

Hallwood Group Inc  
Form 10-Q  
August 14, 2013  
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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 June 30, 2013

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)

**51-0261339**  
(I.R.S. Employer  
Identification No.)

**3710 Rawlins, Suite 1500, Dallas, Texas**  
(Address of principal executive offices)

**75219**  
(Zip Code)

**214-528-5588**  
(Registrant's telephone number, including area code)

**Not Applicable**

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

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

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

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

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 July 31, 2013
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)

	June 30, 2013	December 31, 2012
<b>ASSETS</b>		
<b>Current Assets</b>		
Cash and cash equivalents	\$ 160	\$ 193
Accounts receivable, net		
Factors	17,976	15,199
Trade and other	3,334	4,145
Inventories	24,038	25,066
Deferred income tax	439	441
Prepays, deposits and other assets	408	716
Income taxes receivable / prepaid income taxes	121	4,832
	46,476	50,592
<b>Noncurrent Assets</b>		
Property, plant and equipment, net	19,477	20,083
Other assets	139	231
	19,616	20,314
<b>Total Assets</b>	<b>\$ 66,092</b>	<b>\$ 70,906</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>Current Liabilities</b>		
Accounts payable	\$ 13,065	\$ 8,884
Accrued expenses and other liabilities	3,613	3,966
Accounts payable - related parties, net	493	161
Current portion of loans payable	1,500	105
Litigation reserve - Hallwood Energy matters	2,079	2,079
	20,750	15,195
<b>Noncurrent Liabilities</b>		
Long term portion of loans payable (includes \$5,411 and \$8,747 to related parties as of June 30, 2013 and December 31, 2012, respectively)	5,411	14,077
Deferred income tax	435	437
	5,846	14,514
<b>Total Liabilities</b>	<b>26,596</b>	<b>29,709</b>
<b>Contingencies and Commitments (Note 11)</b>		
<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	960	2,661

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Treasury stock, 870,939 shares for both periods; at cost	(13,404)	(13,404)
<b>Total Stockholders Equity</b>	39,496	41,197
<b>Total Liabilities and Stockholders Equity</b>	\$ 66,092	\$ 70,906

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>Six Months Ended June 30,</b>	
	<b>2013</b>	<b>2012</b>
<b>Revenues</b>		
Textile products sales	\$ 63,767	\$ 73,061
<b>Expenses</b>		
Textile products cost of sales	54,915	62,413
Administrative and selling expenses	9,955	13,673
Litigation charge Hallwood Energy matters		13,200
	64,870	89,286
Operating loss	(1,103)	(16,225)
<b>Other Income (Expense)</b>		
Interest expense	(349)	(137)
Interest and other income	67	2
	(282)	(135)
Income (loss) before income taxes	(1,385)	(16,360)
Income tax expense (benefit)	316	(5,585)
<b>Net Income (Loss)</b>	<b>\$ (1,701)</b>	<b>\$ (10,775)</b>
<b>Net Income (Loss) Per Common Share</b>		
Basic	\$ (1.12)	\$ (7.07)
Diluted	\$ (1.12)	\$ (7.07)
<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 June 30,</b>	
	<b>2013</b>	<b>2012</b>
<b>Revenues</b>		
Textile products sales	\$ 32,484	\$ 37,182
<b>Expenses</b>		
Textile products cost of sales	27,456	32,264
Administrative and selling expenses	4,987	6,705
	32,443	38,969
Operating income (loss)	41	(1,787)
<b>Other Income (Expense)</b>		
Interest expense	(156)	(112)
Interest and other income	67	1
	(89)	(111)
Income (loss) before income taxes	(48)	(1,898)
Income tax expense (benefit)	309	(675)
<b>Net Income (Loss)</b>	<b>\$ (357)</b>	<b>\$ (1,223)</b>
<b>Net Income (Loss) Per Common Share</b>		
Basic	\$ (0.23)	\$ (0.80)
Diluted	\$ (0.23)	\$ (0.80)
<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)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
<b>Net Income (Loss)</b>	\$ (357)	\$ (1,223)	\$ (1,701)	\$ (10,775)
Other Comprehensive Income (Loss)				
None				
<b>Comprehensive Income (Loss)</b>	\$ (357)	\$ (1,223)	\$ (1,701)	\$ (10,775)

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, 2013</b>	2,396	\$ 240	\$ 51,700	\$ 2,661	871	\$ (13,404)	\$ 41,197
Net income (loss)				(1,701)			(1,701)
<b>Balance, June 30, 2013</b>	2,396	\$ 240	\$ 51,700	\$ 960	871	\$ (13,404)	\$ 39,496

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)

