

Hallwood Group Inc  
Form 10-Q  
November 13, 2012  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
WASHINGTON, D.C. 20549

**FORM 10-Q**

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

For the quarterly period ended September 30, 2012

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)

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**Delaware**  
(State or other jurisdiction of  
incorporation or organization)  
**3710 Rawlins, Suite 1500,**  
**Dallas, Texas**  
(Address of principal executive offices)

**51-0261339**  
(I.R.S. Employer  
Identification No.)  
**75219**  
(Zip Code)  
**214-528-5588**

(Registrant's telephone number, including area code)

**Not Applicable**

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

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

Large accelerated filer  Accelerated filer   
Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company   
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

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

Class	Outstanding at October 31, 2012
Common Stock, \$0.10 par value per share	1,525,166 shares

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**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**

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**Table of Contents****THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES****CONDENSED CONSOLIDATED BALANCE SHEETS**

(dollars in thousands)

(unaudited)

	September 30, 2012	December 31, 2011
<b>ASSETS</b>		
<b>Current Assets</b>		
Cash and cash equivalents	\$ 1,553	\$ 10,869
Accounts receivable, net		
Factors	16,532	17,487
Trade and other	3,196	8,174
Related parties	37	42
Inventories	29,286	24,980
Deferred income tax	5,461	4,788
Prepays, deposits and other assets	631	934
Income taxes receivable	372	1,027
	57,068	68,301
<b>Noncurrent Assets</b>		
Property, plant and equipment	19,973	20,442
Deferred income tax	4,269	
Other assets	247	162
	24,489	20,604
<b>Total Assets</b>	<b>\$ 81,557</b>	<b>\$ 88,905</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
<b>Current Liabilities</b>		
Accounts payable	\$ 14,256	\$ 8,941
Current portion of loans payable (includes \$9,000 to related party)	9,184	
Accrued expenses and other current liabilities	4,792	5,096
Payable Hallwood Energy matters		
Litigation reserve	2,079	9,300
Contingent additional investment in Hallwood Energy		3,201
Income taxes payable		10
	30,311	26,548
<b>Noncurrent Liabilities</b>		
Long term portion of loans payable	3,850	2,000
Deferred income tax	94	1,217
	3,944	3,217
<b>Total Liabilities</b>	<b>34,255</b>	<b>29,765</b>
<b>Contingencies and Commitments (Note 13)</b>		

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<b>Stockholders Equity</b>		
Common stock, issued 2,396,105 shares for both periods; outstanding 1,525,166 shares for both periods	240	240
Additional paid-in capital	51,700	51,700
Retained earnings	8,766	20,604
Treasury stock, 870,939 shares for both periods; at cost	(13,404)	(13,404)
<b>Total Stockholders Equity</b>	47,302	59,140
<b>Total Liabilities and Stockholders Equity</b>	\$ 81,557	\$ 88,905

See accompanying notes to condensed consolidated financial statements.

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

	<b>Nine Months Ended September 30,</b>	
	<b>2012</b>	<b>2011</b>
<b>Revenues</b>		
Textile products sales	\$ 100,207	\$ 101,117
<b>Expenses</b>		
Textile products cost of sales	85,970	82,426
Administrative and selling expenses	18,688	17,358
Litigation reserve - Hallwood Energy matters	13,200	7,500
	117,858	107,284
Operating income (loss)	(17,651)	(6,167)
<b>Other Income (Loss)</b>		
Interest expense	(315)	(74)
Interest and other income	2	35
	(313)	(39)
Income (loss) before income taxes	(17,964)	(6,206)
Income tax expense (benefit)	(6,126)	(2,033)
<b>Net Income (Loss)</b>	<b>\$ (11,838)</b>	<b>\$ (4,173)</b>
<b>Net Income (Loss) Per Common Share</b>		
Basic	\$ (7.76)	\$ (2.74)
Diluted	\$ (7.76)	\$ (2.74)
<b>Weighted Average Shares Outstanding</b>		
Basic	1,525	1,525
Diluted	1,525	1,525

See accompanying notes to condensed consolidated financial statements.

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

	<b>Three Months Ended September 30,</b>	
	<b>2012</b>	<b>2011</b>
<b>Revenues</b>		
Textile products sales	\$ 27,146	\$ 37,649
<b>Expenses</b>		
Textile products cost of sales	23,557	30,116
Administrative and selling expenses	5,015	6,881
	28,572	36,997
Operating income (loss)	(1,426)	652
<b>Other Income (Loss)</b>		
Interest expense	(178)	(25)
Interest and other income		5
	(178)	(20)
Income (loss) before income taxes	(1,604)	632
Income tax expense (benefit)	(541)	282
<b>Net Income (Loss)</b>	<b>\$ (1,063)</b>	<b>\$ 350</b>
<b>Net Income (Loss) Per Common Share</b>		
Basic	\$ (0.70)	\$ 0.23
Diluted	\$ (0.70)	\$ 0.23
<b>Weighted Average Shares Outstanding</b>		
Basic	1,525	1,525
Diluted	1,525	1,525

See accompanying notes to condensed consolidated financial statements.

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**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**

**CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)**

**(in thousands)**

**(unaudited)**

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2012</b>	<b>2011</b>	<b>2012</b>	<b>2011</b>
<b>Net Income (Loss)</b>	\$ (1,063)	\$ 350	\$ (11,838)	\$ (4,173)
Other Comprehensive Income (Loss) None				
<b>Comprehensive Loss</b>	\$ (1,063)	\$ 350	\$ (11,838)	\$ (4,173)

See accompanying notes to condensed consolidated financial statements.



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## THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS EQUITY

(in thousands)

(unaudited)

	Common Stock		Additional	Retained	Treasury Stock		Total
	Shares	Par Value	Paid-In Capital		Earnings	Shares	Cost
<b>Balance, January 1, 2012</b>	2,396	\$ 240	\$ 51,700	\$ 20,604	871	\$ (13,404)	\$ 59,140
Net loss				(11,838)			(11,838)
<b>Balance, September 30, 2012</b>	2,396	\$ 240	\$ 51,700	\$ 8,766	871	\$ (13,404)	\$ 47,302

See accompanying notes to condensed consolidated financial statements.

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

	<b>Nine Months Ended September 30,</b>	
	<b>2012</b>	<b>2011</b>
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net loss	\$ (11,838)	\$ (4,173)
Adjustments to reconcile net loss to net cash used in operating activities:		
Litigation charge Hallwood Energy matters	13,200	7,500
Deferred tax expense (benefit)	(6,065)	(2,638)
Depreciation, amortization and impairment	1,724	1,886
Provision (recovery) for obsolete inventory	445	96
Provision (recovery) for doubtful accounts and factor dilution	108	(30)
Changes in assets and liabilities:		
Payment of litigation reserve Hallwood Energy matters	(23,622)	
(Increase) decrease in accounts receivable	5,830	(4,606)
Increase (decrease) in accounts payable	5,387	4,128
(Increase) decrease in inventories	(4,751)	(9,908)
Net change in income taxes receivable/payable	645	420
Increase (decrease) in accrued expenses and other current liabilities	(304)	6
Net change in other assets and liabilities	218	(545)
Net cash used in operating activities	(19,023)	(7,864)
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Investments in short-term investments		(10)
Proceeds from redemption of short-term investments		7,500
Investments in property, plant and equipment, net	(1,327)	(1,389)
Net cash provided by (used in) investing activities	(1,327)	6,101
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Proceeds from revolving credit facilities	11,718	2,000
Proceeds from loans payable	10,237	
Repayments of revolving credit facilities	(9,868)	(2,000)
Repayments of loans payable	(1,053)	
Net cash provided by financing activities	11,034	
<b>DECREASE IN CASH AND CASH EQUIVALENTS</b>	<b>(9,316)</b>	<b>(1,763)</b>
<b>CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD</b>	<b>10,869</b>	<b>11,159</b>
<b>CASH AND CASH EQUIVALENTS, END OF PERIOD</b>	<b>\$ 1,553</b>	<b>\$ 9,396</b>

See accompanying notes to condensed consolidated financial statements.



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**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**Nine Months Ended September 30, 2012 and 2011**

**(unaudited)**

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

*Organization.* The Hallwood Group Incorporated (the Company) (NYSE MKT: HWG) was incorporated in Delaware in 1981. The Company operates as a holding company. The Company operates its principal business in the textile products industry through its wholly owned subsidiary, Brookwood Companies Incorporated ( Brookwood ). The consolidated financial statements include the accounts of the Company and its subsidiaries (collectively, the Hallwood Group ).

*Interim Condensed Consolidated Financial Statements.* The interim condensed consolidated financial statements of Hallwood Group have been prepared in accordance with the instructions to Form 10-Q and do not include all of the information and disclosures required by accounting principles generally accepted in the United States of America. Although condensed, in the opinion of management, all adjustments considered necessary for a fair presentation have been included. These condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and related disclosures thereto included in Hallwood Group's annual report on Form 10-K for the year ended December 31, 2011.

*Textile Products.* Textile products operations are conducted through Brookwood. Brookwood is an integrated textile firm that develops and produces innovative fabrics and related products through specialized finishing, treating and coating processes. Brookwood has two principal subsidiaries at September 30, 2012:

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

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

Textile products accounts for all of Hallwood Group's operating revenues. See Note 4 for additional information on Brookwood.

*Energy.* Prior to October 2009, the Company held an investment in Hallwood Energy, L.P. ( Hallwood Energy ). Hallwood Energy was a privately held independent oil and gas limited partnership and operated as an upstream energy company engaged in the acquisition, development, exploration, production, and sale of hydrocarbons, with a primary focus on natural gas assets. The Company accounted for the investment in Hallwood Energy using the equity method of accounting. As further discussed in Note 5, Hallwood Energy filed for bankruptcy in March 2009. In connection with the confirmation of Hallwood Energy's bankruptcy 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.

*Investments in Financial Instruments.* In the 2011 first quarter, the Company opened an investment account with UBS AG, a global financial services firm, and intended to transfer a significant portion of the cash it holds from time to time to the UBS account to be placed in various financial instruments and to borrow additional amounts from UBS to invest on a leveraged basis. As of November 13, 2012, no funds have been transferred into the UBS account and currently the Company does not intend to transfer funds into the UBS account.



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*Consolidation Policy.* The Company's Brookwood subsidiary operates on a 5-4-4 accounting cycle with its months always ending on a Saturday for accounting purposes, while the Company operates on a traditional fiscal month accounting cycle. For purposes of the year-end financial statements the Brookwood cycle always ends on December 31, however, quarterly interim financial statements may not correspond to the fiscal quarter-end. Hallwood Group's condensed consolidated financial statements as of September 30, 2012 and 2011 include Brookwood's operations through September 29, 2012 and October 1, 2011, respectively. Estimated operating results of Brookwood for the intervening periods to September 30, 2012 and 2011, respectively, are provided below (in thousands):

	<b>Amounts in Intervening Periods Nine Months Ended September 30,</b>	
	<b>2012 (one day)</b>	<b>2011 (one day)</b>
Textile products sales	\$	\$ 6
Textile products costs of sales		4
Administrative and selling expenses	60	80

*New Accounting Pronouncements.* Accounting standard-setting organizations frequently issue new or revised accounting rules. Hallwood Group regularly reviews new pronouncements to determine their impact, if any, on Hallwood Group's consolidated financial statements.

In May 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2011-04, which requires a more uniform framework for fair value measurements and related disclosures between GAAP and International Financial Reporting Standards (IFRS). This guidance also requires additional disclosure (a) for Level 3 fair value measurements including quantitative information about unobservable inputs used, a description of the valuation processes used, by the entity, and a qualitative discussion about the sensitivity of the measurements to changes in the unobservable inputs; (b) for an entity's use of a nonfinancial asset that is different from the asset's highest and best use and the reason for the difference; (c) for financial instruments not measured at fair value but for which disclosure of fair value is required, the fair value hierarchy level in which the fair value measurements were determined; and (d) the disclosure of all transfers between Level 1 and Level 2 of the fair value hierarchy. This guidance is effective for interim and annual periods beginning on or after December 15, 2011. Hallwood Group adopted this guidance prospectively as of January 1, 2012, the beginning of the 2012 fiscal year. The adoption of this guidance did not require any additional disclosure in the consolidated financial statements.

