

Hallwood Group Inc  
Form 10-K/A  
April 08, 2010

**Table of Contents**

**UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
FORM 10-K/A  
AMENDMENT NO. 1**

(Mark One)

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

**For the year ended December 31, 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)

**Securities Registered Pursuant to Section 12(b) of the Act:**

**Title of Class**

Common Stock (\$0.10 par value)

**Name of Exchange  
on Which Registered**

NYSE Amex

**Securities Registered Pursuant to Section 12(g) of the Act:**

**Title of Class**

Series B Redeemable Preferred Stock

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

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

Edgar Filing: Hallwood Group Inc - Form 10-K/A

Indicate by check mark if the disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in, definitive proxy or information statements incorporated by reference in part III of this Form 10-K or any amendment to this form 10-K.

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   
(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

The aggregate market value of the Common Stock, held by non-affiliates of the registrant as of June 30, 2009, the last business day of the registrant's most recently completed second fiscal quarter, based on the closing price of \$13.91 per share on the NYSE Amex, was \$7,022,000.

1,525,166 shares of Common Stock were outstanding at March 26, 2010.

**DOCUMENTS INCORPORATED BY REFERENCE**

The information called for by Part III is incorporated by reference to the definitive Proxy Statement for the Annual Meeting of Stockholders of the Company.

**Table of Contents**

**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES  
EXPLANATORY NOTE**

This Form 10-K/A amendment to the Company's Annual Report on Form 10-K for the year ended December 31, 2009 is being filed to amend certain disclosures in Part II, Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations related to sources and uses of cash reported in the section entitled Liquidity and Capital Resources, which were reported incorrectly due to a clerical error.

All other information in the Form 10-K, including the financial statements, is unchanged from the original filing. This filing amends only the disclosures related to the sources and uses of cash in the section entitled Liquidity and Capital Resources and does not otherwise update disclosures in the Form 10-K as originally filed and does not reflect events occurring after the original filing of the Form 10-K.

Provided below are the disclosures related to the sources and uses of cash as originally reported and as amended:

**As Originally Reported**

*General.* The Company, through its Brookwood subsidiary, 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 \$1,822,000 during 2009 to \$7,838,000 as of December 31, 2009. The principal source of cash in 2009 was \$9,140,000 provided by operations. The principal uses of cash in 2009 were \$3,330,000 for investments in property, plant and equipment, principally at Brookwood, and \$3,988,000 for repayment of bank borrowings.

**As Amended**

*General.* The Company, through its Brookwood subsidiary, 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 \$1,822,000 during 2009 to \$7,838,000 as of December 31, 2009. The principal source of cash in 2009 was \$8,637,000 provided by operations. The principal uses of cash in 2009 were \$3,102,000 for investments in property, plant and equipment, principally at Brookwood, and \$3,988,000 for net repayment of the revolving credit facility and bank borrowings.

The financial statements and related footnotes in the originally filed Form 10-K are not included with this Form 10-K/A as they are unchanged. Disclosures in the first paragraph of Management's Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources are effected by the changes in the disclosures.

**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES  
FORM 10-K/A  
TABLE OF CONTENTS**

<b>ITEM NO.</b>		<b>PAGE</b>
<b>PART II</b>		
<u>7</u>	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	4
<b>PART IV</b>		
	<u>Signature Page</u>	21
	<u>Index to Exhibits</u>	22
<u>EX-31.1</u>		
<u>EX-31.2</u>		
<u>EX-32.1</u>		

**Table of Contents**

**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**

**Item 7. 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 in 2009 of its former Hallwood Energy affiliate. For financial reporting purposes, the Company fully consolidates all of its subsidiaries and accounted for the investment in its Hallwood Energy affiliate using the equity method of accounting.

*Textile Products.* In the three years ended December 31, 2009, the Company derived all of its operating revenues from the textile activities of its 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 flow 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 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 \$130,103,000, \$101,813,000 and \$70,006,000 for 2009, 2008 and 2007, respectively, were 27.8% higher in 2009 and 45.4% higher in 2008 from the respective previous years.

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 to replace sales lost to imports. In addition to its existing products and proprietary technologies, Brookwood has been developing advanced breathable, waterproof laminate 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 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

**Table of Contents**

**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**

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.

The textile products business is not interdependent with the Company's other business 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 of the debtors.

Refer to the section Investments in Hallwood Energy for a further discussion of the Company's former energy activities, including the bankruptcy case.

**Critical Accounting Policies**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and judgments that affect the reported amounts of certain assets, liabilities, revenues, expenses, and related disclosures. Actual results may differ from these estimates under different assumptions or conditions.

The Securities and Exchange Commission (SEC) requested that registrants identify critical accounting policies in Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations. The SEC indicated that a critical accounting policy is one that is both important to the portrayal of an entity's financial condition and results and requires management's most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain. The Company believes that the following of its accounting policies fit this description:

*Revenue Recognition.* Textile products sales are recognized upon shipment or release of product, when title passes to the customer. Brookwood provides allowances for expected cash discounts, returns, claims and doubtful accounts based upon historical bad debt and claims experience and periodic evaluation of the aging of accounts receivable. If the financial condition of Brookwood's customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances would be required.

Brookwood may receive instructions from some of its customers to finish fabric, invoice the full amount and hold the finished inventory for delivery at a later date. In those cases, Brookwood records the sale and sends the customer an invoice containing normal and usual payment terms and identifies the inventory as separate from Brookwood's inventory. Generally, a customer provides such instructions to accommodate its lack of available storage space for inventory. This practice is customary in the textile industry and with respect to certain Brookwood customers. In these cases, the Brookwood customer either dictates delivery dates at the time the order is placed or when the customer has not specified a fixed delivery date, the customer owns the goods and has asked Brookwood to keep them in the warehouse. For all of its bill and hold sales, Brookwood has no future obligations, the customer is billed when the product is ready for shipment and expected to pay under standard billing and credit terms, regardless of the actual delivery date, and the inventory is identified and not available for Brookwood's use. The bill and hold sales held by Brookwood at the end of each of the three years ended December 31, 2009 were not material.