	Six Months Ended June 30,	
	2013	2012
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net income (loss)	\$ (1,701)	\$ (10,775)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Litigation charge Hallwood Energy matters		13,200
Deferred tax expense (benefit)		(5,565)
Depreciation, amortization and impairment	1,270	1,195
Provision (recovery) for obsolete inventory	55	257
Provision (recovery) for doubtful accounts and factor dilution	(73)	50
Changes in assets and liabilities:		
Partial payment of litigation reserve Hallwood Energy matters		(23,522)
(Increase) decrease in accounts receivable	(1,893)	3,127
Increase (decrease) in accounts payable	4,174	2,887
(Increase) decrease in inventories	973	(144)
Net change in income taxes receivable/payable	4,711	(161)
Increase (decrease) in accrued expenses and other current liabilities	140	(307)
Net change in other assets and liabilities	368	(148)
Net cash provided by (used in) operating activities	8,024	(19,906)
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Investments in property, plant and equipment	(786)	(793)
Net cash used in investing activities	(786)	(793)
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Proceeds from revolving credit facilities	27,790	8,018
Repayments of revolving credit facilities	(31,620)	(6,518)
Proceeds from loans payable	705	10,000
Repayments of loans payable	(4,146)	(1,000)
Net cash provided by (used in) financing activities	(7,271)	10,500
<b>DECREASE IN CASH AND CASH EQUIVALENTS</b>	(33)	(10,199)
<b>CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD</b>	193	10,869
<b>CASH AND CASH EQUIVALENTS, END OF PERIOD</b>	\$ 160	\$ 670

See accompanying notes to condensed consolidated financial statements.



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**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**Six Months Ended June 30, 2013 and 2012**

**(unaudited)**

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

*Organization.* The Hallwood Group Incorporated (the Company) (NYSE MKT: HWG) was incorporated in Delaware in 1981 and 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, 2012.

*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 June 30, 2013:

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 operations accounts for all of Hallwood Group's operating revenues in 2013 and 2012. 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 11, 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.

*Impact of the Judgment and Dependency Upon Brookwood for Dividends on the Company's Liquidity.* The Company and its subsidiaries are involved in a number of litigation matters and have spent significant amounts in professional fees in connection with the defense of its pending legal matters. As further discussed in Note 11, in connection with Hallwood Energy's bankruptcy proceeding, Hallwood Energy and other parties filed a number of lawsuits against the Company, its directors and various other parties. In July 2011, the court in the Adversary Proceeding issued Proposed Findings (as hereinafter defined) setting forth damages totaling approximately \$18,700,000, plus prejudgment and postjudgment interest. In April 2012, the United States District Court substantially adopted the Proposed Findings. The Company satisfied the Judgment (as defined in Note 11) of \$21,721,000, including prejudgment and postjudgment interest, in May 2012.

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As a holding company, the Company is dependent on Brookwood to receive the cash necessary to fund its ongoing operations and its obligations. At June 30, 2013 and December 31, 2012, the Company had approximately \$126,000 and \$145,000, respectively, of cash and cash equivalents. This amount is not sufficient to fund the Company's ongoing operations and obligations. Any failure to receive from Brookwood cash required by the Company could have a material adverse effect on the Company's financial position, results of operations and cash flows and could substantially impair the Company's ability to continue as a going concern. In the event that Brookwood is unable to pay sufficient dividends to the Company to fund its ongoing operating costs, the Company will utilize its available line of credit under the HFL Loan (see Note 5 for further information).

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**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**Six Months Ended June 30, 2013 and 2012**

**(unaudited)**

*Second Amendment to HFL Loan and Proceeds of IRS Refund Reduce HFL Loan.* On May 13, 2013, the promissory note associated with the HFL Loan was amended, pursuant to a Second Amendment to Promissory Note, to convert it to a revolving credit facility to provide additional liquidity to the Company. The maturity date of the promissory note continues to be June 30, 2015. See Note 5 for additional information on the HFL Loan.

In late May 2013, the Company received a net refund of approximately \$4,300,000 from the IRS of 2010 federal taxes. The proceeds of these funds were used to pay \$4,000,000 towards principal and interest outstanding on the HFL Loan, with the balance retained for the Company's expenses and cash needs. As of June 30, 2013, the outstanding balance of the HFL Loan was \$5,411,000. As of June 30, 2013, the Company had \$695,000 of credit availability under the HFL Loan for general and administrative costs for the second quarter, and all of the availability for the third and fourth quarters of 2013 of \$940,000 and \$986,000, respectively.

Brookwood paid dividends to the Company of \$650,000 and \$250,000, respectively, in January 2013 and April 2013. Subsequent to June 30, 2013, Brookwood paid a dividend to the Company of \$1,000,000 in July 2013.

If for any reason Brookwood is unable to pay cash dividends or other advances to the Company, or if sufficient funding is unavailable under the HFL Loan when requested by the Company, the Company would be required to seek alternative sources of funding. The Company has not yet determined what, if any, sources would be available to it, but will consider such alternatives as an additional or new facility or term loan and potential sales of assets or additional securities. No assurance can be given that any such additional sources of funding will be available to the Company.

Additionally, any payment of dividends or advances by Brookwood to the Company are dependent on a number of other factors including compliance with the loan covenants in the Revolving Credit Facility (as hereinafter defined) with Branch Banking and Trust Company, the approval of Brookwood's board of directors, Brookwood's ability to meet the requirements of the Delaware corporate laws for payment of dividends, and compliance with other applicable laws and requirements. As a result, no assurance can be given that these amounts will be available when needed or required.