In September 2011, the FASB issued Accounting Standards Update No. 2011-09 (ASU 2011-09), *Compensation - Retirement Benefits Multiemployer Plans (Subtopic 715-80), Disclosures about an Employer's Participation in a Multiemployer Plan*. This standard requires an employer that participates in multiemployer pension plans to provide additional quantitative and qualitative disclosures in order to provide users with more detailed information about the employer's involvement in multiemployer pension plans. In addition, this standard also includes changes in the disclosures required for multiemployer plans that provide postretirement benefits other than pensions. ASU 2011-09 is effective for Hallwood Group for the fiscal year ending after December 15, 2011. Hallwood Group adopted ASU 2011-09 in its annual financial statements for the year ended December 31, 2011. The adoption of ASU 2011-09 did not affect Hallwood Group's financial position, results of operations or cash flows, although additional disclosures related to postretirement benefits have been included in the accompanying footnotes.

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**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**Nine Months Ended September 30, 2012 and 2011**

(unaudited)

**Note 2 Cash and Cash Equivalents**

Hallwood Group's cash and cash equivalents are presented below (in thousands). Hallwood Group had no marketable securities as of September 30, 2012 or December 31, 2011.

	Cost	September 30, 2012 Gross Unrealized Losses	September 30, 2012 Gross Unrealized Gains	Fair Value
Cash and Cash Equivalents				
Cash	\$ 1,504	\$ 0	\$ 0	\$ 1,504
Money market funds	49	0	0	49
Total cash and cash equivalents	\$ 1,553	\$ 0	\$ 0	\$ 1,553

	Cost	December 31, 2011 Gross Unrealized Losses	December 31, 2011 Gross Unrealized Gains	Fair Value
Cash and Cash Equivalents				
Cash	\$ 5,621	\$	\$	\$ 5,621
Money market funds	5,248			5,248
Total cash and cash equivalents	\$ 10,869	\$	\$	\$ 10,869

**Note 3 Inventories**

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

	September 30, 2012	December 31, 2011
Raw materials	\$ 8,467	\$ 7,727
Work in progress	5,639	5,796
Finished goods	15,180	11,457
Total	\$ 29,286	\$ 24,980

**Note 4 Operations of Brookwood Companies Incorporated**

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*Receivables.* Brookwood maintains factoring agreements with several factors, which provide that receivables resulting from credit sales to customers may be sold to the factor, subject to a commission and the factor's prior approval. Factored receivables were \$16,532,000 and \$17,487,000 at September 30, 2012 and December 31, 2011, which were net of a returned goods dilution allowance of \$109,000 and \$63,000, respectively.

Brookwood monitors its factors and their ability to fulfill their obligations to Brookwood in a timely manner. As of November 13, 2012, all of Brookwood's factors were complying with payment terms in accordance with factor agreements.



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**(unaudited)**

Trade receivables were \$2,973,000 and \$8,031,000 at September 30, 2012 and December 31, 2011, which were net of an allowance for doubtful accounts of \$180,000 and \$118,000, respectively. The trade receivable balance at December 31, 2011 included approximately \$1,643,000, which was the balance remaining related to fabric sold in two products to a Brookwood customer in the period from September 2008 to April 2009 that supplies the U.S. military for which payment had been delayed due to a compliance issue (see also Note 13). Brookwood received payment at full value of \$1,643,000 in January 2012.

*Sales Concentration.* Brookwood has one customer who accounted for more than 10% of Brookwood's sales. Sales to that Brookwood customer, Tennier Industries, Inc. (Tennier), accounted for more than 10% of Brookwood's sales during 2012 and 2011. Brookwood's relationship with Tennier is ongoing. Sales to Tennier, which are included in military sales, were \$6,164,000 and \$16,864,000 in the 2012 third quarter and nine month periods, respectively, compared to \$5,061,000 and \$11,456,000 in the 2011 comparable periods. Sales to Tennier represented 22.7% and 13.4% of Brookwood's net sales in the 2012 and 2011 third quarters, respectively, and 16.8% and 11.3% in the 2012 and 2011 nine month periods, respectively.

Military sales accounted for \$12,924,000 and \$54,155,000 in the 2012 third quarter and nine month periods, compared to \$21,802,000 and \$52,212,000 in 2011, respectively. The military sales represented 47.6% and 57.9% of Brookwood's net sales in the 2012 and 2011 third quarters, respectively, and 54.0% and 51.6% in the 2012 and 2011 nine month periods, respectively. Generally, military sales represent sales of a product to a customer (prime and sub-prime contractors) that will be incorporated into an end product that will be used to fulfill a U.S. or international military contract.

*Stockholders' Equity.* The Company is the holder of all of Brookwood's outstanding \$13,500,000 Series A, \$13.50 annual dividend per share, redeemable preferred stock and all of its 10,000,000 outstanding shares of common stock. The preferred stock has a liquidation preference of \$13,500,000 plus accrued but unpaid dividends. At September 30, 2012, cumulative dividends in arrears on the preferred stock amounted to approximately \$456,000.

*2005 Long-Term Incentive Plan for Brookwood.* In December 2005, the Company adopted The Hallwood Group Incorporated 2005 Long-Term Incentive Plan for Brookwood Companies Incorporated (the 2005 Long-Term Incentive Plan for Brookwood) to encourage employees of Brookwood to increase the value of Brookwood and to be employed by Brookwood. The terms of the incentive plan provide for a total award amount to participants equal to 15% of the fair market value of consideration received by the Company in a change of control transaction, as defined, in excess of the sum of the liquidation preference plus accrued unpaid dividends on the Brookwood preferred stock (approximately \$13,956,000 at September 30, 2012). The base amount will fluctuate in accordance with a formula that increases by the amount of the annual dividend on the preferred stock, currently \$1,823,000, and decreases by the amount of the actual preferred dividends paid by Brookwood to the Company. The plan generally defines a change of control transaction as a transaction approved by the Company's board of directors or by the holders of at least 50% of the voting capital stock of the Company that results in: (i) a change in beneficial ownership of the Company or Brookwood of 50% or more of the combined voting power, (ii) the sale of all or substantially all of the assets of Brookwood, or (iii) any other transaction that, in the Company's board of directors discretion, has substantially the same effect of item (i) or (ii). Certain transfers, generally among existing stockholders and their related parties, are exempted from the definition.

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. No amounts have been accrued under this plan.

**Note 5 Investments in Hallwood Energy, L.P.**

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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. The Company had invested \$75,401,000 in Hallwood Energy comprised of a general partnership interest, Class A and Class C limited partnership interests and convertible notes.

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**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**Nine Months Ended September 30, 2012 and 2011**

**(unaudited)**

Prior to the confirmation of Hallwood Energy's plan of reorganization in Bankruptcy Court in October 2009 (discussed below), the Company accounted for the investment in Hallwood Energy using the equity method of accounting. In connection with Hallwood Energy's bankruptcy reorganization, the Company's general and limited partnership interests in Hallwood Energy were extinguished and the Company no longer accounts for the investment in Hallwood Energy using the equity method of accounting.

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

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 limited partnership interests, including those held by the Company. In addition, Hallwood Energy's convertible notes, including those held by the Company, were subordinated to recovery in favor of Hall Phoenix/Inwood, Ltd. (HPI), the secured lender to and an investor in Hallwood Energy.

*Litigation.* In connection with Hallwood Energy's bankruptcy proceeding, Hallwood Energy and other parties filed lawsuits and had 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 Note 13.

In one of these matters, the Adversary Proceeding, on July 25, 2011, the Bankruptcy Court issued the Proposed Findings of Fact, Conclusions of Law and Judgment Awarding Various Monetary Damages (the Proposed Findings) proposing that damages be awarded against the Company totaling approximately \$18,700,000 plus prejudgment and postjudgment interest and plaintiff's attorney's fees as may be requested and awarded pursuant to a subsequent motion. As a result of the Proposed Findings and taking into consideration the Company's objections to the Proposed Findings, during 2011 the Company recorded a charge of \$7,500,000 in its statement of operations and its balance sheet as an accrual under Hallwood Energy matters' Litigation Reserve in the Adversary Proceeding, in addition to \$3,201,000 that was previously recorded in connection with the Equity Support Agreement discussed below for a total reserve of \$10,701,000 at December 31, 2011 for the Adversary Proceeding.

On April 24, 2012, the United States District Court entered a final judgment (the Judgment) substantially adopting the Proposed Findings. Based upon the monetary damages (including prejudgment and postjudgment interest, legal fees and court costs) awarded in the Judgment, the Company, in consultation with the Company's litigation counsel, recorded an additional charge of \$13,200,000 at March 31, 2012 in its statement of operations and balance sheet as an accrual under Hallwood Energy matters' Litigation Reserve. Accordingly, the total reserve at March 31, 2012 for the Adversary Proceeding was \$23,901,000. The Company satisfied the Judgment, including prejudgment and postjudgment interest, in two payments; \$3,774,000 on May 4, 2012 and \$17,947,000 on May 9, 2012. In addition, the Company will be required to pay certain court costs and attorneys' fees incurred by the plaintiffs. At September 30, 2012, the litigation reserve for the Hallwood Energy matters is \$2,079,000. The parties settled the amount of court costs for approximately \$101,000, which was paid in August 2012. While the Company will be required to pay some additional amount of money to the plaintiffs as compensation for their attorney fees related to the breach of contract claim they prosecuted against the Company, the amount and timing of that payment are currently unresolved and will be determined by the court. The plaintiffs have alleged that they are entitled to approximately \$4,000,000 for attorney fees while the Company contends that they should only recover a small fraction of that amount. In addition, the Company is in the process of appealing to the Fifth Circuit Court of Appeals the portions of the Judgment awarding a combined \$17,947,000 on the plaintiffs' tort claims. On September 13, 2012, the Company filed its appellate brief in the Fifth Circuit. On November 15, 2012, FEI Shale, L.P. (FEI), the only appellee, will file its response, and the Company will then file a reply brief, completing the briefing process. It is difficult to determine or even approximate when the Fifth Circuit will rule on the Company's appeal, but it will likely be several months, if not longer.

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In the Hallwood Energy litigation matters, other than the Adversary Proceeding, effective February 14, 2012, the Company and certain other parties entered into a Confidential Settlement Agreement and Mutual Release of Claims (the Settlement Agreement ). The Settlement Agreement effectively settled the claims by HPI, the Trustee of the Hallwood Energy I Creditors Trust, and their related parties (the Plaintiffs ) against the Company and its related parties, other than the claims in the Adversary Proceeding, in which the District Court rendered the Judgment.

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The terms of the Settlement Agreement included the payment by the Company of \$1,800,000, in addition to payments by other defendants and the Company's insurance carrier for its directors and officers' liability insurance policy. Under the Settlement Agreement, the Plaintiffs released the Company, its current and former directors and officers, the former directors and officers of the general partner of Hallwood Energy and various entities related to the foregoing persons from all claims asserted in or related to (i) *Hall Phoenix/Inwood Ltd. and Hall Performance Energy Partners 4, Ltd. v. The Hallwood Group Incorporated et al.* in the United States Bankruptcy Court for the Northern District of Texas, Dallas Division, Adversary No. 10-03358; (ii) *Ray Balestri, Trustee of the Hallwood Energy I Creditor's Trust v. Anthony J. Gumbiner, et al.* in the United States Bankruptcy Court for the Northern District of Texas, Dallas Division, Adversary No. 10-03263; and (iii) another suit in which the Company is not named as a party, and any other claims based on the facts alleged in the foregoing matters or that could have been alleged in the foregoing matters, other than the claims against the Company asserted in the Adversary Proceeding or any claims required to enforce any final judgment entered against the Company in the Adversary Proceeding. Similarly, the defendants released the Plaintiffs from all claims based on the facts alleged in the foregoing matters or that could have been alleged in the foregoing matters, other than any claims or defenses the defendants had in the Adversary Proceeding.

