial Segment.
- Hallmark County Mutual Insurance Company (“HCM”) control and management was acquired effective June 5, 2009 through the acquisition of all of the issued and outstanding shares of CYR Insurance Management Company (“CYR”). CYR has as its primary asset a management agreement with HCM which provides for CYR to have management and control of HCM. HCM is used to front certain lines of business in our Specialty Commercial and Personal Segments in Texas where we previously produced policies for third party county mutual insurance companies and reinsured 100% for a fronting fee. HCM does not retain any business.

AHIC, HSIC, and HIC have entered into a pooling arrangement pursuant to which AHIC retains 46% of the total net premiums written by all of our operating units, HIC retains 34% of our total net premiums written and HSIC retains 20% of our total net premiums written. This pooling arrangement has no impact on our consolidated financial statements under GAAP.

## Results of Operations

**Management Overview.** During the three and nine months ended September 30, 2009, our total revenues were \$71.9 million and \$213.6 million, representing a 11% and 2% increase from the \$65.0 million and \$208.5 million in total revenues for the same periods of 2008. This increase in revenue was primarily attributable to increased earned premium due to increased retention of business in our Specialty Commercial Segment, the acquisition of our Heath XS Operating Unit in the third quarter of 2008 and increased production by our Personal Lines Segment. Increased revenue was partially offset by reduced earned premium in our Standard Commercial Segment due to the deterioration of the general economic environment in our major markets and by lower commission and fee income in our Specialty Commercial Segment due to profit sharing commission adjustments related to adverse loss development on prior accident years as well as the shift from a third party agency structure to an insurance underwriting structure.

We reported net earnings of \$4.2 million and \$15.3 million for the three and nine months ended September 30, 2009, which were \$3.6 million higher than the \$0.6 million reported for the third quarter 2008 and the same as reported for the nine months ended September 30, 2008. On a diluted basis per share, net earnings were \$0.20 and \$0.73 per share for the three months and nine months ended September 30, 2009, as compared to \$0.03 and \$0.73 per share for the same periods in 2008. The increase in net earnings for the three months ended September 30, 2009 was primarily attributable to increased revenue, partially offset by higher loss and loss adjustment expense ("LAE") due mostly to unfavorable prior year loss development of \$1.7 million recognized in the three months ending September 30, 2009 as compared to favorable development of \$0.1 million recognized during the three months ending September 30, 2008. The increase in revenue for the nine months ending September 30, 2009 was offset by increased loss and LAE due mostly to unfavorable prior year loss development of \$3.5 million recognized during the nine months ending September 30, 2009 as compared to favorable development of \$1.9 million recognized during the nine months ending September 30, 2008.

## Third Quarter 2009 as Compared to Third Quarter 2008

The following is additional business segment information for the three months ended September 30, 2009 and 2008 (in thousands):

Hallmark Financial Services, Inc  
Consolidated Segment Data

	Three Months Ended September 30, 2009				
	Standard Commercial Segment	Specialty Commercial Segment	Personal Segment	Corporate	Consolidated
Produced premium (1)	\$ 17,309	\$ 36,064	\$ 17,424	\$ -	\$ 70,797
Gross premiums written	17,309	39,280	17,424	-	74,013
Ceded premiums written	(1,144)	(10,078)	-	-	(11,222)
Net premiums written	16,165	29,202	17,424	-	62,791
Change in unearned premiums	1,627	92	(272)	-	1,447
Net premiums earned	17,792	29,294	17,152	-	64,238
Total revenues	19,569	32,346	18,735	1,253	71,903
Losses and loss adjustment expenses	11,425	17,641	11,513	-	40,579
Pre-tax income (loss), net of non-controlling interest	2,164	3,588	2,225	(2,178)	5,799
Net loss ratio (2)	64.2%	60.2%	67.1%		63.2%
Net expense ratio (2)	32.8%	29.8%	22.4%		31.0%
Net combined ratio (2)	97.0%	90.0%	89.5%		94.2%

	Three Months Ended September 30, 2008				
	Standard Commercial Segment	Specialty Commercial Segment	Personal Segment	Corporate	Consolidated
Produced premium (1)	\$ 18,957	\$ 36,295	\$ 14,763	\$ -	\$ 70,015
Gross premiums written	18,954	25,288	14,763	-	59,005
Ceded premiums written	(1,274)	(1,219)	-	-	(2,493)
Net premiums written	17,680	24,069	14,763	-	56,512
Change in unearned premiums	1,784	650	(18)	-	2,416
Net premiums earned	19,464	24,719	14,745	-	58,928
Total revenues	20,280	30,245	16,053	(1,589)	64,989
Losses and loss adjustment expenses	13,239	16,287	9,455	-	38,981
Pre-tax income (loss), net of					

non-controlling interest	887	745	2,544	(4,030)	146
Net loss ratio (2)	68.0%	65.9%	64.1%		66.2%
Net expense ratio (2)	30.9%	30.8%	21.5%		30.1%
Net combined ratio (2)	98.9%	96.7%	85.6%		96.3%