The Company can give no assurance that Brookwood will have the ability to satisfy the Company's cash flow needs, nor that the Company would be able to obtain other sources of funding in such a circumstance, and therefore the aforementioned circumstances raise substantial doubt as to 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.

*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.

*Consolidation Policy.* The Company's Brookwood subsidiary operates on a 5-4-4 week accounting cycle with its months 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, its quarterly interim financial statements may not correspond to the fiscal quarter-end. Hallwood Group's condensed consolidated financial statements as of June 30, 2013 and 2012 include Brookwood's operations through June 29, 2013 and June 30, 2012, respectively. Estimated operating results of Brookwood for the intervening periods to June 30, 2013 and 2012, respectively, are provided below (in thousands):

**Table of Contents****THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****Six Months Ended June 30, 2013 and 2012****(unaudited)**

	Amounts in Intervening Periods	
	Six Months Ended June 30,	
	2013	2012
	(no business days)	(no business days)
Textile products sales	\$	\$
Textile products costs of sales		
Administrative and selling expenses		

**Note 2 Hallwood Financial Limited Proposal and Merger Agreement**

As previously announced, on November 6, 2012, the Company received a proposal (the HFL Proposal) from Hallwood Financial Limited (Parent) to acquire all of the outstanding shares of Company Common Stock that it does not beneficially own at a cash purchase price of \$10.00 per share. On November 7, 2012, at the Company's regularly scheduled Board of Directors meeting, a special committee, consisting solely of independent and disinterested directors (the Special Committee), was formed to consider and negotiate the HFL Proposal and to make a recommendation to the Company's Board of Directors. Subsequently, the Special Committee retained its own independent legal representation and selected and engaged a financial advisor to assist in the review of the proposed transaction.

On June 4, 2013, the Company announced that the Company, Parent, and HFL Merger Corporation, a Delaware corporation and a wholly owned subsidiary of the Parent (Merger Sub), entered into an Agreement and Plan of Merger (the Merger Agreement). The Merger Agreement provides that, upon the terms and subject to the conditions set forth in the Merger Agreement, Merger Sub will merge with and into the Company (the Merger), with the Company continuing as the surviving corporation and a wholly owned subsidiary of Parent. Parent is controlled by Anthony J. Gumbiner, Chairman and Chief Executive Officer of the Company and Parent currently owns 1,001,575, or 65.7%, of the issued and outstanding shares of common stock, par value \$0.10 per share, of the Company (such shares, collectively, the Company Common Stock, and, each, a Share).

All of the members of the Board of Directors of the Company other than Mr. Gumbiner (who did not participate in the meeting), acting upon the unanimous recommendation of the Special Committee, have (i) determined that it is in the best interests of the Company and its stockholders (other than Parent and Merger Sub), and declared it advisable, to enter into the Merger Agreement, (ii) approved the execution, delivery and performance of the Merger Agreement and the consummation of the transactions contemplated thereby, including the Merger and (iii) resolved to recommend adoption of the Merger Agreement by the stockholders of the Company;

At the effective time of the Merger, each Share of Company Common Stock outstanding immediately prior to the effective time of the Merger and not already owned by Parent will receive \$10.00 in cash, without interest.

Stockholders of the Company will be asked to vote on the adoption of the Merger Agreement at a special stockholders meeting that will be held on a date to be announced. The closing of the Merger is subject to a non-waivable condition that the Merger Agreement be adopted by (i) the affirmative vote of the holders of a majority of the outstanding shares of the Company Common Stock entitled to vote on the adoption of the Merger Agreement, voting together as a single class, and (ii) the affirmative vote of the holders of a majority of the outstanding shares of the Company Common Stock, voting together as a single class, excluding all shares of Company Common Stock owned by Parent, Merger Sub, Mr. Gumbiner or any of their respective affiliates (other than the Company and its subsidiaries), or by any director, officer or other employee of the Company or any of its subsidiaries.

Consummation of the Merger is subject to certain other customary conditions, including, among others, (i) absence of any order or injunction prohibiting the consummation of the Merger, (ii) subject to certain exceptions, the accuracy of representations and warranties with respect to the business of the Company, (iii) each of the Company and Parent having performed their respective obligations pursuant to the Merger Agreement and (iv) the absence of a Company Material Adverse Effect, which is defined in the Merger Agreement to include the occurrence of an Event of Default under that certain Loan Agreement, dated as of March 30, 2012, among Branch Banking and Trust Company, Brookwood Companies Incorporated, the Company and the other signatories thereto, filed with Securities and Exchange Commission (the SEC) as Exhibit 10.20 to the

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Company's Annual Report on Form 10-K for the year ended December 31, 2011.