The parties entered into the Settlement Agreement for a number of reasons, including to save time and expense, to ensure available insurance proceeds could be used toward the settlement of the disputed claims rather than the payment of expenses and legal fees, and otherwise to resolve the litigation claims. The defendants continue to believe that the claims asserted against them in the lawsuits had no merit and their agreement to settle and compromise those claims should not be deemed as an admission of any liability, wrongdoing, or fault.

At December 31, 2011, the Company recorded a charge of \$1,800,000 in its statement of operations and balance sheet under Hallwood Energy matters' Litigation Reserve for the full value of the Company's payment required by the Settlement Agreement. The Company paid the settlement amount of \$1,800,000 to the Plaintiffs on February 15, 2012.

*Equity Support Agreement.* In connection with the then ongoing efforts to complete an Acquisition and Farmout Agreement entered into between Hallwood Energy and FEL, the Company loaned Hallwood Energy \$2,961,000 in May 2008. Concurrent with the completion of the Acquisition and Farmout Agreement 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, under the terms of a \$12,500,000 convertible subordinated note agreement (the "Second Convertible Note") issued by Hallwood Energy in May 2008 and underwritten by the Company. In September 2008, the Company loaned \$4,300,000 to Hallwood Energy pursuant to the Equity Support Agreement. 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 the amount of \$3,201,000.

The Equity Support Agreement terminated not later than October 2009 in connection with the confirmation of Hallwood Energy's plan of reorganization. The Equity Support Agreement is no longer in effect, although (as previously discussed) the obligation to pay the remaining unpaid contingent commitment under the Equity Support Agreement, which was subject to litigation in the Adversary Proceeding, was \$3,201,000 and was paid on May 4, 2012. No further amounts are due.

*Other.* For further information on Hallwood Energy's activities, including its bankruptcy reorganization, refer to Hallwood Group's annual report on Form 10-K for the year ended December 31, 2011.

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**Note 6 Loans Payable**

Loans payable at the balance sheet dates were as follows (in thousands):

	September 30, 2012	December 31, 2011
HFL Loan; due June 2013	\$ 9,000	\$
New Revolving Credit Facility; due March 2014	3,850	
Other, due April 2013	184	
Working Capital Revolving Credit Facility; repaid April 2012		2,000
	13,034	2,000
Current portion	(9,184)	
Noncurrent portion	\$ 3,850	\$ 2,000

*Working Capital Revolving Credit Facility.* The Company's Brookwood subsidiary had a revolving credit facility in an amount up to \$25,000,000 with KeyBanc (the Working Capital Revolving Credit Facility). Borrowings were collateralized by accounts receivable, certain finished goods inventory, machinery and equipment and all of the issued and outstanding capital stock of Brookwood and its subsidiaries. The facility contained various financial covenants regarding Brookwood's income and debt levels. The interest rate was a blended rate of 1.78% at December 31, 2011. The loan balance of \$2,000,000 was repaid on April 2, 2012 with proceeds from the New Revolving Credit Facility (discussed below).

*New Revolving Credit Facility entered into in March 2012.* On March 30, 2012, Brookwood and its subsidiaries entered into a loan agreement by and among Brookwood, its subsidiaries and Branch Banking and Trust Company (BB&T) (the New Revolving Credit Facility). The New Revolving Credit Facility replaced the Working Capital Revolving Credit Facility.

The New Revolving Credit Facility provides for borrowings of up to \$25,000,000 and is secured by a first lien on substantially all of the assets of Brookwood. The New Revolving Credit Facility has a maturity date of March 30, 2014. On April 2, 2012, Brookwood borrowed \$2,018,000 under this new facility to repay outstanding amounts due under the Working Capital Revolving Credit Facility, including accrued interest. In May 2012, the Company requested a dividend of \$8,000,000 from Brookwood, which obtained consent from BB&T for such payment. Accordingly, Brookwood borrowed \$8,000,000 under the New Revolving Credit Facility and paid that amount as a dividend to the Company in May 2012. The Company combined such funds with other available cash and the HFL Loan, discussed below, to satisfy the Judgment in the Adversary Proceeding issued by the United States District Court. During the nine months ended September 30, 2012, Brookwood repaid a portion of its borrowings under the New Revolving Credit Facility and the outstanding balance was \$3,850,000 at September 30, 2012. As of September 30, 2012, subject to the existing loan covenants, Brookwood had approximately \$2,512,000 of additional borrowing availability under this facility, which was net of a standby letter of credit for \$91,000.

On August 24, 2012, the New Revolving Credit Facility was amended to (i) modify the funded debt to EBITDA loan covenant to 4.00 to 1.00 from its previous requirement of 2.75 to 1.00, providing greater borrowing capacity for Brookwood, (ii) modify the covenant regarding declaration or payment of discretionary and other dividends by Brookwood to the Company, and (iii) modify the pricing grid for the applicable margin with respect to the LIBOR interest rate and unused line fees. Brookwood paid a fee of \$31,250, or 12.5 basis points, to BB&T in consideration for the amendment.

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The interest rate payable on the New Revolving Credit Facility, as amended, is dependent on a leverage ratio, as defined, and can vary from LIBOR plus 1.00% to 3.50%. At anytime BB&T is not one of Brookwood's primary factoring service providers, then Brookwood will pay a onetime fee in the amount of \$62,500 and the interest rates will be increased by 0.50%. The interest rate on the facility was 1.23% at September 30, 2012.

The terms of the New Revolving Credit Facility, as amended, provide that the facility may be used for refinancing existing indebtedness, providing for working capital and financing on-going operations and capital expenditures.

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The New Revolving Credit Facility, as amended, contains customary representations, warranties and affirmative covenants on behalf of Brookwood and also contains negative covenants that, among other things, prohibit Brookwood from, without obtaining prior BB&T written consent and with certain exceptions: (i) permitting liens (other than customary liens) to exist on any of its properties; (ii) incurring other debt other than accounts payable to trade creditors incurred in the ordinary course of business and factors; (iii) making capital expenditures in excess of \$5,000,000 in any year; (iv) purchasing substantially all the assets of another entity; (v) entering into new leases except operating leases for machinery and equipment that do not in the aggregate require payments in excess of \$250,000 in any year and real estate leases in the ordinary course of business; (vi) paying dividends, or acquiring any of its stock, other than described below in *Payments of Dividends*; (vii) making loans or advances to, or guaranties for the benefit of, any person; and (viii) disposing of its assets or properties except in the ordinary course of its business.

The New Revolving Credit Facility, as amended, requires Brookwood to satisfy certain financial covenants on the last day of each fiscal quarter, including maintaining:

- (i) a ratio of total current assets to the sum of total current liabilities and the outstanding loan balance of not less than 1.40 to 1.00.
- (ii) a ratio of total liabilities to tangible net worth of not greater than 1.50 to 1.00. Tangible net worth is defined as net worth, plus obligations contractually subordinated to debts owed to BB&T, minus goodwill, contract rights, and assets representing claims on stockholders or affiliated entities.
- (iii) a ratio of funded debt (as defined) to EBITDA (earnings before interest, taxes, depreciation and amortization) for the trailing four quarters of not greater than 4.00 to 1.00.

Brookwood was in compliance with such financial covenants at September 30, 2012. In order to maintain compliance with such covenants in the future, Brookwood may be required to limit aggregate borrowings under the New Revolving Credit Facility to less than \$25,000,000 at the end of each fiscal quarter.

*Payments of Dividends.* During the term of the Working Capital Revolving Credit Facility, Brookwood submitted a quarterly loan compliance certificate to KeyBanc and concurrently requested the bank's consent to pay cash dividends and tax sharing payments to the Company. Brookwood paid to the Company dividends of \$1,000,000 in February 2012 and \$4,000,000 during the year ended December 31, 2011.

In May 2012, following the Company's request for additional dividends, Brookwood requested BB&T to approve two dividends for a total amount of \$9,000,000 (including the previously mentioned \$8,000,000 dividend that the Company used in part to satisfy the Judgment in the Adversary Proceeding). BB&T consented to the dividends, which were paid to the Company in May 2012. In August 2012, Brookwood requested BB&T to approve a dividend for \$1,000,000. BB&T consented to the dividend, which was paid to the Company in August 2012.

The August 24, 2012 amendment provides that cash dividends or advances to the Company may be made provided no event of default has occurred or would result from any such payment. Brookwood may pay to the Company (a) periodic payments for tax sharing obligations, (b) discretionary dividends in an aggregate amount not to exceed 50% of Borrowers' net income for the fiscal year with respect to which such dividends are made, and (c) other dividends or distributions in an aggregate amount not to exceed \$15,000,000 (of which, as of November 13, 2012, \$8,000,000 was previously disbursed in May 2012). Any future payments or advances would also be contingent upon the approval of Brookwood's board of directors and Brookwood's ability to meet the requirements of the Delaware corporate laws for the payment of dividends and compliance with other applicable laws and requirements.



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*HFL Loan.* Also in May 2012, to fund in part the payment of the Judgment, the Company borrowed from Hallwood Family (BVI) L.P., a limited partnership associated with Mr. Anthony J. Gumbiner, the Company's chairman and principal stockholder, the sum of \$10,000,000 (the HFL Loan). The HFL Loan is secured by a pledge of all of the stock of Brookwood and by the Company's interest in the anticipated refunds of federal income taxes, which are in excess of \$5,000,000 that the Company expects

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to receive in 2012 and 2013. In connection with the HFL Loan, a Pledge and Security Agreement and a Subordination and Intercreditor Agreement ( Intercreditor Agreement ) were entered into and effective May 9, 2012. The Intercreditor Agreement, among other things, subordinates any security interest or lien that Hallwood Family (BVI) L.P. may have in certain assets of the Company, including the stock of Brookwood, to BB&T. The HFL Loan is due in full on June 28, 2013 and bears interest at the rate of 6% per year, payable on a quarterly basis. The Company may prepay the HFL Loan at any time without penalty. The documents reflecting the HFL Loan contain representations, warranties and covenants that are typical for loans of this type. The outstanding balance on the HFL Loan was \$9,000,000 at September 30, 2012 after a principal repayment of \$1,000,000 in May 2012.

*Restricted Net Assets.* Cash dividends and tax sharing payments by Brookwood to the Company are contingent upon compliance with the New Revolving Credit Facility loan covenants and/or consent from BB&T in certain circumstances. This limitation on the transferability of assets constitutes a restriction of Brookwood's net assets, which were \$48,371,000 and \$59,970,000 at September 30, 2012 and December 31, 2011, respectively.

*Other.* On July 31, 2012, the Company entered into a promissory note to finance approximately \$237,000 of premiums (net of a down payment of about \$27,000) related to certain insurance policies with premiums equal to a total of approximately \$264,000. The promissory note has an interest rate of 2.99%, requires nine equal monthly payments of approximately \$27,000 beginning August 31, 2012, and will incur about \$3,000 of finance charges, or interest, over the term until its maturity on April 30, 2013. The outstanding balance as of September 30, 2012 was approximately \$184,000.

**Note 7 Stockholders Equity**

*Stock Options.* At September 30, 2012, there were no outstanding stock options. The Company's former stock option plan expired in 2005 and no stock options are available for issuance.

**Note 8 Income Taxes**

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

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2012	2011	2012	2011
Federal				
Current	\$ (40)	\$ 208	\$ (48)	\$ 398
Deferred	(500)	(13)	(6,066)	(2,638)
Sub-total	(540)	195	(6,114)	(2,240)
State				
Current	(1)	87	(12)	207
Deferred				
Sub-total	(1)	87	(12)	207
Total	\$ (541)	\$ 282	\$ (6,126)	\$ (2,033)

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The net deferred tax asset was \$9,636,000 and \$3,571,000 at September 30, 2012 and December 31, 2011, respectively. The net deferred tax asset at September 30, 2012 was comprised of temporary differences, including \$707,000 related to loss reserves on litigation matters and \$9,648,000 related to the carryforward of 2012 taxable losses to future periods, including an estimated \$4,569,000 that the Company expects to carryback to 2010 for a refund to be received in the 2013 second quarter. The net deferred tax asset at December 31, 2011 was comprised of temporary differences, including \$3,162,000 related to loss reserves on litigation matters and \$1,088,000 associated with the Company's investment in Hallwood Energy. The federal tax rate was 34%, while state taxes were determined based upon taxable income apportioned to those states in which Hallwood Group does business at their respective tax rates.