*Deferred Income Tax Asset.* A deferred income tax asset is recognized for net operating loss and certain other tax carryforwards, tax credits and temporary differences, reduced by a valuation allowance, which is established when it is more





**Table of Contents****THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**

likely than not that some portion or all of the asset will not be realized. Management is required to estimate taxable income for future years and to use its judgment to determine whether or not to record a valuation allowance to reduce part or all of a deferred tax asset. Management considers various tax planning strategies, anticipated gains from the potential sale of investments and projected future income from operations to determine the valuation allowance to be recorded, if any.

*Impairment of Long-Lived Assets.* Management reviews its investments for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Unforeseen events and changes in circumstances and market conditions could negatively affect the fair value of assets and result in an impairment charge. In the event such indicators exist for assets held for use, if undiscounted cash flows before interest charges are less than carrying value, the asset is written down to estimated fair value. For assets held for sale, these assets are carried at the lower of cost or estimated sales price less costs of sale. Fair value is the amount at which the asset could be bought or sold in a current transaction between willing parties and may be estimated using a number of techniques, including quoted market prices or valuations by third parties, present value techniques based on estimates of cash flows, or multiples of earnings or revenues performance measures. The fair value of the asset could be different using different estimates and assumptions in these valuation techniques. Significant assumptions used in this process depend upon the nature of the investment, but would include an evaluation of the future business opportunities, sources of competition, advancement of technology and its impact on patents and processes and the level of expected operating expenses.

*Impairment of Investments Accounted for Under Equity Method.* Investments that are accounted for under the equity method of accounting are reviewed for impairment when the fair value of the investment is believed to have fallen below the Company's carrying value. When such a decline is deemed other than temporary, an impairment charge is recorded to the statement of operations for the difference between the investment's carrying value and its estimated fair value at the time. In making the determination as to whether a decline is other than temporary, the Company considers such factors as the duration and extent of the decline, the investee's financial performance, and the Company's ability and intention to retain its investment for a period that will be sufficient to allow for any anticipated recovery in the investment's market value. However, a decline in the quoted market price below the carrying amount or the existence of operating losses is not necessarily indicative of a loss in value that is other than temporary. All are factors to be evaluated. Differing assumptions could affect whether an investment is impaired. At least annually, the Company performs impairment reviews and determines if a writedown is required.

As application of the equity method of accounting resulted in the carrying value of the Company's investment in Hallwood Energy to be reduced to zero in each of the years ended December 31, 2009, 2008 and 2007, impairment reviews were not required for the investments in Hallwood Energy for those years.

In prior years, the Company's evaluation of its investment in Hallwood Energy, or its predecessors, contained assumptions including (i) an evaluation of reserves using assumptions commonly used in the industry, some of which were not the same as are required by the SEC to be used for financial reporting purposes; (ii) realization of fair value for various reserve categories based upon Hallwood Energy's historical experience; and (iii) value per acre in a potential sale transaction, based upon acreage owned in productive areas with shale characteristics similar to acreage previously sold by Hallwood Energy Corporation and Hallwood Energy III, L.P., former energy affiliates, and other sale activity of acreage with shale formations.

*Inventories.* Inventories at the Brookwood subsidiary are valued at the lower of cost (first-in, first-out or specific identification method) or market. Inventories are reviewed and adjusted for changes in market value based on assumptions related to past and future demand and worldwide and local market conditions. If actual demand and market conditions vary from those projected by management, adjustments to lower of cost or market value may be required.

The policies listed are not intended to be a comprehensive list of all of the Company's accounting policies. In most cases, the accounting treatment of a particular transaction is specifically dictated by accounting principles generally accepted in the United States of America, with no need for management's judgment in the application. There are also areas in which management's judgment in selecting any available alternative would not produce a materially different

result than those recorded and reported.

**Table of Contents****THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES****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 of \$17,055,000 for the year ended December 31, 2009, compared to net income of \$1,398,000 for 2008, and a net loss of \$32,825,000 for 2007. Revenue was \$179,554,000 for 2009, \$162,237,000 for 2008 and \$132,497,000 for 2007. Operating income, principally from Brookwood's operations, was \$25,632,000, \$15,767,000 and \$7,250,000 in 2009, 2008 and 2007, respectively.

**Revenues**

Textile products sales of \$179,554,000 in 2009 increased by \$17,317,000, or 10.7%, compared to \$162,237,000 in 2008, which was an increase of \$29,740,000, or 22.4%, compared to \$132,497,000 in 2007. The increases were principally due to an increase of \$28,290,000 in 2009 and an increase of \$31,807,000 in 2008, over prior year amounts, in sales of specialty fabric to U.S. military contractors as a result of increases in orders from the military to Brookwood's customers, partially offset by a decline in sales of other products including sailcloth, flag material and other consumer related items.

Brookwood has several customers who accounted for more than 10% of Brookwood's sales in one or more of the three years ended December 31, 2009. Sales to one Brookwood customer, Tennier Industries, Inc. (Tennier), accounted for more than 10% of Brookwood's sales in each of the three years ended December 31, 2009. Brookwood's relationship with Tennier is ongoing. Sales to Tennier, which are included in military sales, were \$60,994,000, \$47,310,000 and \$40,844,000 in 2009, 2008 and 2007, respectively, which represented 34.0%, 29.2% and 30.8% of Brookwood's sales. Sales to another customer, ORC Industries, Inc. (ORC), accounted for more than 10% of Brookwood's sales in 2009 and 2008. Brookwood's relationship with ORC is ongoing. Sales to ORC, which are also included in military sales, were \$24,598,000, \$18,436,000 and \$8,971,000 in 2009, 2008 and 2007, respectively, which represented 13.7%, 11.4% and 6.8% of Brookwood's sales. Sales to another customer accounted for slightly 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 military sales, were \$16,752,000 in 2008, which represented 10.3% of Brookwood's sales.