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**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**Six Months Ended June 30, 2013 and 2012**

**(unaudited)**

In connection with the proposed merger transaction, the Company will file with the SEC and furnish to the Company's stockholders a Proxy Statement and other relevant documents. Before making any voting decision, the Company's stockholders are urged to read the Proxy Statement in its entirety when it becomes available and any other documents to be filed with the SEC in connection with the proposed merger or incorporated by reference into the Proxy Statement because those documents will contain important information about the proposed merger and the parties to the merger. The Company's stockholders will be able to obtain a free copy of documents filed with the SEC at the SEC's website at <http://www.sec.gov>. In addition, the Company's stockholders may obtain a free copy of the Company's filings with the SEC from the Company's website at <http://www.hallwood.com/hwg/SEC.php> or by directing a request to: The Hallwood Group Incorporated, 3710 Rawlins, Suite 1500, Dallas, TX 75219; Attention: Investor Relations; Phone: (214) 528-5588 or (800) 225-0135.

On July 11, 2013, the Merger Agreement was amended to provide that it would not be commercially reasonable to file the Proxy Statement and Schedule 13E-3 prior to October 31, 2013.

The foregoing information only summarizes certain terms of the Merger Agreement, as amended, and is not a complete description of all of the parties' rights and obligations under the Merger Agreement, as amended. For the complete terms, please read: (a) the Merger Agreement as Exhibit 2.1 to the Company's Current Report on Form 8-K filed with the SEC on June 5, 2013 and (b) the amendment included as Exhibit 2.1 to the Company's Current Report on Form 8-K filed with the SEC on June 12, 2013.

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 HFL Proposal) at \$6.00 per share. The Company's shares closed on August 8, 2013 at \$9.60 per share.

**Note 3 Inventories**

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

	<b>June 30, 2013</b>	<b>December 31, 2012</b>
Raw materials	\$ 5,338	\$ 6,873
Work in progress	4,841	4,401
Finished goods	13,859	13,792
Total	\$ 24,038	\$ 25,066

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**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**Six Months Ended June 30, 2013 and 2012**

**(unaudited)**

**Note 4 Operations of Brookwood Companies Incorporated**

*Receivables.* Brookwood maintains factoring agreements with several factors, which provide that receivables resulting from credit sales to customers, excluding U.S. Government, may be assigned for collection to the factor, subject to a commission and the factor's prior approval. Factored receivables were \$17,976,000 and \$15,199,000 at June 30, 2013 and December 31, 2012, which were net of a returned goods dilution allowance of \$176,000 and \$174,000, respectively.

Brookwood monitors its factors and their ability to fulfill their obligations to Brookwood in a timely manner. As of August 14, 2013, all of Brookwood's factors were complying with payment terms in accordance with factor agreements.

Trade receivables were \$3,209,000 and \$3,980,000 at June 30, 2013 and December 31, 2012, which were net of an allowance for doubtful accounts of \$59,000 and \$134,000, respectively.

*Sales Concentration.* Sales to one Brookwood customer, Tennier Industries, Inc. (Tennier), accounted for more than 10% of Brookwood's sales during 2013 and 2012. Brookwood's relationship with Tennier is ongoing. Sales to Tennier, which are included in military sales, were \$7,898,000 and \$14,848,000 in the 2013 second quarter and six month periods, respectively, compared to \$3,992,000 and \$10,700,000 in the 2012 comparable periods. Sales to Tennier represented 24.3% and 10.7% of Brookwood's net sales in the 2013 and 2012 second quarters, respectively, and 23.3% and 14.6% in the 2013 and 2012 six month periods, respectively.

Military sales accounted for \$16,388,000 and \$32,102,000 in the 2013 second quarter and six month periods, compared to \$19,556,000 and \$41,231,000 in 2012, respectively. The military sales represented 50.5% and 52.6% of Brookwood's net sales in the 2013 and 2012 second quarters, respectively, and 50.3% and 56.4% in the 2013 and 2012 six 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 an aggregate liquidation preference of \$13,500,000 plus accrued but unpaid dividends. At June 30, 2013, cumulative dividends in arrears on the preferred stock totaled 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 (2005 Plan) to incentivize employees of Brookwood to increase the value of Brookwood and to continue their employment with Brookwood. The terms of the 2005 Plan provide for a total award amount to participants equal to 15% of the net fair market value of all consideration received by the Company or its stockholders in a change of control transaction (as defined in the 2005 Plan and further explained below), in excess of the sum of the liquidation preference plus accrued but unpaid dividends on Brookwood's Series A Preferred Stock (the Preferred Stock) (\$14,161,000 at June 30, 2013). The base amount will fluctuate in accordance with a formula that increases by the amount of the annual dividend on the preferred stock of \$1,823,000, and decreases by the amount of the cash dividends actually paid. The 2005 Plan generally defines a change of control transaction as a transaction that (i) is approved by the Company's board of directors or by the holders of at least 50% of the Company's voting capital stock then-entitled to vote generally in the election of directors, (ii) is a transaction in which either the Company or its stockholders receive consideration, and (iii) results in: (x) a change in beneficial ownership of the Company or Brookwood of at least 50% of the combined voting power of the Company's or Brookwood's then-outstanding stock then-entitled to vote generally in the election of directors, (y) the sale of all or substantially all of the assets of Brookwood, or (z) any other transaction that, in the discretion of the Company's board of directors has substantially the same effect as the transactions specified in clauses (x) and (y), above. Pursuant to the terms of the 2005 Plan, certain transfers, generally among existing stockholders and their related parties, do not fall within the meaning of "change in control" under the 2005 Plan.