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Hallwood Group had a federal income tax receivable of \$-0- and \$821,000 at September 30, 2012 and December 31, 2011, respectively, and a net state tax receivable of \$372,000 and \$195,000, at September 30, 2012 and December 31, 2011, respectively. During the 2012 third quarter, the Company received federal tax refunds of \$869,000, including \$689,000 from the carryback of the 2011 federal net operating loss to 2009. The Company anticipates that \$4,569,000 of the deferred tax asset at September 30, 2012 will be reclassified to federal income tax receivable at December 31, 2012 due to the carryback of the 2012 federal net operating loss to 2010.

**Note 9 Fair Value of Financial Instruments**

The following table summarizes the valuation of Hallwood Group's financial instruments based upon the inputs used to measure fair value in the three levels of the fair value hierarchy as of September 30, 2012 and December 31, 2011.

Level 1 Quoted market prices in active markets for identical assets or liabilities

Level 2 Quoted prices for similar assets or liabilities in active markets or inputs that are observable

Level 3 Inputs that are unobservable

	<b>September 30, 2012</b>		
	<b>Level</b>		
	<b>Level 1</b>	<b>2</b>	<b>Level 3</b>
<b>Cash Equivalents</b>			
Money market funds	\$ 49	\$	\$

  

	<b>December 31, 2011</b>		
	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>
<b>Cash Equivalents</b>			
Money market funds	\$ 5,248	\$	\$

Money market funds are classified as Level 1 instruments as they are traded in active markets with sufficient volume and frequency of transactions.

The fair value of financial instruments that are short-term or reprice frequently and have a history of negligible credit losses are considered to approximate their carrying value. These include cash, short term receivables, accounts payable, the HFL Loan and other liabilities. In addition, because the interest rate on the revolving credit facility is variable, the fair value approximates its carrying value.

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**Note 10 Supplemental Disclosures to the Condensed Consolidated Statements of Cash Flows**

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

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

Description	Nine Months Ended September 30,	
	2012	2011
Accrued capital expenditures in accounts payable and accrued expenses:		
Amount at end of period	\$ 58	\$ 51

*Supplemental disclosures of cash payments:*

Income taxes paid (refunded)	\$ (704)	\$ 202
Interest paid	151	76

**Note 11 Computation of Income (Loss) Per Common Share**

The following table reconciles weighted average shares outstanding from basic to diluted methods and reconciles net income (loss) used in the computation of income (loss) per share for the basic and diluted methods (in thousands):

Description	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
<b>Weighted Average Shares Outstanding</b>				
Basic and diluted	1,525	1,525	1,525	1,525
<b>Net Income (Loss)</b>				
Basic and diluted	\$ (1,063)	\$ 350	\$ (11,838)	\$ (4,173)

For the three months and nine months ended September 30, 2012 and 2011, there were no outstanding stock options. No shares were excluded from the calculation of diluted earnings per share.

**Note 12 Related Party Transactions**

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*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 in Europe in connection with HIL's services to the Company pursuant to the financial consulting contract and for travel and related expenses to between Europe and the Company's locations in the United States and health insurance premiums.

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

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2012</b>	<b>2011</b>	<b>2012</b>	<b>2011</b>
Consulting fees	\$ 249	\$ 249	\$ 747	\$ 747
Office space and administrative services	68	71	221	238
Travel and other expenses	44	71	71	151
Interest expense on HFL Loan	136		216	
<b>Total</b>	<b>\$ 497</b>	<b>\$ 391</b>	<b>\$ 1,255</b>	<b>\$ 1,136</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. No such services were performed, or compensation earned, during 2012 or 2011. 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.

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. Certain individuals employed by the Company, in addition to their services provided to the Company, perform services on behalf of the HIL-related affiliates. In addition, HIL utilizes some of the office space for purposes unrelated to the Company's business. The Company pays certain common general and administrative expenses for salaries, rent and other office expenses and charges the HIL-related companies an overhead reimbursement fee for the share of the expenses allocable to these companies. For the three months ended September 30, 2012 and 2011, these companies reimbursed the Company \$27,000 and \$25,000, respectively, for such expenses. For the nine months ended September 30, 2012 and 2011, these companies reimbursed the Company \$80,000 and \$72,000, respectively.

In May 2012, to fund in part the payment of the Judgment, the Company entered into the HFL Loan with Hallwood Family (BVI) L.P., a limited partnership associated with Mr. Gumbiner. The interest expense payable on the HFL Loan was \$136,000 and \$0- at September 30, 2012 and December 31, 2011, respectively. See Note 6 for more information.

**Note 13 Litigation, Contingencies and Commitments**

Reference is made to Note 15 to the consolidated financial statements contained in Hallwood Group's annual report on

Form 10-K for the year ended December 31, 2011.

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

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In July 2007, Nextec Applications, Inc. filed *Nextec Applications, Inc. v. Brookwood Companies Incorporated and The Hallwood Group Incorporated* in the United States District Court for the Southern District of New York (SDNY No. CV 07-6901) claiming that Brookwood infringed five United States patents pertaining to internally-coated webs. In October 2007, The Hallwood Group Incorporated was dismissed from the lawsuit. Nextec later added additional patents to the lawsuit. After a number of motions, only two patents remained in the action and were being asserted against the process and machine for making defendants' Agility Storm-Tec X-Treme and Eclipse Storm-Tec X-Treme fabrics, which constitute two levels of the Military's Extended Cold Weather Clothing System. Nextec was seeking a permanent injunction as well as damages in an amount to be determined at trial. After a five week trial that ended on June 1, 2012, the Court ruled from the bench that, while Nextec's patents were valid, Brookwood had not



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infringed any of the patents in the lawsuit. On July 20, 2012, Nextec filed a motion requesting that the Court either correct/amend its finding of non-infringement or grant a new trial, which the Court subsequently denied. The Court's Order and Final Judgment was issued June 21, 2012. Nextec has since filed a notice of appeal to the United States Court of Appeals for the Federal Circuit; Brookwood subsequently filed a notice of cross-appeal. Separately, and prior to trial, Brookwood filed requests for reexamination by the United States Patent and Trademark Office of the remaining patent claims at issue in the litigation. The United States Patent and Trademark Office has granted the reexamination requests and issued first office actions rejecting all the reexamined patent claims as unpatentable over the prior art of record. With respect to one of the patents currently under examination, the Patent Office has received Nextec's responsive arguments and subsequently issued a second office action finalizing its initial rejection of all the claims. With respect to the second patent, the Patent Office has received Nextec's responsive arguments and is currently evaluating them. Nextec will have an opportunity to appeal any final decision by the Patent Office.

*Hallwood Energy.* In March 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 Brookwood.

In October 2009, the Bankruptcy Court confirmed a plan of reorganization of the debtors that, among other things, extinguished the Company's interest in Hallwood Energy's general partnership and limited partnership interests. In addition, Hallwood Energy's convertible notes, including those held by the Company, were subordinated to recovery in favor of Hall Phoenix/Inwood, Ltd ( HPI ), the secured lender to and an investor in Hallwood Energy.

The confirmed plan of reorganization in the Hallwood Energy bankruptcy proceeding also created a creditors' trust that was authorized to pursue various claims against the Company, its officers, directors and affiliates and Hallwood Energy's officers and directors, including claims assigned to the creditors' trust by HPI.

*Adversary Proceeding.* On March 30, 2009, Hallwood Energy filed an adversary proceeding against the Company seeking a judgment for \$3,200,000. The case was originally styled as *Hallwood Energy, L.P. v. The Hallwood Group Incorporated, Adversary No. 09-03082*, and was brought in the United States Bankruptcy Court for the Northern District of Texas, Dallas Division. This dispute arose in connection with an Acquisition and Farmout Agreement entered into between Hallwood Energy and FEI Shale, L.P. ( FEI ), a subsidiary of Talisman Energy, Inc., in June 2008. The Company and Hallwood Energy entered into an Equity Support Agreement dated June 9, 2008 under which the Company agreed, under certain conditions, to contribute to Hallwood Energy up to \$12,500,000, in consideration for which the Company would receive equity or debt securities of Hallwood Energy. As of February 25, 2009, the Company had contributed \$9,300,000 to Hallwood Energy pursuant to the Equity Support Agreement. On that date, Hallwood Energy demanded that the Company fund the \$3,200,000, which the Company did not do.

Following the commencement of litigation, HPI and FEI intervened in the lawsuit and filed their respective complaints in intervention. In their complaints, they alleged that the Company's failure to fund \$3,200,000 under the Equity Support Agreement damaged Hallwood Energy in an amount in excess of \$3,200,000. FEI claimed that, in addition to not paying the \$3,200,000, the Company defrauded FEI and tortiously interfered with its rights under the Acquisition and Farmout Agreement, and it sought approximately \$38,000,000 in additional damages. In their second amended complaint, HPI and the trustee for the creditors' trust contended that the additional damages were at least \$20,000,000 based on the alleged failure of the Company to fund the \$3,200,000, which allegedly caused FEI to not fund \$20,000,000 due under the Farmout Agreement between Hallwood Energy and FEI. HPI and the trustee also asserted that the Company was liable for exemplary damages of \$100,000,000 on account of its failure to fund the last \$3,200,000 under the Equity Support Agreement. In the second amended complaint, HPI and the trustee had named as additional defendants Hallwood Family (BVI) L.P., Hallwood Investments Limited, Hallwood Company Limited, the Hallwood Trust, Hallwood Financial Limited and Brookwood Companies Incorporated contending that the additional defendants are liable to the plaintiffs under allegations requesting the remedy of substantive consolidation. On May 5, 2010, the Court dismissed with prejudice the substantive consolidation claim and abuse of the bankruptcy process against all parties, resulting in the Company remaining as the sole

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Defendant. In light of the Court's disposition of the theories advanced in the second amended complaint, the adversary proceeding was styled as *Ray Balestri, Trustee of the Hallwood Energy I Creditors' Trust, as successor in interest to Hallwood Energy, L.P., Plaintiffs and FEI Shale L.P. and Hall Phoenix/Inwood Ltd., Plaintiffs in Intervention vs. The Hallwood Group Incorporated, Defendant; Adversary No. 09-03082-SGJ* (the Adversary Proceeding). The trial took place over a 13 day period from October 2010 to December 2010 and was followed with the Bankruptcy Court's proposed findings in July 2011.

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On July 25, 2011, the Bankruptcy Court issued the Proposed Findings of Fact, Conclusions of Law and Judgment Awarding Various Monetary Damages (the Proposed Findings). The court proposed that the United States District Court award damages of \$3,200,000 for the Company's alleged breach of the Equity Support Agreement, to be allocated among the three plaintiffs and damages of \$15,485,714 to FEI, for the Company's alleged tortious interference with the Farmout Agreement, and, in the alternative, for the Company's alleged fraud in failing to disclose to FEI that the Company allegedly did not intend to fund the remaining obligation under the Equity Support Agreement, plus prejudgment and postjudgment interest and attorneys' fees as may be requested and awarded pursuant to subsequent motions and hearings. With respect to the issue of fraud by nondisclosure, the Bankruptcy Court proposed a finding that the Company (i) failed to disclose a belief that the Equity Support Agreement could legally be treated as terminated, (ii) failed to disclose its alleged intention not to fund the final \$3,200,000 under the Equity Support Agreement and (iii) orchestrated an alleged misimpression that Hallwood Energy was not contemplating bankruptcy while planning Hallwood Energy's bankruptcy and how to use FEI's funding in a Hallwood Energy bankruptcy against FEI's wishes. The court also proposed that the District Court reject HPI and the trustee's claim that the Company's failure to fund the \$3,200,000 caused FEI to not fund \$20,000,000 under the Farmout Agreement, that the District Court reject HPI and the trustee's claim that the Company tortiously interfered with certain contractual rights, and that the District Court reject HPI and the trustee's claim for exemplary or punitive damages.