(1) Produced premium is a non-GAAP measurement that management uses to track total premium produced by our operations. Produced premium excludes unaffiliated third party premium fronted on our recently acquired HCM subsidiary. We believe this is a useful tool for users of our financial statements to measure our premium production whether retained by our insurance company subsidiaries or assumed by third party insurance carriers who pay us commission revenue.

(2) The net loss ratio is calculated as incurred losses and LAE divided by net premiums earned, each determined in accordance with GAAP. During the second quarter of 2009 we changed the method in which the net expense ratio is calculated. The net expense ratio is now calculated for our operating units that retain 100% of produced premium as total operating expenses for the unit offset by agency fee income divided by net premiums earned, each determined in accordance with GAAP. For the operating units that do not retain 100% of the produced premium, the net expense ratio is calculated as underwriting expenses of the insurance company subsidiaries for the unit offset by agency fee income, divided by net premiums earned, each determined in accordance with GAAP. Net combined ratio is calculated as the sum of the net loss ratio and the net expense ratio. All prior periods have been restated to conform to the new method, resulting in an increase to the consolidated net expense ratio of 1.3% for the three months ended September 30, 2008.

### Standard Commercial Segment

Gross premiums written for the Standard Commercial Segment were \$17.3 million for the three months ended September 30, 2009, which was \$1.7 million, or 9%, less than the \$19.0 million reported for the same period in 2008. Net premiums written were \$16.2 million for the three months ended September 30, 2009 as compared to \$17.7 million reported for the same period in 2008. The decrease in premium volume was predominately due to the deterioration of the general economic environment, particularly in the construction industry, reducing the available insured exposures.

Total revenue for the Standard Commercial Segment of \$19.6 million for the three months ended September 30, 2009 was \$0.7 million less than the \$20.3 million reported during the same period in 2008. This 4% decrease in total revenue was mostly due to decreased net premiums earned of \$1.7 million, offset by increased profit sharing commissions of \$1.3 million related to favorable loss development on prior treaty years during 2009 compared to unfavorable loss development on prior treaty years for the same period in 2008. Decreased net investment income of \$0.3 million during the three months ended September 30, 2009 as compared to the same period during 2008 also contributed to the decrease in total revenue.

Pre-tax income for our Standard Commercial Segment of \$2.2 million for the three months ended September 30, 2009 increased \$1.3 million, or 144%, from the \$0.9 million reported for the same period of 2008. Decreased revenue was offset by lower loss and LAE expenses of \$1.8 million primarily as a result of hurricane related losses recorded in the third quarter of 2008 and by lower operating expenses of \$0.2 million mostly due to lower premium volume.

The Standard Commercial Segment reported a net loss ratio of 64.2% for the three months ended September 30, 2009 as compared to 68.0% for 2008. The gross loss ratio before reinsurance for the three months ended September 30, 2009 was 66.2% as compared to the 89.7% reported for the same period of 2008. The gross loss results for the three months ended September 30, 2008 included \$8.8 million of hurricane related losses partially offset by \$0.4 million of favorable development on prior accident years. Hurricane related losses accounted for 42.3% of the gross loss ratio and 17.1% of the net loss ratio for the third quarter of 2008. During the three months ended September 30, 2009, the Standard Commercial Segment reported unfavorable development of \$0.4 million. The Standard Commercial Segment reported a higher net expense ratio of 32.8% for the three months ended September 30, 2009 as compared to 30.9% for the same period in 2008 due mostly to lower earned premium.

### Specialty Commercial Segment

The \$32.3 million of total revenue for the three months ended September 30, 2009 was \$2.1 million higher than the \$30.2 million reported for the same period in 2008. This increase in revenue was largely due to increased net premiums earned of \$4.6 million as a result of the increased retention of business and the acquisition of the Heath XS Operating Unit during the third quarter of 2008. These increases were partially offset by lower commission and fee income of \$2.4 million primarily related to profit sharing commission adjustments related to adverse loss development on prior accident years as well as the shift from a third party agency structure to an insurance underwriting structure.