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However, if the Company's board of directors determines that certain specified Brookwood officers, or other persons performing similar functions do not have, in the aggregate and prior to the change of control transaction 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 certain members of Brookwood's senior management do not have, in the aggregate and prior to a change of control transaction, 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. As of June 30, 2013, no amounts have been accrued or paid under the 2005 plan.

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**Note 5 Loans Payable**

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

	June 30, 2013	December 31, 2012
HFL Loan; due June 2015	\$ 5,411	\$ 8,747
Revolving Credit Facility; due March 2014	1,500	5,330
Other loan payable; repaid April 2013		105
<b>Total</b>	<b>6,911</b>	<b>14,182</b>
Current portion	(1,500)	(105)
Noncurrent portion	\$ 5,411	\$ 14,077

*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 Revolving Credit Facility ). The Revolving Credit Facility replaced a revolving credit facility with Key Bank.

The 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 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 its credit facility with Key Bank, 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 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.

On August 24, 2012, the 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.

The interest rate payable on the Revolving Credit Facility, as amended, is dependent on a leverage ratio (as defined in the Revolving Credit Facility) and can vary from LIBOR plus 1.00% to 3.00%, as long as BB&T continues to be one of Brookwood's primary factoring service providers. If at any time BB&T is not one of Brookwood's primary factoring service providers, then Brookwood will pay a one-time fee in the amount of \$62,500 and the interest rates will be increased by 0.50%. The interest rate on the facility was 1.71% and 2.21% at June 30, 2013 and December 31, 2012, respectively.

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



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The Revolving Credit Facility, as amended, contains customary representations, warranties and affirmative covenants on behalf of Brookwood and also contains negative covenants which, among other things, prohibit Brookwood from taking any of the following actions (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 of 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.

*Loan Covenants of the Revolving Credit Facility.* The 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 in the Revolving Credit Facility)-to-EBITDA for the trailing four quarters of not greater than 4.00 to 1.00 (prior to the August 2012 amendment this ratio could not exceed 2.75 to 1.00).

The outstanding balance of the Revolving Credit Facility was \$1,500,000 and \$5,330,000 at June 30, 2013 and December 31, 2012, respectively. As of June 30, 2013 and December 31, 2012, subject to the existing loan covenants, Brookwood had approximately \$13,137,000 and \$1,647,000, respectively, of additional borrowing availability under this facility, which was net of a standby letter of credit for \$91,000 in each period.

As of June 30, 2013, March 31, 2013 and for each of the quarterly periods during 2012, Brookwood was in compliance with loan covenants of the Revolving Credit Facility.

*Payments of Dividends.* 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.

The August 24, 2012 amendment provides that cash dividends or advances to the Company may be made under certain circumstances, as discussed below, 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 Brookwood's 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 July 31, 2013, a total of \$11,902,000 has been utilized with an \$8,000,000 dividend in May 2012, the reclassification of \$3,000,000 of discretionary dividends attributable to 2012 due to Brookwood's financial results for 2012, and reclassification of approximately \$902,000 of discretionary dividends attributable to 2013). 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

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dividends and compliance with other applicable laws and requirements.

Additionally, Brookwood paid 2012 dividends to the Company of \$1,000,000 in August and \$350,000 in December. Brookwood paid dividends to the Company of \$650,000 and \$250,000, respectively, in January 2013 and April 2013. Subsequent to June 30, 2013, Brookwood paid a dividend to the Company of \$1,000,000 in July 2013.

*Restricted Net Assets.* Cash dividends and tax sharing payments by Brookwood to the Company are contingent upon compliance with the Revolving Credit Facility loan covenants. This limitation on the transferability of assets constitutes a restriction of Brookwood's net assets, which were \$47,548,000 and \$47,751,000 at June 30, 2013 and December 31, 2012, respectively.

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*HFL Loan.* In May 2012, to fund in part the payment of the Judgment, the Company borrowed \$10,000,000 from Hallwood Family (BVI) L.P., a limited partnership associated with Mr. Anthony J. Gumbiner, the Company's chairman and principal stockholder (the HFL Loan). The Company paid \$4,000,000 towards principal and interest outstanding on the net HFL Loan after receiving a net refund from the IRS of 2010 federal income taxes of approximately \$4,300,000 in late May 2013. The remaining balance on the HFL Loan is secured by a subordinated pledge of all of the stock of Brookwood. 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 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 \$8,747,000 at December 31, 2012.