As a result of Proposed Findings, taking into consideration the Company's objections to the Proposed Findings, the Company recorded a litigation reserve charge for \$7,500,000 at September 30, 2011. As no new information had become available regarding the outcome of the litigation, the Company did not believe the reserve related to the Adversary Proceeding should be changed at December 31, 2011. This accrued reserve of \$7,500,000 was reported in the Company's balance sheet under Hallwood Energy matters Litigation reserve for those periods, in addition to the \$3,201,000 that was previously recorded in connection with the Equity Support Agreement, for a total reserve of \$10,701,000 at December 31, 2011 for the Adversary Proceeding. This reserve amount was established in consultation with the Company's litigation counsel in the Hallwood Energy litigation, based on their best judgment of the probabilities of success related to, among other factors, the objections to be filed by the Company on its possible appeal of the District Court's Judgment.

On April 24, 2012, the United States District Court entered a final judgment (the Judgment) substantially adopting the Proposed Findings. Based upon the monetary damages (including prejudgment and postjudgment interest, legal fees and court costs) awarded in the Judgment, the Company, in consultation with the Company's litigation counsel, recorded an additional charge of \$13,200,000 at March 31, 2012 in its statement of operations and balance sheet as an accrual under Hallwood Energy matters Litigation Reserve. Accordingly, the total reserve at March 31, 2012 for the Adversary Proceeding was \$23,901,000. The Company satisfied the Judgment, including prejudgment and postjudgment interest, in two payments; \$3,774,000 on May 4, 2012 and \$17,947,000 on May 9, 2012. In addition, the Company will be required to pay certain attorneys' fees incurred by the plaintiffs. At September 30, 2012, the litigation reserve for the Hallwood Energy Matters is \$2,079,000. The parties settled the amount of court costs for approximately \$101,000, which was paid in August 2012. While the Company will be required to pay some additional amount of money to the plaintiffs as compensation for their attorney fees related to the breach of contract claim they prosecuted against the Company, the amount and timing of that payment are currently unresolved and will be determined by the court. The plaintiffs have alleged that they are entitled to approximately \$4,000,000 for attorney fees while the Company contends that they should only recover a small fraction of that amount. In addition, the Company is in the process of appealing to the Fifth Circuit Court of Appeals the portions of the Judgment awarding a combined \$17,947,000 on the plaintiffs' tort claims. On September 13, 2012, the Company filed its appellate brief in the Fifth Circuit. On November 15, 2012, FEI, the only appellee, will file its response, and the Company will then file a reply brief, completing the briefing process. It is difficult to determine or even approximate when the Fifth Circuit will rule on the Company's appeal, but it will likely be several months, if not longer.

*Other Litigation Claims.* On August 3, 2009, the Company was served with a complaint in *Hall Phoenix/Inwood Ltd. and Hall Performance Energy Partners 4, Ltd. v. The Hallwood Group Incorporated, et al.* filed in the 298<sup>th</sup> District of Texas, No. 09-09551. The other defendants included Anthony J. Gumbiner, the Chairman and Chief Executive Officer of the Company, Bill Guzzetti, the President of the Company, certain affiliates of Mr. Gumbiner and certain officers of Hallwood Energy. The complaint alleged that the defendants defrauded plaintiffs in connection with plaintiffs acquiring interests in and providing loans to Hallwood Energy and sought unspecified actual and exemplary damages. On September 15, 2010, Ray Balestri, Trustee of the Hallwood Energy I



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Creditors Trust, intervened in this proceeding and added certain of the Company's officers, directors, and an employee as defendants. The complaint alleged, among other things, claims against the defendants for breach of fiduciary duties, gross negligence and willful misconduct and sought indeterminable actual and exemplary damages. On November 5, 2010, this case was removed to the United States Bankruptcy Court for the Northern District of Texas, Dallas Division, Adversary No. 10-03358. As discussed below, in February 2012, this claim was settled.

On July 30, 2010, Hallwood Energy's trustee filed a complaint captioned *Ray Balestri, Trustee of the Hallwood Energy I Creditors Trust v. Anthony J. Gumbiner, et al* in the Dallas County Court at Law No. 4, No. CC-10-05212D. The other defendants include certain current and former directors, officers and employees of the Company, certain of Hallwood Energy's former officers and directors, as well as outside legal counsel. The complaint alleged, among other things, claims against the defendants for breach of fiduciary duties, gross negligence and willful misconduct and sought unspecified actual and exemplary damages. This case was removed to the United States Bankruptcy Court for the Northern District of Texas, Dallas Division, Adversary No. 10-03263. As discussed below, in February 2012, this claim was settled with respect to all parties except outside legal counsel.

*Settlement in February 2012 of Litigation Claims other than Adversary Proceeding.* Effective February 14, 2012, the Company and certain other parties entered into a Confidential Settlement Agreement and Mutual Release of Claims (the Settlement Agreement). The Settlement Agreement settled the claims by HPI, the Trustee of the Hallwood Energy I Creditors Trust, and their related parties (the Plaintiffs) against the Company and its related parties other than the Adversary Proceeding in which the Bankruptcy Court issued the Proposed Findings.

The terms of the Settlement Agreement included the payment by the Company of \$1,800,000, in addition to payments by other defendants and the Company's insurance carrier for its directors and officers liability insurance policy. Under the Settlement Agreement, the Plaintiffs released the Company, its current and former directors and officers, the former directors and officers of the general partner of Hallwood Energy and various entities related to the foregoing persons from all claims asserted in or related to (i) *Hall Phoenix/Inwood Ltd. and Hall Performance Energy Partners 4, Ltd. v. The Hallwood Group Incorporated et al.* in the United States Bankruptcy Court for the Northern District of Texas, Dallas Division, Adversary No. 10-03358; (ii) *Ray Balestri, Trustee of the Hallwood Energy I Creditors Trust v. Anthony J. Gumbiner, et al.* in the United States Bankruptcy Court for the Northern District of Texas, Dallas Division, Adversary No. 10-03263; and (iii) another suit in which the Company is not named as a party, and any other claims based on the facts alleged in the foregoing matters or that could have been alleged in the foregoing matters, other than the claims against the Company asserted in the Adversary Proceeding or any claims required to enforce any final judgment entered against the Company in the Adversary Proceeding. Similarly, the defendants released the Plaintiffs from all claims based on the facts alleged in the foregoing matters or that could have been alleged in the foregoing matters, other than any claims or defenses the defendants had in the Adversary Proceeding.

The parties entered into the Settlement Agreement for a number of reasons, including to save time and expense, to ensure available insurance proceeds could be used toward the settlement of the disputed claims rather than the payment of expenses and legal fees, and otherwise to resolve the litigation claims. The defendants continue to believe that the claims asserted against them in the lawsuits had no merit and their agreement to settle and compromise those claims should not be deemed as an admission of any liability, wrongdoing, or fault.

At December 31, 2011, the Company recorded a reserve of \$1,800,000 in its statement of operations and balance sheet under Hallwood Energy matters Litigation Reserve for the full value of the Company's payments required by the Settlement Agreement. The Company paid the settlement amount of \$1,800,000 to the Plaintiffs on February 15, 2012.

*Claim Filed by Company with Insurance Carrier for Directors and Officers Liability Insurance Policy.* Prior to entering into the Settlement Agreement, the Company incurred significant legal fees and associated costs in connection with these legal matters. The Company filed claims with the insurance carrier for the directors and officers liability insurance policies maintained by the Company for reimbursement of certain legal fees and costs. The aggregate limit for each policy year under the Company's policies has been \$10,000,000. The insurance carrier took the position that all of the claims asserted in the Hallwood Energy litigation relate to the 2008-2009 policy year.



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The Company received reimbursement of legal fees and associated costs of approximately \$257,000 and \$1,373,000 in the years ended December 31, 2011 and 2010, respectively, which were recorded as expense recoveries in administrative and selling expenses. Additionally, the insurance carrier paid legal fees and associated costs on behalf of other defendants in connection with the Hallwood Energy litigation matters other than the Adversary Proceeding. Significant additional costs in excess of insurance reimbursements have been incurred by the Company and on behalf of the other defendants.

In connection with the Settlement Agreement, the insurance carrier agreed to make a payment to the Plaintiffs and received a release and full discharge from any further payments for the Hallwood Energy litigation. Accordingly, the Company did not have insurance coverage available to satisfy the Judgment that was rendered in connection with the Adversary Proceeding. The insurance carrier did not reimburse the Company for the legal fees and costs associated with the Adversary Proceeding.

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

The Company's Brookwood subsidiary is subject to a number of environmental laws, regulations, licenses and permits and has ongoing discussions with environmental regulatory authorities, including the U.S. Environmental Protection Agency (the "EPA"), the Rhode Island Department of Health ("RIDOH"), the Rhode Island Department of Environmental Management ("RIDEM") and the Connecticut Department of Energy and Environmental Protection ("CTDEEP") on a number of matters, including compliance with safe drinking water rules and wastewater discharge and treatment regulations, the control of chemicals used in the companies' coating operations that are classified as air pollutants, the presence of groundwater and soil contaminants at the companies' facilities, the removal of underground storage tanks, and hazardous waste management.

From time to time Brookwood and its subsidiaries have paid fines or penalties for alleged failure to comply with certain environmental requirements, which did not exceed \$100,000 in the aggregate during the three years ended December 31, 2011 and the nine months ended September 30, 2012. In addition, Brookwood and its subsidiaries have entered into various settlements and agreements with the regulatory authorities requiring the companies to perform certain tests, undertake certain studies, and install remedial facilities. Brookwood and its subsidiaries incurred capital expenditures to comply with environmental regulations of approximately \$136,000 in the year ended December 31, 2011 and \$334,000 during the nine months ended September 30, 2012. In addition, Brookwood and its subsidiaries regularly incur expenses associated with various studies and tests to monitor and maintain compliance with diverse environmental requirements.

*Other Contingencies.* In May 2009, one of Brookwood's suppliers advised Brookwood that shipments to Brookwood during the period from September 2008 to April 2009 of a quantity of greige fabric from the supplier incorporated some fiber that was not of domestic origin in some yarn from the vendor. The fabric in question was ordered to fill contracts in support of the United States military, was required to be domestic and is subject to the preference for domestic source required flow down provisions of the Department of Defense Supplement to the Federal Acquisition Regulations implementing the provisions of 10 USC 2533a. Brookwood's suppliers had advised that the greige fabric containing the non-compliant yarn was supplied inadvertently to Brookwood in limited quantity. Brookwood determined that this yarn affected two of their greige products. Brookwood advised its affected customers and the United States military of this circumstance. Brookwood resolved the issue with respect to one of the products and received payment at full value in 2009. Additionally, resolution on the second product with one of the procurement entities was achieved and Brookwood received payment at full value of \$3,242,000 in October 2010. Resolution with the final procurement entity was reached in the 2011 fourth quarter, and Brookwood received payment at full value of \$1,643,000 in January 2012.