**Expenses**

Textile products cost of sales of \$128,812,000 increased by \$5,017,000, or 4.1%, in 2009, compared to \$123,795,000 in 2008, which was an increase of \$18,877,000, or 18.0%, compared to \$104,918,000 in 2007. The 2009 increase principally resulted from material and labor costs associated with the higher sales volume, which were favorably offset by changes in product mix and reduced energy costs, which decreased overall by 28% in 2009. The 2008 increase principally resulted from material and labor costs associated with the higher sales volume, changes in product mix and utility costs, which increased by 47% compared to 2007. 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's facilities, including inbound freight, purchasing and receiving costs, inspection costs, internal transfer costs and other costs of the distribution network. 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 was 28.3%, 23.7% and 20.8% in 2009, 2008 and 2007, respectively. The higher gross profit margin for 2009 was attributed to higher sales volumes, changes in product mix, energy savings and manufacturing efficiencies such as a reduction in material working loss. The higher gross margin for 2008 principally resulted from higher sales volume, changes in product mix and manufacturing efficiencies such as a reduction in material working loss.

**Table of Contents****THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**

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

	<b>Years Ended December 31,</b>		
	<b>2009</b>	<b>2008</b>	<b>2007</b>
Textile products	\$ 18,419	\$ 17,143	\$ 15,115
Corporate	6,691	5,532	5,214
<b>Total</b>	<b>\$ 25,110</b>	<b>\$ 22,675</b>	<b>\$ 20,329</b>

Textile products administrative and selling expenses of \$18,419,000 for 2009 increased by \$1,276,000, or 7.4%, from the 2008 amount of \$17,143,000, which increased by \$2,028,000, or 13.4%, compared to the 2007 amount of \$15,115,000. The 2009 increase was primarily attributable to increases in performance compensation and payroll and benefit costs of \$1,282,000 and professional fees, principally legal fees, of \$200,000. The 2008 increase was primarily attributable to an increase of \$341,000 of employee related expenses associated with higher sales volume, and in support of increased compliance requirements for Sarbanes-Oxley and environmental matters, increased performance compensation and other related payroll costs of \$761,000, and \$879,000 for legal and professional fees. The textile products administrative and selling expenses include items such as payroll, professional fees, sales 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 expenses were approximately \$835,000 in 2009, \$862,000 in 2008 and \$605,000 in 2007.

Corporate administrative expenses were \$6,691,000 for 2009, compared to \$5,532,000 for 2008 and \$5,214,000 for 2007. The 2009 increase of \$1,159,000, or 21.0%, was primarily attributable to higher professional fees of \$2,343,000, including costs related to the Hallwood Energy bankruptcy, the special committee's activities in considering the offer by a company affiliated with the chairman and principal stockholder to acquire the Company's outstanding common stock that was cancelled and accounting and tax services. The increases were partially offset by decreased employee related expenses of \$825,000 from 2008, which included severance costs of \$355,000 associated with a reduction in staff. The 2008 increase of 6.1% was principally attributable to costs associated with the terminated initiative regarding strategic alternatives for Brookwood of approximately \$440,000, employee severance costs of \$355,000, and higher office space and administrative service costs for HIL of \$119,000, partially offset by a reduction in Sarbanes-Oxley costs of \$299,000.

**Other Income (Loss)**

Equity losses from the Company's investments in Hallwood Energy, attributable to the Company's share of losses reported by Hallwood Energy, were \$12,120,000 in 2008 and \$55,957,000 in 2007. The Company did not record a 2009 equity loss as the carrying value of its investment in Hallwood Energy was zero at December 31, 2008 and the Company made no additional investment or commitment to provide additional financial support to Hallwood Energy during 2009.

In consideration of Hallwood Energy's bankruptcy reorganization, the extinguishment of the Company's ownership interest in Hallwood Energy in the confirmed plan of reorganization, the previously recorded reduction in the carrying value of the Hallwood Energy investment to zero and possession by 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 year ended December 31, 2009.

The Company recorded a 2008 equity loss to the extent of loans it made to Hallwood Energy in 2008 of \$8,920,000 and a contingent commitment to invest additional funds, under certain conditions, of up to \$3,200,000 and reduced the carrying value of its investment in Hallwood Energy to zero. For the year ended December 31, 2008, Hallwood Energy reported a loss of \$60,941,000, which included an impairment of its oil and gas properties of \$32,731,000, interest expense of \$23,642,000 and other income of \$6,017,000, which principally related to a contract services

agreement with Talisman Energy.

The Company recorded a 2007 equity loss of \$55,957,000 in Hallwood Energy as its proportionate share of significant losses reported by Hallwood Energy. In the first nine months of 2007, Hallwood Energy reported a loss of \$54,602,000, which included an impairment of \$31,680,000 associated with its oil and gas properties and interest expense of \$17,913,000. The interest expense included make-whole provisions in the amounts of \$7,100,000 related to its former credit facility and \$9,009,000 related to its Senior Secured Credit Facility. In the 2007 fourth quarter, Hallwood Energy reported a net loss of \$221,811,000, which included an impairment of its oil and gas properties of \$191,322,000 and interest expense of \$12,163,000. A significant portion of the impairment charge, approximately \$111,000,000, related to the early lease

**Table of Contents**

**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**

surrenders and writedowns of Arkansas leaseholds associated with low or non-prospective oil and gas leases and approximately \$52,829,000 related to its Louisiana properties from its drilling program that had been unsuccessful. The fourth quarter interest expense included \$7,488,000 related to the change in the value of the make-whole provision contained in its Senior Secured Credit Facility.

The Company earned interest income of \$92,000 during 2007 from loans it made to Hallwood Energy in the period from March to May 2007.