On March 11, 2013, the promissory note associated with the HFL Loan was amended, pursuant to a First Amendment to Promissory Note, to primarily (i) extend the maturity date of the HFL Loan by two years until June 30, 2015 and (ii) provide for an additional advance of \$300,000 under the promissory note, resulting in a then outstanding balance of \$9,047,000 as of March 31, 2013.

On May 13, 2013, the promissory note associated with the HFL Loan was amended, pursuant to a Second Amendment to Promissory Note, to convert it to a revolving credit facility to provide additional liquidity to the Company. The maturity date of the promissory note continues to be June 30, 2015.

Subject to the terms and conditions of the HFL Loan, upon written request, the Company may borrow and receive advances of amounts requested by the Company (including amounts previously repaid) not to exceed either of:

- (a) The amount in each calendar quarter equal to the amount budgeted by the Company to fund general and administrative costs for that calendar quarter; or

- (b) An amount that would result in the aggregate principal amount of the HFL Loan outstanding to exceed \$10,000,000. General and administrative costs were \$1,064,000 in the second quarter of 2013, and are estimated to be approximately \$940,000, and \$986,000 in the third and fourth quarters of 2013. These general and administrative costs are estimated based on historic recurring costs of the Company and the actual amount of general and administrative costs of the Company for these periods could differ significantly as a result of unforeseen and/or other non-recurring costs. Amounts borrowed may be repaid and reborrowed at any time prior to the earliest of any of the following (the Final Revolver Draw Date): (v) such date as either (i) Hallwood Financial Limited has notified the Company in writing that it has withdrawn the HFL Proposal or (ii) the Company has notified Hallwood Financial Limited that it is no longer considering the HFL Proposal; (w) the consummation of the purchase of all of the issued and outstanding shares of common stock of the Company, as contemplated by the HFL Proposal; (x) the termination of any definitive agreement between the Company and Hallwood Financial Limited relating to the HFL Proposal in accordance with the terms of such agreement; (y) the occurrence of any Event of Default for which the Opportunity to Cure Non-Monetary Default, if applicable, shall have expired, or (z) December 31, 2013. Hallwood Financial Limited shall have no obligation to advance any additional amounts to the Company on or after the Final Revolver Draw Date.

In late May 2013, the Company received a net refund of approximately \$4,300,000 from the IRS of 2010 federal taxes. The proceeds of these funds were used to pay \$4,000,000 towards principal and interest outstanding on the HFL Loan, with the balance retained for the Company's expenses and cash needs. As of June 30, 2013, the outstanding balance of the HFL Loan was \$5,411,000. As of June 30, 2013, the Company had \$695,000 of credit availability under the HFL Loan for general and administrative costs for the second quarter, and all of the availability for the



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third and fourth quarters of 2013 of \$940,000 and \$986,000, respectively.

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*Other Loan Payable.* On July 31, 2012, the Company entered into a promissory note to finance \$237,000 of premiums (net of a down payment of \$27,000) related to certain insurance policies with premiums equal to a total of \$264,000. The promissory note had an interest rate of 2.99%, required nine equal monthly payments of approximately \$27,000 beginning August 31, 2012, and incurred approximately \$3,000 of finance charges, or interest, over the term until its maturity on April 30, 2013. The promissory note was paid in full on May 2, 2013. The outstanding balance as of June 30, 2013 and December 31, 2012 was \$-0- and \$105,000, respectively.

**Note 6 Income Taxes**

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

	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2013</b>	<b>2012</b>	<b>2013</b>	<b>2012</b>
<b>Federal</b>				
Current	\$ 265	\$ 1,045	\$ 265	\$ (8)
Deferred		(1,698)		(5,566)
Sub-total	265	(653)	265	(5,574)
<b>State</b>				
Current	44	(22)	51	(11)
Deferred				
Sub-total	44	(22)	51	(11)
<b>Total</b>	<b>\$ 309</b>	<b>\$ (675)</b>	<b>\$ 316</b>	<b>\$ (5,585)</b>

The Company recorded no federal deferred tax benefit for the six months ended June 30, 2013 since the deferred tax asset resulting from the estimated tax loss for the same period in the amount of \$496,000 was offset by a full valuation allowance. The federal current tax expense in the second quarter of 2013 and six month period ended June 30, 2013 of \$265,000 is attributable to the receipt of federal tax refund of \$4,305,000, compared to the estimated refund amount of \$4,570,000 reported at December 31, 2012.

The net deferred tax asset for the Company was \$4,000 and \$4,000 at June 30, 2013 and December 31, 2012, respectively.

At June 30, 2013, the deferred tax asset, before valuation allowance, was comprised principally of \$4,971,000 related to the anticipated carryforward of the remaining 2012 taxable loss not eligible for carryback and the estimated taxable loss for the first six months of 2013 to future periods; \$265,000 of alternative minimum tax credits; and \$520,000 of net temporary differences, including \$707,000 related to loss reserves on litigation matters. Due to continuing uncertainty related to taxable income to be reported in future periods (after consideration of historical results, current business trends, and other objectively verifiable information), the Company continues to record a valuation allowance on substantially all of its deferred tax assets at June 30, 2013.