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**Note 14 Segments and Related Information**

The following represents Hallwood Group's reportable segment operations for the three months and nine months ended September 30, 2012 and 2011, respectively (in thousands):

	Textile Products (a)	Other	Consolidated
<b>Three Months ended September 30, 2012</b>			
Total revenue from external sources	\$ 27,146	\$	\$ 27,146
Operating income (loss)	\$ (199)	\$ (1,227)	\$ (1,426)
Other income (loss), net	(42)	(136)	(178)
Income (loss) before income taxes	\$ (241)	\$ (1,363)	\$ (1,604)
<b>Three Months ended September 30, 2011</b>			
Total revenue from external sources	\$ 37,649	\$	\$ 37,649
Operating income (loss)	\$ 2,420	\$ (1,768)	\$ 652
Other income (loss), net	(25)	5	(20)
Income (loss) before income taxes	\$ 2,395	\$ (1,763)	\$ 632
<b>Nine Months ended September 30, 2012</b>			
Total revenue from external sources	\$ 100,207	\$	\$ 100,207
Operating income (loss)	\$ (867)	\$ (16,784)	\$ (17,651)
Other income (loss), net	(99)	(214)	(313)
Income (loss) before income taxes	\$ (966)	\$ (16,998)	\$ (17,964)
<b>Nine Months ended September 30, 2011</b>			
Total revenue from external sources	\$ 101,117	\$	\$ 101,117
Operating income (loss)	\$ 5,447	\$ (11,614)	\$ (6,167)
Other income (loss), net	(47)	8	(39)
Income (loss) before income taxes	\$ 5,400	\$ (11,606)	\$ (6,206)

(a) The operating income (loss) amounts for Brookwood, the textile products segment, include costs and expenses for the Nextec litigation of \$163,000 and \$3,572,000 for the 2012 third quarter and nine month periods and \$1,464,000 and \$2,308,000 for the 2011 third quarter and nine month periods, respectively. See Note 13 for more information on the Nextec litigation.

No differences have occurred in the basis or methodologies used in the preparation of this interim segment information from those used in the December 31, 2011 annual report. The total assets for Hallwood Group the Company's operating segments have not materially changed since the December 31, 2011 annual report.

**Note 15 Impact of Litigation on Liquidity**

The Company and its subsidiaries are and have been involved in a number of litigation matters, as described in Note 13, and have spent significant amounts in professional fees in connection with the defense of its pending and resolved legal matters. As previously described, on April 24, 2012, the United States District Court in the Adversary Proceeding issued a Judgment awarding damages against the Company totaling approximately \$18,700,000 plus prejudgment and postjudgment interest and court costs and plaintiff's attorneys' fees as may be requested and awarded pursuant to a subsequent motion.

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The Company satisfied the Judgment, including prejudgment and postjudgment interest, in two payments; \$3,774,000 on May 4, 2012 and \$17,947,000 on May 9, 2012. At September 30, 2012, the litigation reserve for the Hallwood Energy Matters is \$2,079,000. The parties settled the amount of court costs for approximately \$101,000, which was paid in August 2012. While the Company will be required to pay some additional amount of money to the plaintiffs as compensation for their attorney fees related to the breach of contract claim they prosecuted against the Company, the amounts and timing of that payment are currently unresolved and will be determined by the court. The plaintiffs have alleged that they are entitled to approximately \$4,000,000 for attorney fees while the Company contends that they should only recover a small fraction of that amount. In addition, the Company is in the process of appealing to the Fifth Circuit Court of Appeals the portions of the Judgment awarding a combined \$17,947,000 on the plaintiffs' tort claims. On September 13, 2012, the Company filed its appellate brief in the Fifth Circuit. On November 15, 2012, FEI, the only appellee, will file its response, and the Company will then file a reply brief, completing the briefing process. It is difficult to determine or even approximate when the Fifth Circuit will rule on the Company's appeal, but it will likely be several months, if not longer.

In May 2012, in addition to its then current available cash, to obtain additional funds to satisfy the Judgment, the Company received an \$8,000,000 dividend from Brookwood and the \$10,000,000 HFL Loan. The outstanding balance on the HFL Loan was \$9,000,000 at September 30, 2012 after a principal repayment of \$1,000,000 in May 2012. The HFL Loan is secured by a pledge of all of the stock of Brookwood, pursuant to the terms of the Intercreditor Agreement, and by the Company's interest in the anticipated refunds of federal income taxes, which are in excess of \$5,000,000, that the Company expects to receive in 2012 and 2013.

As discussed in Note 6, in August 2012, Brookwood's New Revolving Credit Facility was amended to, among other things, clarify the provisions to which cash dividends or advances to the Company may be made provided no event of default has occurred or would result from any such payment. Brookwood may pay to the Company (a) periodic payments for tax sharing obligations, (b) discretionary dividends in an aggregate amount not to exceed 50% of Borrowers' net income for the fiscal year with respect to which such dividends are made, and (c) other dividends or distributions in an aggregate amount not to exceed \$15,000,000 (of which, as of November 13, 2012, \$8,000,000 was previously disbursed in May 2012). Any such payments or advances would also be contingent upon the approval of Brookwood's board of directors and Brookwood's ability to meet the requirements of the Delaware corporate laws for the payment of dividends and compliance with other applicable laws and requirements.

The aforementioned circumstances raise substantial doubt about the Company's ability to continue as a going concern. The consolidated financial statements have been prepared assuming the Company will continue as a going concern and do not include any adjustments that might result should the Company be unable to continue as a going concern.

**Note 16 Subsequent Event**

On November 6, 2012, the Company received a proposal from Hallwood Financial Limited to acquire all of the outstanding shares of common stock of the Company that it does not beneficially own at a cash purchase price of \$10.00 per share. Hallwood Financial Limited, a private limited company organized under the laws of the British Virgin Islands, is controlled by the Company's Chief Executive Officer and members of his family. Hallwood Financial Limited owns 1,001,575, or 65.7%, of the outstanding shares of the Company.

On November 7, 2012 at the Company's regularly scheduled board of directors meeting, a special committee, consisting of its independent directors, was formed to consider and negotiate the proposal and to make a recommendation to the full board of directors. The special committee is empowered to retain its own independent legal and financial advisors to assist in its review and negotiation of the proposed transaction. The Company's shares trade on the NYSE MKT stock exchange under the symbol of HWG and closed on November 5, 2012 (the day prior to the receipt of the offer) at \$6.00 per share.

The board of directors cautions the Company's shareholders and others considering trading in its securities that it has only received the proposal and that no decision has been made with respect to the Company's response to the proposal. There can be no assurance that any offer will be

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accepted, that any agreement will be executed or that the transaction contemplated in the proposal or any other transaction will be approved or consummated. The Company does not anticipate making any further public statements about this matter or the activities of the special committee unless and until either it enters into a definitive agreement for a transaction or the special committee determines that no such transaction will be effected.

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**Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**  
**Forward-Looking Statements**

In the interest of providing stockholders with certain information regarding the Company's and its subsidiaries' future plans and operations, certain statements set forth in this quarterly report on Form 10-Q relate to management's future plans, objectives and expectations. Such statements are forward-looking statements. Although any forward-looking statement expressed by or on behalf of Hallwood Group 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 Hallwood Group'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 Hallwood Group's annual report on Form 10-K for the year ended December 31, 2011 in Item 1A Risk Factors. These risks and uncertainties are difficult or impossible to predict accurately and many are beyond the control of Hallwood Group. Other risks and uncertainties may be described, from time to time, in Hallwood Group's periodic reports and filings with the Securities and Exchange Commission.

**Overview**

*General.* The Hallwood Group Incorporated (the Company) (NYSE MKT:HWG) operates as a holding company. The Company operates its principal business in the textile products industry through its wholly owned subsidiary, Brookwood Companies Incorporated ( Brookwood ). Information contained herein includes references to the Company and its subsidiaries (collectively, the Hallwood Group ).

*Textile Products.* In 2012 and 2011, Hallwood Group 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, costs, availability of supplies, its response to competition and its ability to generate new markets. Although the textile activities of the Company and its subsidiaries have generated positive cash flow in recent years, there is no assurance that this trend will continue.

While Brookwood has enjoyed substantial revenues from its military business, there is no assurance that such revenues will continue. Brookwood's sales to the customers from whom it derives its military business have been volatile and difficult to predict, a trend management 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. As this activity changes, then orders from the military generally, including orders for Brookwood's products, may be similarly affected. The fluctuations in gross profit margin are attributed to varying levels of sales volume, changes in product mix and a more competitive pricing environment, primarily in the military market. Military sales of \$12,924,000 and \$54,155,000 for the 2012 third quarter and nine month periods, respectively, were 40.7% lower and 3.7% higher than the comparable periods in 2011 of \$21,802,000 and \$52,212,000.

From time to time, the military limits orders for existing products and adopts revised specifications for new products to replace the products for which Brookwood's customers have been suppliers. The U.S. government released orders in recent years that include Brookwood's products, which resulted in significant military sales. Changes in specifications or orders present a potential opportunity for additional sales; however, it is a continuing challenge to adjust to changing specifications, budgetary 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. Management 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 may continue.



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

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

The 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 other subsidiaries and is not obligated to contribute additional capital to the Company beyond preferred dividend payments and the tax sharing agreement.

*Investments in Financial Instruments.* In the 2011 first quarter, the Company opened an investment account with UBS AG, a global financial services firm, and intended to transfer a significant portion of the cash it holds from time to time to the UBS account to be placed in various financial instruments and to borrow additional amounts from UBS to invest on a leveraged basis. As of November 13, 2012, no funds have been transferred into the UBS account and currently the Company does not intend to transfer funds into the UBS account.

**Presentation**

The discussion of Hallwood Group's financial condition and results of operations that follows is intended 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**

Hallwood Group reported a net loss of \$1,063,000 for the 2012 third quarter, compared to net income of \$350,000 in 2011. Revenue for the 2012 third quarter was \$27,146,000, compared to \$37,649,000 in 2011.

The net loss for the 2012 nine month period was \$11,838,000, compared to a net loss of \$4,173,000 in 2011. Revenue for the 2012 nine month period was \$100,207,000, compared to \$101,117,000 in 2011.

**Revenues**

Textile products sales of \$27,146,000 decreased by \$10,503,000, or 27.9%, in the 2012 third quarter, compared to \$37,649,000 in 2011. Sales for the 2012 nine month period of \$100,207,000 decreased by \$910,000, or 0.9%, compared to \$101,117,000 in 2011. The decreases in 2012 were principally due to decreases in sales of specialty fabric to U.S. military contractors as a result of decreases in orders from the military to Brookwood's customers, as well as by reduced sales in its other market segments. Military sales accounted for \$12,924,000 and \$54,155,000 in the 2012 third quarter and nine month periods, compared to \$21,802,000 and \$52,212,000 in 2011, respectively. The military sales represented 47.6% and 57.9% of Brookwood's net sales in the 2012 and 2011 third quarters, respectively, and 54.0% and 51.6% in the 2012 and 2011 nine month periods, respectively. Generally, military sales represent sales of a product to a customer (prime and sub-prime contractors) that will be incorporated into an end product that will be used to fulfill a U.S. or international military contract.

*Sales Concentration.* Brookwood has one customer who accounted for more than 10% of Brookwood's sales. Sales to that Brookwood customer, Tennier Industries, Inc. (Tennier), accounted for more than 10% of Brookwood's sales during 2012 and 2011. Brookwood's relationship with Tennier is ongoing. Sales to Tennier, which are included in military sales, were \$6,164,000 and \$16,864,000 in the 2012 third quarter and nine month periods, respectively, compared to \$5,061,000 and \$11,456,000 in the 2011 comparable periods. Sales to Tennier represented 22.7% and 13.4% of Brookwood's net sales in the 2012 and 2011 third quarters, respectively, and 16.8% and 11.3% in the 2012 and 2011 nine month periods, respectively.





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

Textile products cost of sales of \$23,557,000 for the 2012 third quarter decreased by \$6,559,000, or 21.8%, compared to \$30,116,000 in 2011. For the nine month periods, textile products cost of sales of \$85,970,000 for 2012 increased by \$3,544,000, or 4.3%, compared to \$82,426,000 in 2011. The third quarter decrease is primarily a result of lower textile product sales in a quarter to quarter comparison. The nine month increase principally resulted from material and labor costs associated with the higher sales volume for the military segment, and from changes in product mix. Cost of sales includes all costs associated with the manufacturing process, including but not limited to, materials, labor, utilities, royalties, 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 for the 2012 third quarter was 13.2%, compared to 20.0% for 2011 and for the 2012 nine month period, 14.2% versus 18.5%. The fluctuations in gross profit margin were attributed to varying levels of sales volume, changes in product mix and a more competitive pricing environment, primarily in the military market.