**Table of Contents****THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**

Interest expense was comprised of the following (in thousands):

	<b>Years Ended December 31,</b>		
	<b>2009</b>	<b>2008</b>	<b>2007</b>
Textile products	\$ 252	\$ 688	\$ 1,146
Corporate			
<b>Total</b>	<b>\$ 252</b>	<b>\$ 688</b>	<b>\$ 1,146</b>

Textile products interest expense principally relates to Brookwood's Working Capital Revolving Credit Facility. The decreases in interest expense were due to a decline in the average outstanding loan amount (\$6,450,000 and \$10,411,000 at December 31, 2009 and 2008, respectively) and lower average interest rates (3.32% and 2.30% at December 31, 2009 and 2008, respectively).

Interest and other income was \$36,000 in 2009, compared to \$144,000 in 2008 and \$307,000 in 2007. The 2009 decrease was principally due to reduced interest income earned on lower balances of cash and cash equivalents and lower interest rates. The 2008 decrease was principally due to reduced interest income earned on cash equivalents and a gain in the amount of \$74,000 from the sale of a marketable security in March 2007.

**Income Taxes**

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

	<b>Years Ended December 31,</b>		
	<b>2009</b>	<b>2008</b>	<b>2007</b>
Federal			
Current	\$ 5,377	\$ (116)	\$ (14,294)
Deferred	2,549	744	(2,998)
<b>Sub-total</b>	<b>7,926</b>	<b>628</b>	<b>(17,292)</b>
State			
Current	1,144	759	610
Deferred	(429)	38	53
<b>Sub-total</b>	<b>715</b>	<b>797</b>	<b>663</b>
Foreign			
Current	(280)	280	
<b>Total</b>	<b>\$ 8,361</b>	<b>\$ 1,705</b>	<b>\$ (16,629)</b>

The income tax expense for 2009 was principally due to the operating income from Brookwood, partially offset by corporate administrative expenses.

The income tax expense for 2008 was principally due to the operating income from Brookwood, partially offset by the equity loss from the investment in Hallwood Energy and corporate administrative expenses. The income tax benefit for 2007 was principally due to the equity loss from the investment in Hallwood Energy. The statutory federal tax rate in 2009, 2008 and 2007 was 35%, 34% and 34%, respectively, while state taxes were determined based upon



taxable income apportioned to those states in which the Company does business at their respective tax rates.

In 2009, it is anticipated that the Company will fully utilize its remaining federal net operating loss carryforward and alternative minimum tax credits when completing the Company's 2009 federal income tax return and will report taxable income, principally attributable to the operating income from Brookwood.

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**

After filing its 2007 federal income tax return with the Internal Revenue Service ( IRS ) in September 2008, the Company filed a carryback of its 2007 taxable loss and received a tax refund in October 2008 in the amount of \$12,347,000.

The Company filed an application for tentative refund with the IRS in March 2007 and received \$1,000,000 in April 2007. Following the filing of the 2006 income tax return in September 2007, the Company received an additional refund of \$376,000 in October 2007. The Company also filed a carryback of its 2006 taxable loss in September 2007 and obtained an additional refund of \$4,512,000 in November 2007.

At December 31, 2009 and 2008, the net deferred tax asset was \$1,698,000 and \$3,818,000, respectively. The 2009 balance was comprised of \$1,273,000 attributable to temporary differences (including \$1,120,000 associated with the Company's investment in Hallwood Energy) and \$425,000 of state tax credits. The 2008 balance was comprised of \$550,000 attributable to temporary differences (including \$365,000 associated with the Company's investment in Hallwood Energy), \$2,509,000 attributable to a federal net operating loss carryforward, and \$759,000 of alternative minimum tax credits.

**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>Years Ended December 31,</b>		
	<b>2009</b>	<b>2008</b>	<b>2007</b>
Consulting fees	\$ 996	\$ 996	\$ 996
Office space and administrative services	240	301	182
Travel and other expenses	171	110	70
<b>Total</b>	<b>\$ 1,407</b>	<b>\$ 1,407</b>	<b>\$ 1,248</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 years ended December 31, 2009, 2008 and 2007, Mr. Gumbiner received a consulting fee from only one affiliate, Hallwood Energy, of \$ -0-, \$150,000 and \$200,000, respectively. In addition, Mr. Gumbiner held a profit interest only in Hallwood Energy in the three year period ended December 31, 2009. Mr. Gumbiner transferred this profit interest to HPI, the primary secured lender to Hallwood Energy, in June 2008 in connection with a loan restructuring by Hallwood Energy.

During the three years ended December 31, 2009, HIL and certain of its affiliates in which Mr. Gumbiner has an indirect financial interest share 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 years ended December 31, 2009, 2008 and 2007, these companies reimbursed the Company \$100,000, \$110,000 and \$155,000, respectively, for such expenses.

*Hallwood Financial Limited.* As further discussed in the section entitled Announcement and Subsequent Withdrawal of Offer to Acquire All Outstanding Publicly Held Common Shares of Company by Chairman and Principal Stockholder, Hallwood Financial 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. On

**Table of Contents****THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**

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

*Investments in Hallwood Energy.* In April 2007, HIL and HPI committed to fund one-half of potential additional equity or subordinated debt funding calls totaling \$55,000,000, or \$27,500,000, by Hallwood Energy, to the extent other investors, including the Company, did not respond to a call. Hallwood Family BVI, L.P. ( HFBL ), a partnership affiliated with HIL and Mr. Gumbiner, funded \$2,591,000 and \$1,842,000 in June 2007 and September 2007, respectively, pursuant to such commitment, which represented the Company's share of its full equity call allotment not subscribed to by the Company due to the fact that the Company did not have available sufficient cash. In addition, HFBL made further investments of \$2,223,000 during 2007 pursuant to various equity calls from Hallwood Energy. In September 2007, the \$55,000,000 commitment from HIL and HPI expired as a result of the receipt of sufficient contributions from various equity calls initiated by Hallwood Energy between April 2007 and August 2007.