At December 31, 2012, the deferred tax asset, before valuation allowance, was comprised principally of \$4,482,000 related to the anticipated carryforward of the 2012 taxable loss to future periods and \$528,000 of net temporary differences, including \$707,000 related to loss reserves on litigation matters. Due to uncertainty related to taxable income to be reported in future periods, the Company recorded an additional valuation

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allowance at December 31, 2012 for the deferred tax asset in the amount of \$5,012,000.

The Company had a federal income tax receivable of \$- and \$4,570,000 at June 30, 2013 and December 31, 2012, respectively, and net state taxes receivable of \$121,000 and \$262,000 at June 30, 2013 and December 31, 2012, respectively. The federal income tax receivable as of December 31, 2013 is for the carryback of the 2012 federal net operating loss to the 2010 tax year; in late May 2013, the Company received a net refund of approximately \$4,300,000, after payment of \$265,000 of alternative minimum taxes related to the 2010 tax year.

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**Note 7 Fair Value of Financial Instruments**

The following table summarizes the valuation of the Company's financial instruments based upon the inputs used to measure fair value in the three levels of the fair value hierarchy as of June 30, 2013 and December 31, 2012.

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>June 30, 2013</b>		
	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>
Cash Equivalents			
Money market funds	\$ 2	\$	\$

  

	<b>December 31, 2012</b>		
	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>
Cash Equivalents			
Money market funds	\$ 23	\$	\$

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 and other liabilities. Because the interest rate on the Revolving Credit Facility is variable, the fair value approximates its carrying value. In addition, the fair value of the HFL Loan approximates its carrying as of June 30, 2013 and December 31, 2012.

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

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

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

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Description	Six Months Ended	
	June 30,	
	2013	2012
Accrued capital expenditures in accounts payable and accrued expenses:		
Amount at end of period	\$ 142	\$ 59
<b><i>Supplemental disclosures of cash payments:</i></b>		
Income taxes paid (refunded)	\$ (4,395)	\$ 130
Interest paid	357	46

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**Note 9 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 June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
<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	\$ (357)	\$ (1,223)	\$ (1,701)	\$ (10,775)

No shares were excluded from the calculation of diluted earnings per share.

**Note 10 Related Party Transactions**

*Hallwood Investments Limited.* The Company has entered into a financial consulting contract with Hallwood Investments Limited ( HIL ), an entity associated with Mr. Anthony J. Gumbiner, the Company's chairman, Chief Executive Officer 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 June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Consulting fees	\$ 249	\$ 249	\$ 498	\$ 498
Interest expense on HFL Loan	111	80	241	80
Office space and administrative services	47	88	117	153
Travel and other expenses	4	9	19	27
<b>Total</b>	<b>\$ 411</b>	<b>\$ 426</b>	<b>\$ 875</b>	<b>\$ 758</b>

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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 \$111,000 and \$133,000 at June 30, 2013 and December 31, 2012, respectively. See Note 5 for more information.

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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 have received consulting fees, bonuses, stock options, profit interests or other forms of compensation and expenses. No such services were performed, or compensation earned, during 2013 or 2012. 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 Dallas 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 June 30, 2013 and 2012, these companies reimbursed the Company \$26,000 and \$27,000, respectively, for such expenses. For the six months ended June 30, 2013 and 2012, these companies reimbursed the Company \$56,000 and \$53,000, respectively.

**Note 11 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, 2012.

*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 the Company 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. Hallwood Group has spent significant amounts in professional fees and other associated costs in connection with these matters, and it expends professional fees and other costs associated with litigation matters as incurred.

In July 2007, Nextec Applications, Inc. filed *Nextec Applications, Inc. v. Brookwood Companies Incorporated and The Hallwood Group Incorporated* in the United States District Court for the Southern District of New York (SDNY No. CV 07-6901) claiming that 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 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 and submitted its appeal brief on January 28, 2013. Brookwood subsequently filed a notice of cross-appeal and filed its brief on May 3, 2013. Nextec filed its Response and Reply brief on July 1, 2013, and Brookwood filed its Reply brief on August 1, 2013. 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 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, the Patent Office has since received Nextec's responsive arguments and subsequently issued a reexamination certificate. With respect to the second patent, the Patent Office has since received Nextec's responsive arguments and has issued a final rejection to that patent. Nextec has appealed this rejection.



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*Hallwood Energy*. In March 2009, Hallwood Energy, Hallwood Energy Management, LLC, its general partner, ( 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 Brookwood.

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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 (the 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 damage was 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 Defendant. In light of the Court's disposition of the theories advanced in the second amended complaint, the adversary proceeding was now 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.

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

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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.