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

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2012	2011	2012	2011
Brookwood	\$ 3,790	\$ 5,113	\$ 15,105	\$ 13,244
Company	1,225	1,768	3,583	4,114
<b>Total</b>	<b>\$ 5,015</b>	<b>\$ 6,881</b>	<b>\$ 18,688</b>	<b>\$ 17,358</b>

Brookwood's administrative and selling expenses of \$3,790,000 for the 2012 third quarter decreased by \$1,323,000, or 25.9%, from 2011. For the 2012 nine months, administrative and selling expenses increased by \$1,861,000, or 14.1%, compared to 2011. The nine month increase was primarily attributable to an increase in professional services of \$1,356,000, principally legal fees. The principal component of the third quarter decrease was due to lower professional services, primarily legal fees of \$1,373,000. Costs and expenses incurred by Brookwood in its successful defense of the Nextec litigation were \$163,000 and \$3,572,000 for the 2012 third quarter and nine month periods and \$1,464,000 and \$2,308,000 for the 2011 third quarter and nine month periods, respectively. The Court ruled from the bench on June 1, 2012 that, while Nextec's patents were valid, Brookwood had not infringed any of the patents in the lawsuit. Nextec has since filed a notice of appeal to the United States Court of Appeals for the Federal Circuit; Brookwood subsequently filed a notice of cross-appeal. For a further discussion on the Nextec litigation, see Note 13 in the accompanying condensed consolidated financial statements.

Brookwood's administrative and selling expenses included items such as payroll, professional fees, sales commissions, factor commissions, marketing, rent, insurance and travel. Brookwood conducts research and development activities related to the exploration, development and production of innovative products and technologies. Research and development costs were approximately \$212,000 and \$582,000 for the three and nine months ended September 30, 2012, respectively, compared to \$149,000 and \$486,000 for the comparable 2011 periods.

The Company's administrative expenses decreased \$543,000, or 30.7%, for the 2012 third quarter, compared to 2011. For the 2012 nine months, the Company's administrative expenses decreased \$531,000, or 12.9%, compared to 2011. The decreases were principally attributable to lower professional fees primarily associated with the defense in the Hallwood Energy litigation matters.

In connection with the Hallwood Energy litigation matters discussed in Note 13, on July 25, 2011, the Bankruptcy Court issued Proposed Findings in the Adversary Proceeding, proposing that damages be awarded against the Company totaling approximately \$18,700,000 plus

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prejudgment and postjudgment interest and plaintiff's attorneys' fees as may be requested and awarded pursuant to a subsequent motion.

On April 24, 2012, the United States District Court entered a final judgment (the Judgment) substantially adopting the Proposed Findings. Based upon the monetary damages (including prejudgment and postjudgment interest, legal fees and court costs) awarded in the Judgment, the Company recorded an additional charge of \$13,200,000 at March 31, 2012 in its statement of operations and balance sheet as an accrual under Hallwood Energy matters' Litigation Reserve. Accordingly, the total reserve at

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

March 31, 2012 for the Adversary Proceeding was \$23,901,000. The Company satisfied the Judgment, including prejudgment and postjudgment interest, in two payments; \$3,774,000 on May 4, 2012 and \$17,947,000 on May 9, 2012. In addition, the Company will be required to pay certain attorneys' fees incurred by the plaintiffs. At September 30, 2012, the litigation reserve for the Hallwood Energy matters is \$2,079,000. The parties settled the amount of court costs for approximately \$101,000, which was paid in August 2012. While the Company will be required to pay some additional amount of money to the plaintiffs as compensation for their attorney fees related to the breach of contract claim they prosecuted against the Company, the amount and timing of that payment are currently unresolved and will be determined by the court. The plaintiffs have alleged that they are entitled to approximately \$4,000,000 for attorney fees while the Company contends that they should only recover a small fraction of that amount. In addition, the Company is in the process of appealing to the Fifth Circuit Court of Appeals the portions of the Judgment awarding a combined \$17,947,000 on the plaintiffs' tort claims. On September 13, 2012, the Company filed its appellate brief in the Fifth Circuit. On November 15, 2012, FEI Shale, L.P. (FEI), the only appellee, will file its response, and the Company will then file a reply brief, completing the briefing process. It is difficult to determine or even approximate when the Fifth Circuit will rule on the Company's appeal, but it will likely be several months, if not longer.

**Other Income (Loss)**

Interest expense was \$178,000 and \$315,000 in the 2012 third quarter and nine month periods, respectively, compared to \$25,000 and \$74,000 for the 2011 third quarter and nine month periods. The interest expense primarily relates to Brookwood's revolving credit facilities and the HFL Loan, which was entered into in May 2012.

Interest and other income was \$-0- and \$2,000 in the 2012 third quarter and nine month periods, compared to \$5,000 and \$35,000 for the 2011 periods. The 2012 decreases were principally due to the redemption of marketable securities in 2011.

**Income Taxes**

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Federal				
Current	\$ (40)	\$ 208	\$ (48)	\$ 398
Deferred	(500)	(13)	(6,066)	(2,638)
Sub-total	(540)	195	(6,114)	(2,240)
State				
Current	(1)	87	(12)	207
Deferred				
Sub-total	(1)	87	(12)	207
Total	\$ (541)	\$ 282	\$ (6,126)	\$ (2,033)

At September 30, 2012, the net deferred tax asset was attributable to temporary differences, that upon reversal, could be utilized to offset income from operations and the carryforward of 2012 taxable losses to future periods. The statutory federal tax rate in both periods was 34%, while state taxes were determined based upon taxable income apportioned to those states in which Hallwood Group does business at their respective tax rates.

**Critical Accounting Policies**

There have been no changes to the critical accounting policies identified and set forth in Hallwood Group's annual report on Form 10-K for the year ended December 31, 2011.

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*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 in Europe in connection with HIL's services to the Company pursuant to the financial consulting contract and for travel and related expenses between Europe and the Company's locations in the United States and health insurance premiums.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Consulting fees	\$ 249	\$ 249	\$ 747	\$ 747
Office space and administrative services	68	71	221	238
Travel and other expenses	44	71	71	151
Interest expense on HFL loan	136		216	
<b>Total</b>	<b>\$ 497</b>	<b>\$ 391</b>	<b>\$ 1,255</b>	<b>\$ 1,136</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. No such services were performed or compensation earned during 2012 or 2011. 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.

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. Certain individuals employed by the Company, in addition to their services provided to the Company, perform services on behalf of the HIL-related affiliates. In addition, HIL utilizes some of the office space for purposes unrelated to the Company's business. The Company pays certain common general and administrative expenses for salaries, rent and other office expenses and charges the HIL-related companies an overhead reimbursement fee for the share of the expenses allocable to these companies. For the three months ended September 30, 2012 and 2011, these companies reimbursed the Company \$27,000 and \$25,000, respectively, for such expenses. For the nine months ended September 30, 2012 and 2011, these companies reimbursed the Company \$80,000 and \$72,000, respectively, for such expenses.

In May 2012, to fund in part the payment of the Judgment, the Company entered into the HFL Loan with Hallwood Family (BVI) L.P., a limited partnership associated with Mr. Gumbiner, as described below under *Liquidity and Capital Resources*. The interest expense payable on the HFL Loan was \$136,000 and \$-0- at September 30, 2012 and December 31, 2011, respectively.

**Litigation**

Refer to Note 13 in the accompanying condensed consolidated financial statements for a discussion of litigation matters.



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The Company and its subsidiaries have entered into various contractual obligations and commercial commitments in the ordinary course of conducting its business operations, which are provided below as of September 30, 2012 (in thousands):

	2012*	Payments Due During the Year Ending December 31,					Total
		2013	2014	2015	2016	Thereafter	
<b>Contractual Obligations</b>							
Loans payable	\$ 78	\$ 9,106	\$ 3,850	\$	\$	\$	\$ 13,034
Operating leases	189	683	594	397	212		2,075
Total	\$ 267	\$ 9,789	\$ 4,444	\$ 397	\$ 212	\$	\$ 15,109

\* For the three months ending December 31, 2012.

At September 30, 2012, the Company's debt was comprised of the HFL Loan, which bears interest at a 6% annual fixed rate. Brookwood's debt consisted of the New Revolving Credit Facility, which bears interest at variable rates. Estimated interest payments, based on the current principal balances and weighted average interest rates, assuming the repayment of the HFL Loan at its June 2013 maturity date and renewal of the revolving credit facility at its loan balance as of September 30, 2012, are \$147,000 for the three months ending December 31, 2012 and \$317,000, \$47,000, \$47,000, and \$47,000 for each of the years ending December 31, 2013 through December 31, 2016, respectively.

*Payments in Adversary Proceeding.* In May 2012, the Company satisfied the Judgment, including prejudgment and postjudgment interest, in two payments; \$3,774,000 on May 4, 2012 and \$17,947,000 on May 9, 2012. In addition, the Company will be required to pay certain attorneys' fees incurred by the plaintiffs. The parties settled the amount of court costs for approximately \$101,000, which was paid in August 2012. While the Company will be required to pay some additional amount of money to the plaintiffs as compensation for their attorney fees related to the breach of contract claim they prosecuted against the Company, the amount and timing of that payment are currently unresolved and will be determined by the court. The plaintiffs have alleged that they are entitled to approximately \$4,000,000 for attorney fees while the Company contends that they should only recover a small fraction of that amount. In addition, the Company is in the process of appealing to the Fifth Circuit Court of Appeals the portions of the Judgment awarding a combined \$17,947,000 on the plaintiffs' tort claims. On September 13, 2012, the Company filed its appellate brief in the Fifth Circuit. On November 15, 2012, FEI, the only appellee, will file its response, and the Company will then file a reply brief, completing the briefing process. It is difficult to determine or even approximate when the Fifth Circuit will rule on the Company's appeal, but it will likely be several months, if not longer.

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

*2005 Long-Term Incentive Plan for Brookwood.* In December 2005, the Company adopted The Hallwood Group Incorporated 2005 Long-Term Incentive Plan for Brookwood Companies Incorporated (2005 Long-Term Incentive Plan for Brookwood) to encourage employees of Brookwood to increase the value of Brookwood and to continue to be employed by Brookwood. The terms of the incentive plan provide for a total award amount to participants equal to 15% of the fair market value of consideration received by the Company in a change of control transaction, as defined, in excess of the sum of the liquidation preference plus accrued unpaid dividends on the Brookwood preferred stock (approximately \$13,956,000 at September 30, 2012). The base amount will fluctuate in accordance with a formula that increases by the annual amount of the dividend on the preferred stock accrued, currently \$1,823,000, and decreases by the amount of the cash dividends actually paid. The plan generally defines a change of control transaction as a transaction approved by the Company's board of directors or by the holders of at least 50% of the voting capital stock of the Company that results in: (i) a change in beneficial ownership of the Company or Brookwood of 50%

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or more of the combined voting power, (ii) the sale of all or substantially all of the assets of Brookwood, or (iii) any other transaction that, in the Company's board of directors discretion, has substantially the same effect of item (i) or (ii). Certain transfers, generally among existing stockholders and their related parties, are exempted from the definition.

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. No amounts have been accrued under the plan.



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Hallwood Group has no off-balance sheet arrangements.

**Financial Covenants**

The principal financial ratios required under Brookwood's New Revolving Credit Facility, as amended, were as follows:

Description	Requirement	Quarter Ended		
		September 30, 2012	June 30, 2012	March 31, 2012
Current assets to current liabilities plus funded debt	must be greater than ratio of 1.40	2.35	2.53	3.17
Total liabilities to tangible net worth	must be less than ratio of 1.50	0.50	0.45	0.34
Total funded debt to EBITDA	must be less than ratio of 4.00 (a)	2.44	0.83	0.24

- (a) On August 24, 2012, the New Revolving Credit Facility was amended to (i) modify the funded debt to EBITDA loan covenant to 4.00 to 1.00 from its previous requirement of 2.75 to 1.00, providing greater borrowing capacity for Brookwood, (ii) modify the covenant regarding declaration or payment of discretionary and other dividends by Brookwood to the Company, and (iii) modify the pricing grid for the applicable margin with respect to the LIBOR interest rate and unused line fees. Brookwood paid a fee of \$31,250, or 12.5 basis points, to BB&T in consideration for the amendment.