In November 2007, HFBL committed to fund \$7,500,000 of additional equity to Hallwood Energy no later than November 15, 2007. HFBL funded the full \$7,500,000 in November under this agreement, with Hallwood Energy executing a promissory note bearing interest at 16% per annum. On January 2, 2008, as per the commitment agreement, the outstanding amount plus accrued interest was automatically converted into Hallwood Energy Class C limited partnership interest.

In January 2008, HFBL 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* . Prior to the confirmation of Hallwood Energy's bankruptcy plan in October 2009, HFBL had invested a total of \$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 confirmed plan of reorganization, the Class C partnership interest was extinguished and the convertible note is subordinated to recovery in favor of HPI.

*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 years ended December 31, 2009 and 2008 and 2007, Hallwood Energy reimbursed the Company \$70,000, \$415,000 and \$297,000, respectively, for such expenses. Hallwood Energy completed its move from the office space by July 31, 2009 and no longer shares such expenses.

**Investments in Hallwood Energy**

At December 31, 2009, the Company had invested \$61,481,000 in Hallwood Energy's general partner interest and Class A and Class C limited partner interests. In addition, the Company loaned Hallwood Energy \$13,920,000 in the form of convertible notes issued by Hallwood 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. Additionally, any right of recovery for the convertible note interests is subordinated in favor of HPI.

Provided below is a schedule of the Company's investments in Hallwood Energy by year (in thousands):

<b>Description</b>	<b>2009</b>	<b>2008</b>	<b>2007</b>	<b>Prior</b>	<b>Total Investment</b>
Class A limited partner interest	\$	\$	\$ 3	\$ 50,381	\$ 50,384
Class C limited partner interest			11,084		11,084
General partner interest			6	7	13
First Convertible Note		5,000			5,000
Second Convertible Note:					
Cash investment		9,300			9,300

Less: portion invested by third parties		(380)			(380)
Total	\$	\$ 13,920	\$ 11,093	\$ 50,388	\$ 75,401

Hallwood Energy was a privately held independent oil and gas limited partnership and operated as an upstream energy

**Table of Contents****THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**

company engaged in the acquisition, development, exploration, production, and sale of hydrocarbons, with a primary focus on natural gas assets. Certain of the Company's officers and directors were investors in Hallwood Energy. In addition, as a member of management of Hallwood Energy, one officer of the Company held a profit interest in Hallwood Energy that was also extinguished in the bankruptcy.

*Bankruptcy Reorganization 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 16, 2009, the Bankruptcy Court confirmed a plan of reorganization of the debtors that, among other things, extinguished Hallwood Energy's general partnership and limited partnership interests, including those held by the Company. In addition, Hallwood Energy's convertible notes including those held by the Company, are subordinated to recovery in favor of HPI. 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.

In connection with Hallwood Energy's bankruptcy proceeding, Hallwood Energy and other parties have filed lawsuits and threatened to assert additional claims against the Company and certain related parties alleging actual, compensatory and exemplary damages in excess of \$200,000,000, based on purported breach of contract, fraud, breach of fiduciary duties, neglect, negligence and various misleading statements, omissions and misrepresentations. See Item 3. Legal Proceedings of this report. The Company believes that the allegations and claims are without merit and intends to defend the lawsuits and any future claims vigorously.

*Equity Losses.* As previously stated, the Company recorded its pro rata share of Hallwood Energy's net income (loss) using the equity method of accounting. 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 to the investee, has guaranteed obligations of the investee, or is otherwise committed to provide further financial support to the investee. Although no guarantee or commitment existed at December 31, 2007, the Company loaned \$5,000,000 to Hallwood Energy in January 2008 in connection with Hallwood Energy's \$30,000,000 First Convertible Note (discussed below) to provide capital to continue regular ongoing operations. Accordingly, the Company recorded an additional equity loss in 2007 to the extent of the \$5,000,000 loan, as the Company had not determined to what extent, if any, that it would advance additional funds to Hallwood Energy and the carrying value of its Hallwood Energy investment was reduced to zero at December 31, 2007.

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 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 (discussed below). The Company loaned \$4,300,000 to Hallwood Energy during September 2008 pursuant to the Equity Support Agreement. The Company's additional investments and contingent commitment to provide additional financial support, resulted in the recording of an equity loss in the year ended December 31, 2008 of \$12,120,000, which included accumulated equity losses that had not

been previously recorded, as the Company had reduced the carrying value of its investment to zero.

An obligation and related additional equity loss were recorded in 2008 to the extent of the Company's contingent 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

**Table of Contents**

**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**

commitment amount under the Equity Support Agreement was \$3,201,000 at December 31, 2009. Hallwood Energy has filed an adversary proceeding against the Company demanding that the Company fund the additional \$3,201,000.

The Company's carrying value of its Hallwood Energy investment, which was zero at December 31, 2008 and 2007, remained at zero as of December 31, 2009. Pursuant to Hallwood Energy's plan of reorganization confirmed by the Bankruptcy Court in October 2009, 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.

*Partnership Investments and Convertible Notes.* Prior to Hallwood Energy's bankruptcy reorganization, there were three classes of limited partnership interests, one class of general partnership interest and two classes of convertible notes outstanding for Hallwood Energy:

Class C limited partnership interests bore a 16% priority return which compounded monthly. The Class C capital contributions totaled approximately \$84,422,000 prior to the bankruptcy reorganization.

Class A limited partnership interests had certain voting rights and with the general partner would receive 100% of the distributions of available cash and net proceeds from Terminating Capital Transactions, 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 is reduced to zero, and thereafter share in all future distributions of available cash and net proceeds from Terminating Capital Transactions with the holders of the Class B interests.