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Pre-tax income for the Specialty Commercial Segment of \$3.6 million was \$2.9 million higher than the \$0.7 million reported for the same period in 2008. Increased revenue was complemented by lower operating expenses of \$2.2 million. These lower operating expenses in the third quarter of 2009 were primarily the result of a \$1.2 million premium receivable write-off due to the default of a producer in our TGA Operating Unit during the third quarter of 2008 and lower production related expenses of \$1.0 million due to lower produced premium and lower operating expenses of \$0.1 million in our Aerospace Operating Unit and TGA Operating Unit partially offset by increased operating expenses of \$0.3 million due primarily to the acquisition of the Heath XS Operating Unit effective August 29, 2008. The increase in pre-tax income was further offset by higher loss and LAE expenses of \$1.3 million.

The Specialty Commercial Segment reported a net loss ratio of 60.2% for the three months ended September 30, 2009 as compared to 65.9% for the same period during 2008. Hurricane related losses accounted for 10.8% of the net loss ratio for the third quarter of 2008, offset by unfavorable prior year loss development of \$1.2 million during the third quarter of 2009 as compared to \$0.4 million during the same period of 2008. The Specialty Commercial Segment reported a net expense ratio of 29.8% for the third quarter of 2009 as compared to 30.8% for the same period the prior year.

#### Personal Segment

Net premiums written for our Personal Segment increased \$2.6 million during the third quarter of 2009 to \$17.4 million compared to \$14.8 million for the third quarter of 2008. The increase in premium was due mostly to continued geographic expansion.

Total revenue for the Personal Segment increased 17% to \$18.7 million for the third quarter of 2009 from \$16.1 million for the third quarter of 2008. Higher earned premium of \$2.4 million was the primary reason for the increase in revenue for the period. Increased finance charges of \$0.3 million further contributed to the increase in revenue during the third quarter of 2009.

Pre-tax income for the Personal Segment was \$2.2 million for the three months ended September 30, 2009 compared to \$2.5 million for the same period during 2008. Increased revenue was offset by increased losses and LAE of \$2.1 million and increased operating expenses of \$0.9 million due mostly to increased production and salary expense related to continued geographic expansion.

The Personal Segment reported a net loss ratio of 67.1% for the three months ended September 30, 2009 as compared to 64.1% for the third quarter of 2008. The increase in the net loss ratio was primarily a result of higher current accident year loss experience as compared to the prior year due in part to hail storm related losses. We recognized \$0.1 million of unfavorable prior accident year development for the three months ended September 30, 2009 as compared to \$0.2 million of favorable prior accident year development for the same period during 2008. The Personal Segment reported a net expense ratio of 22.4% for the three months ended September 30, 2009 as compared to 21.5% for the second quarter of 2008.

#### Corporate

Total revenue for corporate increased by \$2.8 million for the three months ended September 30, 2009 as compared to the same period the prior year. This increase in total revenue was due primarily to recognized gains of \$0.6 million on our investment portfolio for the three months ended September 30, 2009 as compared to recognized losses of \$2.5 million during the same period in 2008. This increase in revenue was offset by lower net investment income of \$0.3 million for the three months ended September 30, 2009 as compared to the same period of the prior year.

Corporate pre-tax loss was \$2.2 million for the three months ended September 30, 2009 as compared to \$4.0 million for the same period the prior year. The decreased loss was mostly due to increased revenue partially offset by increased operating expenses of \$0.4 million related to stock option grants to directors and employees and periodic pension costs, other compensation expense of \$0.4 million, and other operating expenses of \$0.3 million. These increases in operating expenses were offset by a \$0.4 million subsequent recovery related to a receivable for a cancelled start-up program. In addition, increased intangible amortization of \$0.3 million related to our acquisition of CYR during the second quarter of 2009 further offset the increased revenue.

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Nine Months Ended September 30, 2009 as Compared to Nine Months Ended September 30, 2008

The following is additional business segment information for the nine months ended September 30, 2009 and 2008 (in thousands):

Hallmark Financial Services, Inc. Consolidated Segment Data					
	Nine Months Ended September 30, 2009				
	Standard Commercial Segment	Specialty Commercial Segment	Personal Segment	Corporate	Consolidated
Produced premium (1)	\$ 56,881	\$ 110,598	\$ 54,968	\$ -	\$ 222,447
Gross premiums written	56,881	108,696	54,968	-	220,545
Ceded premiums written	(3,331)	(13,383)	-	-	(16,714)
Net premiums written	53,550	95,313	54,968	-	203,831
Change in unearned premiums	419	(13,692)	(4,571)	-	(17,844)