Brookwood was in compliance with its loan covenants under the New Revolving Credit Facility at September 30, 2012, June 30, 2012 and March 31, 2012. In order to maintain compliance with such covenants in the future, Brookwood may be required to limit aggregate borrowings under the New Revolving Credit Facility to less than \$25,000,000 at the end of each fiscal quarter.

Cash dividends and tax sharing payments by Brookwood to the Company are contingent upon compliance with the loan covenants in the New Revolving Credit Facility and/or consent from BB&T in certain circumstances. This limitation on the transferability of assets constitutes a restriction of Brookwood's net assets, which were \$48,371,000 and \$59,970,000 as of September 30, 2012 and December 31, 2011, respectively.

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*General.* The Company, through its Brookwood subsidiary, principally operates in the textile products segment. The Hallwood Group's cash position decreased by \$9,316,000 during the 2012 nine month period to \$1,553,000 as of September 30, 2012. The principal uses of cash were \$19,023,000 used in operations (which includes payments totaling \$23,622,000 for the satisfaction of Hallwood Energy litigation matters, other than the plaintiff's attorney fees in the Adversary Proceeding) and \$1,327,000 for property, plant and equipment, principally at Brookwood. The principal sources of cash were net new borrowings of \$11,034,000 for the 2012 nine month period, including a net \$9,000,000 from the HFL Loan and a net \$1,850,000 from the Brookwood revolving credit facilities. The amounts outstanding under the New Revolving Credit Facility and HFL Loan were \$3,850,000 and \$9,000,000, respectively, at September 30, 2012.

In May 2012, to fund in part the payment of the Judgment in the Adversary Proceeding, as further discussed below, the Company obtained an \$8,000,000 dividend from Brookwood. Also in May 2012, to fund in part the payment of the Judgment, the Company borrowed from Hallwood Family (BVI) L.P., a limited partnership associated with its principal shareholder, the sum of \$10,000,000 (the HFL Loan). The HFL Loan is secured by a pledge of all of the stock of Brookwood and by the Company's interest in the anticipated refunds of federal income taxes, which are in excess of \$5,000,000 that the Company expects to receive in 2012 and 2013. In connection with the HFL Loan, a Pledge and Security Agreement and a Subordination and Intercreditor Agreement (Intercreditor Agreement) were entered into and effective May 9, 2012. The Intercreditor Agreement, among other things, subordinates any security interest or lien that Hallwood Family (BVI) L.P. may have in certain assets of the Company, including the stock of Brookwood, to BB&T. The HFL Loan is due in full on June 28, 2013 and bears interest at the rate of 6% per year, payable on a quarterly basis. The Company may prepay the HFL Loan at any time without penalty. The documents reflecting the HFL Loan contain representations, warranties and covenants that are typical for loans of this type. The outstanding balance on the HFL Loan was \$9,000,000 at September 30, 2012 after a principal repayment of \$1,000,000 in May 2012.

The Company is dependent on fees, dividends and advances from Brookwood for its liquidity requirements. Brookwood's ability to generate cash flow from operations will depend on its future performance, including the level and timing of military sales, and its ability to successfully implement business and growth strategies.

*Textiles.* Hallwood Group'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. Brookwood maintains a \$25,000,000 New Revolving Credit Facility with BB&T that replaced its former Working Capital Revolving Credit Facility. The New Revolving Credit Facility has a maturity date of March 30, 2014. As of September 30, 2012, subject to the existing loan covenants, Brookwood had approximately \$2,512,000 of additional borrowing availability on its New Revolving Credit Facility.

Brookwood maintains factoring agreements which provide that receivables resulting from credit sales to customers may be sold to the factor, subject to a commission and the factor's prior approval. Brookwood monitors its factors and their ability to fulfill their obligations to Brookwood in a timely manner. As of November 13, 2012, all of Brookwood's factors were complying with payment terms in accordance with factor agreements.

Brookwood paid cash dividends to the Company of \$11,000,000 and \$3,000,000 in the 2012 and 2011 nine month periods, respectively, and \$4,000,000 for all of 2011. In addition, Brookwood made tax sharing payments to the Company of \$472,000 and \$2,655,000 in the 2012 and 2011 nine month periods, respectively, and \$2,992,000 for all of 2011 under its tax sharing agreement. The New Revolving Credit Facility, as amended in August 2012, provides that cash dividends to the Company may be made provided no event of default has occurred or would result from such payment. Brookwood may pay to the Company (a) periodic payments for tax sharing obligations, (b) discretionary dividends in an aggregate amount not to exceed 50% of Borrowers' net income for the fiscal year with respect to which such dividends are made, and (c) other dividends or distributions in an aggregate amount not to exceed \$15,000,000 (of which, as of November 13, 2012, \$8,000,000 was previously disbursed in May 2012). Any future payments or advances would also be contingent upon the approval of Brookwood's board of directors and Brookwood's ability to meet the requirements of the Delaware corporate laws for the payment of dividends and compliance with other applicable laws and requirements.

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Brookwood continuously evaluates opportunities to reduce production costs and expand its manufacturing capacity and portfolio of products. Accordingly, Brookwood incurs capital expenditures to pursue such opportunities, as well as for environmental and safety compliance, building upgrades, energy efficiencies, and various strategic objectives. In the 2012 nine month period and for all of 2011, Brookwood met its capital expenditure and equipment maintenance requirements from its

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**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**

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

operating cash flows and availability under its revolving credit facilities. There were no material capital commitments as of September 30, 2012. It is anticipated that Brookwood's future capital expenditure projects will be funded from operations and, if necessary, availability under its New Revolving Credit Facility. Brookwood estimates its 2012 capital expenditures will be less than \$2,000,000 having incurred approximately \$1,256,000 of net costs in the first nine months of 2012.

*Impact of Litigation on the Company's Liquidity.* The Company and its subsidiaries are and have been involved in a number of litigation matters, as described in Note 13 of the accompanying condensed consolidated financial statements, and have spent significant amounts in professional fees in connection with the defense of its pending and resolved legal matters. As previously described, on April 24, 2012, the United States District Court in the Adversary Proceeding issued a Judgment awarding damages against the Company totaling approximately \$18,700,000 plus prejudgment and postjudgment interest and court costs and plaintiff's attorneys' fees as may be requested and awarded pursuant to a subsequent motion.

The Company satisfied the Judgment, including prejudgment and postjudgment interest, in two payments; \$3,774,000 on May 4, 2012 and \$17,947,000 on May 9, 2012. The parties settled the amount of court costs for approximately \$101,000, which was paid in August 2012. While the Company will be required to pay some additional amount of money to the plaintiffs as compensation for their attorney fees related to the breach of contract claim they prosecuted against the Company, the amount and timing of that payment are currently unresolved and will be determined by the court. The plaintiffs have alleged that they are entitled to approximately \$4,000,000 for attorney fees while the Company contends that they should only recover a small fraction of that amount. In addition, the Company is in the process of appealing to the Fifth Circuit Court of Appeals the portions of the Judgment awarding a combined \$17,947,000 on the plaintiffs' tort claims. On September 13, 2012, the Company filed its appellate brief in the Fifth Circuit. On November 15, 2012, FEI, the only appellee, will file its response, and the Company will then file a reply brief, completing the briefing process. It is difficult to determine or even approximate when the Fifth Circuit will rule on the Company's appeal, but it will likely be several months, if not longer.

In May 2012, in addition to its then current available cash, to obtain additional funds to satisfy the Judgment, the Company received an \$8,000,000 dividend from Brookwood and the \$10,000,000 HFL Loan. The outstanding balance on the HFL Loan was \$9,000,000 at September 30, 2012 after a principal repayment of \$1,000,000 in May 2012. The HFL Loan is secured by a pledge of all of the stock of Brookwood, pursuant to the terms of the Intercreditor Agreement, and by the Company's interest in the anticipated refunds of federal income taxes, which are in excess of \$5,000,000 that the Company expects to receive in 2012 and 2013.

As discussed in Note 6, in August 2012, Brookwood's New Revolving Credit Facility was amended to, among other things, clarify the provisions to which cash dividends or advances to the Company may be made provided no event of default has occurred or would result from any such payment. Brookwood may pay to the Company (a) periodic payments for tax sharing obligations, (b) discretionary dividends in an aggregate amount not to exceed 50% of Borrowers' net income for the fiscal year with respect to which such dividends are made, and (c) other dividends or distributions in an aggregate amount not to exceed \$15,000,000 (of which, as of November 13, 2012, \$8,000,000 was previously disbursed in May 2012). Any such payments or advances would also be contingent upon the approval of Brookwood's board of directors and Brookwood's ability to meet the requirements of the Delaware corporate laws for the payment of dividends and compliance with other applicable laws and requirements.

The aforementioned circumstances raise substantial doubt about the Company's ability to continue as a going concern. The consolidated financial statements have been prepared assuming the Company will continue as a going concern and do not include any adjustments that might result should the Company be unable to continue as a going concern.

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**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**

**Item 4. CONTROLS AND PROCEDURES**

**Disclosure Controls and Procedures**

Disclosure controls and procedures are designed to ensure that information required to be disclosed in the reports filed or submitted under the Securities Exchange Act of 1934, as amended, (the Exchange Act), is recorded, processed, summarized and reported within the time period specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed under the Exchange Act is accumulated and communicated to management, including the Chief Executive Officer and the Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

An evaluation was performed under the supervision and with the participation of the Company's management, including its Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of the end of the period covered by this quarterly report. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosures controls and procedures were effective.

**Changes in Internal Control over Financial Reporting.**

There were no changes in the Company's internal control over financial reporting that occurred during the quarterly period covered by this report that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**

**PART II OTHER INFORMATION**

<u>Item</u>		
1	Legal Proceedings	
	Reference is made to Note 13 to the Company's condensed consolidated financial statements included within this quarterly report on Form 10-Q.	
1A	Risk Factors	N/A
2	Unregistered Sales of Equity Securities and Use of Proceeds	None
3	Defaults upon Senior Securities	None
4	Mine Safety Disclosures	N/A
5	Other Information	None
6	Exhibits	
31.1	Certification of the Chief Executive Officer, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.	
31.2	Certification of the Chief Financial Officer, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.	
32.1	Certification of Chief Executive Officer and Chief Financial Officer, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.	
101.INS	XBRL Instance Document**	
101.SCH	XBRL Taxonomy Extension Schema**	
101.CAL	XBRL Taxonomy Extension Calculation Linkbase**	
101.DEF	XBRL Taxonomy Extension Definition Linkbase**	
101.LAB	XBRL Taxonomy Extension Label Linkbase**	
101.PRE	XBRL Taxonomy Extension Presentation Linkbase**	

\*\* Furnished electronically herewith. XBRL information is furnished and not filed or a part of a registration statement or prospectus for purposes of sections 11 or 12 of the Securities Act of 1933, as amended, is deemed not filed for purposes of section 18 of the Securities Exchange Act of 1934, as amended, and otherwise is not subject to liability under these sections.

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**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**

**SIGNATURE**

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

**THE HALLWOOD GROUP INCORPORATED**

Dated: November 13, 2012

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

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**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 the Sarbanes-Oxley Act of 2002.
31.2	Certification of the Chief Financial Officer, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer and Chief Financial Officer, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101.INS	XBRL Instance Document**
101.SCH	XBRL Taxonomy Extension Schema**
101.CAL	XBRL Taxonomy Extension Calculation Linkbase**
101.DEF	XBRL Taxonomy Extension Definition Linkbase**
101.LAB	XBRL Taxonomy Extension Label Linkbase**
101.PRE	XBRL Taxonomy Extension Presentation Linkbase**

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