Class B limited partnership interests represented vested profit interests awarded to key individuals by Hallwood Energy. Prior to the bankruptcy reorganization, outstanding Class B interests had rights to receive 20.0% of distributions of defined available cash and net proceeds from Terminating Capital Transactions, as defined, after the unpaid Class C priority return and capital contributions and the unreturned Class A and general partner capital contributions have been reduced to zero.

General partnership interests represented a 0.01% ownership interest in Hallwood Energy. The general partner was Hallwood Energy Management, LLC, which was owned equally by two entities, including the Company.

*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 which accrued 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 and were subject to a make-whole provision. Prior to the bankruptcy reorganization, \$28,839,000 of the First Convertible Notes were outstanding, of which \$5,000,000 was held by the Company.

*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 (discussed below). The Second Convertible Note contained interest terms, conversion features and repayment terms comparable to the First Convertible Note described previously. Prior to the bankruptcy reorganization, \$9,300,000 of the Second Convertible Note was outstanding, of which \$8,920,000 was held by the Company and \$380,000 was held by other Hallwood Energy investors.

In October 2009, the Bankruptcy Court confirmed a plan of reorganization of the debtors that, among other things, extinguished Hallwood Energy's general partnership and Class A, B and C limited partnership interests, including those held by the Company. In addition, Hallwood Energy's convertible notes, including those held by the Company, are subordinated to recovery in favor of HPI.

Following is a description of certain capital and loan transactions completed by Hallwood Energy during 2007 and 2008 and the Company's relative participation in those transactions. No transactions occurred during 2009:



*Capital Transactions.* In April 2007, HIL and HPI, each committed to fund one-half of potential additional equity or subordinated debt funding calls totaling \$55,000,000 by Hallwood Energy, to the extent other investors, including the Company, did not respond to the calls. In April 2007, Hallwood Energy issued a \$25,000,000 Class C equity call to its partners (the April Call ), which was fully satisfied. The Company's share of the April Call was \$6,743,000.

**Table of Contents****THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**

In May 2007, Hallwood Energy issued a \$20,000,000 Class C equity call to its partners (the May Call), which was fully satisfied. The Company's proportionate share of the May Call was \$5,091,000. Due to the fact that the Company did not have available sufficient cash, the Company contributed only \$2,501,000 towards the May Call. Because of the Company's inability to meet its full equity call requirement, HFBL funded \$2,590,000 of the May Call that was not funded by the Company.

In August 2007, Hallwood Energy issued a \$15,000,000 Class C equity call to its partners (the August Call), which was fully satisfied. The Company's proportionate share of the August Call was \$3,683,000. Due to the fact that the Company did not have available sufficient cash, the Company contributed only one-half, or \$1,842,000, towards the August Call. Because of the Company's inability to meet its full equity call requirement, HFBL funded \$1,842,000 of the August Call that was not funded by the Company.

As a result of the receipt of sufficient equity contributions from the April, May and August Calls, the \$55,000,000 commitment from HIL and HPI was extinguished.

In November 2007, Hallwood Energy issued \$15,000,000 of Class C limited partnership interest to a new equity partner. In addition, HIL, another existing investor in Hallwood Energy, and HPI entered into a letter agreement providing for a total of up to \$15,000,000 in additional funding. HFBL, on behalf of HIL, funded \$7,500,000 under the letter agreement, executing a promissory note with an interest rate of 16% per annum and a maturity of March 1, 2010. Two of the partners did not fund under this agreement which constituted a default condition under the Senior Secured Credit Facility, as stipulated in the letter agreement. This default condition was subsequently waived and on January 2, 2008, as per the letter agreement, HFBL's loan and accrued interest was converted into a Class C limited partner interest.

*Talisman Energy Transaction in 2008.* 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 by Hallwood Energy 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 of its third payment.

Under the sale and farmout agreement between Hallwood Energy and FEI, the purchaser made an initial payment of \$60,000,000 for an undivided 10% interest in Hallwood Energy's specified oil and gas properties and other assets. For each well for which FEI paid any costs, it earned an additional interest on the specified properties on which the well was located upon payment of each invoice equal to an additional undivided 23.33% if payment occurred prior to FEI paying a cumulative amount of \$90,000,000 under the farmout agreement (the Initial Milestone), or 13.33% if payment occurred after the Initial Milestone. For other oil and gas properties, FEI earned an undivided 33.33% interest in such properties immediately upon payment of purchase costs paid by FEI under the farmout agreement. With respect to Hallwood Energy's other assets, FEI immediately earned an additional undivided 10% interest in these other assets upon meeting the Initial Milestone and an additional undivided 13.33% interest in these other assets upon payment of a cumulative amount of \$125,000,000 under the farmout agreement. FEI also earned an undivided 33.33% interest in seismic data for which costs were paid by FEI. Hallwood Energy agreed to deliver assignments for the interests earned under the farmout agreement and granted a lien and security interest on 33.33% of its assets in favor of FEI as collateral security for the performance of this agreement.

The farmout agreement prohibited Hallwood Energy from entering into a change of control agreement unless the lender under the Senior Secured Credit Facility and Junior Credit Facility waives its rights to demand prepayment, and holders of the First and Second Convertible Notes waived their rights of redemption upon a change of control or such indebtedness was required to be repaid or redeemed with funds provided or arranged by the party acquiring or merging with Hallwood Energy in the change of control transaction.

In connection with the Talisman Energy Transaction, the Company loaned \$2,961,000 to Hallwood Energy in May 2008. Concurrent with the completion of the Talisman Energy Transaction, 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 of \$5,000,000) to Hallwood

**Table of Contents****THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**

Energy and committed to provide an additional amount of up to \$7,500,000 in certain circumstances, all of which were issued under terms of the Second Convertible Note. In September 2008, the Company loaned an additional \$4,300,000 to Hallwood Energy under the Equity Support Agreement.

During June and July 2008, the Company sold \$380,000 of the Second Convertible Note to other investors in Hallwood Energy. As of December 31, 2009 and 2008, \$9,300,000 of the Second Convertible Note was outstanding, of which \$8,920,000 was held by the Company and \$380,000 was held by other Hallwood Energy investors. The remaining commitment amount under the Equity Support Agreement, which is currently subject to litigation, was \$3,201,000 at December 31, 2009.

*Loan Transaction.* In March and April 2007, the Company loaned a total of \$9,000,000 to Hallwood Energy, of which \$7,000,000 was in the form of demand notes bearing interest at 6% above prime rate, and \$2,000,000 was an advance that was repaid four days later with interest. In connection with the issuance of the April Call, the Company and Hallwood Energy agreed that the \$7,000,000 loan would be applied as the Company's portion of the April Call. In May 2007, Hallwood Energy repaid \$257,000 to the Company, which represented the excess of the \$7,000,000 loaned over the Company's share of the capital contribution and related oversubscription.

*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 was an affiliate of one of the investors, and drew \$65,000,000 from the Senior Secured Credit Facility. The proceeds were used to pay the \$40,000,000 balance of a former credit facility, approximately \$9,800,000 for a make-whole fee, approximately \$500,000 for incremental interest related to the former credit facility, transaction fees of approximately \$200,000 and provide working capital. The Senior Secured Credit Facility was secured by Hallwood Energy's oil and gas leases, was scheduled to mature on February 1, 2010, and bore interest at a rate of the defined LIBOR rate plus 10.75% per annum. In conjunction with executing the Senior Secured Credit Facility, HPI's affiliates resigned their position on Hallwood Energy's board of directors and HPI assigned its general partner interest to the remaining members.

The Senior Secured Credit Facility provided that if Hallwood Energy raised \$25,000,000 through an equity call or through debt subordinate to the Senior Secured Credit Facility, HPI would match subsequent amounts raised on a dollar for dollar basis up to the remaining \$35,000,000 under the Senior Secured Credit Facility through the availability termination date of July 31, 2008. During the 2007 third quarter, Hallwood Energy borrowed an additional \$20,000,000 under the Senior Secured Credit Facility and borrowed the remaining availability of \$15,000,000 in October 2007.

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. The proceeds were used to fund working capital requirements and future operational activities. 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 were scheduled to mature on February 1, 2010.

Hallwood Energy was not in compliance with various covenants required by the Secured Credit Facilities 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 covenant 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 Secured Credit Facilities until at least 91 days after the termination of the farmout agreement.

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 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.

*First Convertible Note.* In January 2008, Hallwood Energy entered into the \$30,000,000 First Convertible Note. During the 2008 first quarter, \$28,839,000 of the convertible subordinated notes were subscribed for and issued. The

Company subscribed for \$5,000,000 of the First Convertible Note and provided the funds to Hallwood Energy in January 2008.

**Table of Contents****THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**

*Second Convertible Note.* In May 2008, Hallwood Energy entered into the \$12,500,000 Second Convertible Note agreement, which was underwritten by the Company. The Second Convertible Note contained interest terms, conversion features and repayment terms comparable to the First Convertible Note. Under terms of the Second Convertible Note, the Company loaned \$2,961,000 in May 2008, \$2,039,000 in June 2008 and \$4,300,000 in September 2008. During June and July 2008, the Company sold \$380,000 of the Second Convertible Note to other investors in Hallwood Energy.

*Litigation.* In connection with Hallwood Energy's bankruptcy proceeding, Hallwood Energy and other parties have filed lawsuits and threatened to assert additional claims against the Company and certain related parties alleging actual, compensatory and exemplary damages in excess of \$200,000,000, based on purported breach of contract, fraud, breach of fiduciary duties, neglect, negligence and various misleading statements, omissions and misrepresentations. See Item 3. Legal Proceedings of this report. The Company believes that the allegations and claims are without merit and intends to defend the lawsuits and any future claims vigorously.

**Liquidity and Capital Resources**

*General.* The Company, through its Brookwood subsidiary, 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 \$1,822,000 during 2009 to \$7,838,000 as of December 31, 2009. The principal source of cash in 2009 was \$8,637,000 provided by operations. The principal uses of cash in 2009 were \$3,102,000 for investments in property, plant and equipment, principally at Brookwood, and \$3,988,000 for net repayment of the revolving credit facility and bank borrowings.

On March 9, 2010, the Company's board of directors adopted a resolution providing for the redemption of the Series B Preferred Stock, at \$4.00 per share, on or before July 20, 2010, the mandatory redemption date. The redemption price of \$1,000,000 is expected to be paid from existing funds held by the Company.

*Textiles.* The Company's textile products segment generates funds from the dyeing, laminating and finishing of fabrics and their sales to customers in the military, consumer, industrial and medical markets. At December 31, 2009, Brookwood had a \$25,000,000 Working Capital Revolving Credit Facility with Key Bank. In October 2009, Brookwood entered into an amendment to the Working Capital Revolving Credit Facility that was scheduled to expire in January 2010, which maintained the \$25,000,000 loan amount and extended the term to January 31, 2011. The \$3,000,000 equipment facility with Key Bank, also scheduled to expire in January 2010, was not renewed. At December 31, 2009, Brookwood had approximately \$18,429,000 of unused borrowing capacity on its Working Capital Revolving Credit Facility.

Brookwood continues to monitor its factors and the effect the current economic conditions 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 took steps to protect its interests with CIT and expanded its relationships with other factors. Additionally, Brookwood 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 March 31, 2010, 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.

In the years ended December 31, 2009, 2008 and 2007, Brookwood paid cash dividends to the Company of \$4,500,000, \$9,300,000 and \$6,000,000, respectively. In addition, Brookwood made payments to the Company of \$7,751,000, \$7,341,000 and \$1,591,000, respectively, under its tax sharing agreement. In the 2010 first quarter, Brookwood made dividend and tax sharing payments of \$1,000,000 and \$3,937,000, respectively. 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 0.66 at December 31, 2009 was reduced from 0.87 at December 31, 2008, principally due to its profitable operations during 2009, as compared to the dividends paid, and was substantially below the maximum allowable ratio of 1.50. 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 (earnings before interest, taxes, depreciation and amortization), for the trailing four quarters, ratio of not greater than 2.00 to be calculated on a quarterly basis, commencing December 31, 2009. The total funded debt to EBITDA ratio was 0.19 at December 31, 2009, which was substantially below the maximum allowable ratio.

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

**Table of Contents****THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**

environmental and safety compliance, building upgrades, energy efficiencies, and various strategic objectives. In the three years ended December 31, 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 December 31, 2009, although Brookwood Laminating plans to exercise its lease option for the purchase of its production facility in Connecticut for \$3,200,000, which is anticipated to be completed in the 2010 second quarter. Brookwood anticipates obtaining a \$2,240,000 loan facility in connection with the acquisition. It is anticipated that Brookwood's future capital expenditure projects will be funded from operations and, if necessary, availability under its Working Capital Revolving Credit Facility. Brookwood estimates its 2010 capital expenditures will be within a range of \$3,500,000 to \$4,500,000, excluding the purchase of the Brookwood Laminating production facility.

*Energy.* During 2008 and 2007, the Company invested \$13,920,000 and \$11,093,000, respectively, in Hallwood Energy, as part of a total investment in Hallwood Energy 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 availability under the Brookwood Working Capital Revolving Credit Facility, the Company believes it has sufficient funds to meet its liquidity needs for the next twelve months.

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.

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

On April 20, 2009, Hallwood Financial, a corporation controlled by Mr. Gumbiner and members of his family, which owns approximately 66% 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.

**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 December 31, 2009 (in thousands):

	Payments Due During the Years Ending December 31,						Total
	2010	2011	2012	2013	2014	Thereafter	
<b>Contractual Obligations</b>							
Long term debt	\$	\$ 6,450	\$	\$	\$	\$	\$ 6,450
Redeemable preferred stock	1,000						1,000
Operating leases	918	602	519	364	364	576	3,343



Edgar Filing: Hallwood Group Inc - Form 10-K/A

Total	\$ 1,918	\$ 7,052	\$ 519	\$ 364	\$ 364	\$ 576	\$ 10,793
-------	----------	----------	--------	--------	--------	--------	-----------

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 facility at its then loan balance as of December 31, 2009, are \$214,000, for each of the years ending December 31, 2010 through December 31, 2014, respectively.

In October 2009, Brookwood Laminating notified the landlord that it was exercising its option for the purchase of its

**Table of Contents****THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**

Connecticut production facility. Brookwood anticipates completing the purchase of the facility in the 2010 second quarter for \$3,200,000, and anticipates partial financing with a \$2,240,000 mortgage loan.

*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 (\$13,956,000 at December 31, 2009). The base amount will fluctuate in accordance with a formula that increases by the amount of the annual dividend on the preferred stock of \$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.

**Financial Covenants**

*Brookwood.* The principal ratios required to be maintained under Brookwood's Working Capital Revolving Credit Facility as of December 31, 2009 and the end of the interim quarters are provided below:

Description	Requirement	Quarters Ended in 2009			
		December 31,	September 30,	June 30,	March 31,
Total debt to tangible net worth	must be less than ratio of 1.50	0.66	0.82	0.71	0.86
Total funded debt to EBITDA	must be less than ratio of 2.00	0.19	n/a	n/a	n/a
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 as of December 31, 2009 and 2008 and for all interim periods during 2009, 2008 and 2007, although a waiver regarding a pro forma (inclusive of projected dividend) total debt to tangible net worth ratio for the 2007 third quarter was granted to allow a \$1,500,000 dividend payment in November 2007 and 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 and restrict calendar 2008 total 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 (earnings before interest, taxes, depreciation and amortization), for the trailing four quarters, ratio of not greater than 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 loan agreement. The restricted net assets of Brookwood subject to this payment limitation were \$48,821,000 and \$32,754,000 at December 31, 2009 and 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.

**Table of Contents**

**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**

**Special Purpose Entities**

The Company has, in certain situations, created Special Purpose Entities ( SPE ). These SPEs were formed to hold title to specific assets and accomplish various objectives. In 1998, the Company formed several SPEs to complete a consolidation of its real estate assets into a new structure to facilitate possible financing opportunities. In other situations, SPEs were formed at the request of lenders for the express purpose of strengthening the collateral for the loans by isolating (for Federal bankruptcy law purposes) the assets and liabilities of the SPE s. In all cases and since their various formation dates, these wholly owned entities (including their assets, liabilities and results of operations) have been fully consolidated into the financial statements of the Company.

**New Accounting Pronouncements**

In May 2009, the Financial Accounting Standards Board ( FASB ) issued, FASB ASC Topic 855 (formerly SFAS No. 165) *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. The Company adopted FASB ASC Topic 855 for the quarter ended June 30, 2009.

In June 2009, the FASB issued FASB ASC Topic 860 (formerly SFAS No. 166) *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, FASB ASC Topic 105 (formerly SFAS No. 168) *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.

**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-K 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 Item 1A. Risk Factors to 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  
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: April 8, 2010

By: /s/ Richard Kelley  
Richard Kelley  
Vice President Finance  
(Principal Financial and Accounting  
Officer)

Page 21

---

**Table of Contents**

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

<b>Exhibit Number</b>	<b>Description</b>
31.1	Certification of the Chief Executive Officer, pursuant to Section 302 of Sarbanes-Oxley Act of 2002.
31.2	Certification of the Chief Financial Officer, pursuant to Section 302 of Sarbanes-Oxley Act of 2002.
32.1	Certification of the Chief Executive Officer and Chief Financial Officer, pursuant to Section 906 of Sarbanes-Oxley Act of 2002.

Page 22