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As a result of the 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 of \$21,721,000, including prejudgment and postjudgment interest, in two payments: \$3,774,000 on May 4, 2012 and \$17,947,000 on May 9, 2012. The Company appealed to the Fifth Circuit Court of Appeals the portions of the Judgment awarding a combined \$17,947,000 on the plaintiffs' tort claims. However, on June 7, 2013, the Fifth Circuit affirmed the judgment. The parties settled the amount of court costs for approximately \$101,000, which was paid in August 2012. In addition, the Company will be required to pay certain attorneys' fees incurred by the plaintiffs. At June 30, 2013 and December 31, 2012, the litigation reserve for the Hallwood Energy Matters is \$2,079,000. 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. On August 6, 2013, the Bankruptcy Court informed the parties that it would recommend to the District Court that the plaintiffs be awarded \$996,490.72 in aggregate attorneys' fees. The Bankruptcy Court indicated that it would soon file its report and recommendation, after which the parties will have the opportunity to submit objections to the District Court. The District Court will decide whether to adopt, reject, or modify the Bankruptcy Court's report and recommendation, which could take several months. The Company has not adjusted downward the litigation reserve amount, pending a final decision from the District Court.

*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 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 Creditor's 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.



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*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 settles 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 include 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, L.P. and various entities related to the foregoing persons from all claims asserted in or relating 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 may have 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 those legal fees and costs. The aggregate limit for each policy year under the Company's policies has been \$10,000,000. The insurance carrier has taken the position that all of the claims asserted in the Hallwood Energy litigation relate to the 2008-2009 policy year.

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 does not have insurance coverage available to satisfy any judgment that may be rendered in connection with the Proposed Findings. The insurance carrier is also not reimbursing 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

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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.

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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, 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 \$572,000 in the year ended December 31, 2012 and \$80,000 during the six months ended June 30, 2013. In addition, Brookwood and its subsidiaries regularly incur expenses associated with various studies and tests to monitor and maintain compliance with diverse environmental requirements.



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**Note 12 Segments and Related Information**

The Company operates as a holding company with its principal business in the textile products industry through its Brookwood subsidiary. The following represents the Company's reportable amounts by business segment for the three and six months ended June 30, 2013 and 2012, respectively (in thousands):

	<b>Textile Products (a)</b>	<b>Other (b)</b>	<b>Consolidated</b>
<b>Three Months ended June 30, 2013</b>			
Total revenue from external sources	\$ 32,484	\$	\$ 32,484
Operating income (loss)	\$ 1,105	\$ (1,064)	\$ 41
Other income (expense), net	(44)	(45)	(89)
Income (loss) before income taxes	\$ 1,061	\$ (1,109)	\$ (48)
<b>Three Months ended June 30, 2012</b>			
Total revenue from external sources	\$ 37,182	\$	\$ 37,182
Operating income (loss)	\$ (734)	\$ (1,053)	\$ (1,787)
Other income (expense), net	(32)	(79)	(111)
Income (loss) before income taxes	\$ (766)	\$ (1,132)	\$ (1,898)
<b>Six Months ended June 30, 2013</b>			
Total revenue from external sources	\$ 63,767	\$	\$ 63,767
Operating income (loss)	\$ 1,199	\$ (2,302)	\$ (1,103)
Other income (expense), net	(106)	(176)	(282)
Income (loss) before income taxes	\$ 1,093	\$ (2,478)	\$ (1,385)
<b>Six Months ended June 30, 2012</b>			
Total revenue from external sources	\$ 73,061	\$	\$ 73,061
Operating income (loss)	\$ (668)	\$ (15,557)	\$ (16,225)
Other income (expense), net	(57)	(78)	(135)
Income (loss) before income taxes	\$ (725)	\$ (15,635)	\$ (16,360)

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- (a) The operating income (loss) amounts for Brookwood, the textile products segment, include costs and expenses for the Nextec litigation of \$255,000 and \$1,741,000 for the 2013 and 2012 second quarter periods, respectively, and \$301,000 and \$3,409,000 for the 2013 and 2012 six month periods, respectively . See Note 11 for more information on the Nextec litigation.
- (b) In connection with the Hallwood Energy litigation matters discussed in Note 11, the Company recorded a loss reserve of \$13,200,000 in the 2012 first quarter.

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, 2012 annual report. The total assets for Hallwood Group s operating segments have not materially changed since the December 31, 2012 annual report.

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**Forward-Looking Statements**

This Quarterly Report on Form 10-Q (this Form 10-Q), including but not limited to the section of this Form 10-Q entitled Management's Discussion and Analysis of Financial Condition and Results of Operations, information concerning the Company's business prospects or future financial performance, anticipated revenues, expenses, profitability or other financial items, including the outcome of pending litigation, and its strategies, plans and objectives, together with other statements that are not historical facts, includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (the Securities Act), and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act). Forward-looking statements generally can be identified by the use of forward-looking terminology, such as may, might, will, would, expect, intend, could, estimate, should, anticipate, doubt or believe. The Company intends that its forward-looking statements be subject to the safe harbors created by these laws. All statements other than statements of historical information provided herein are forward-looking and may contain information about financial results, economic conditions, trends, and known uncertainties. All forward-looking statements are based on current expectations regarding important risk factors. Many of these risks and uncertainties are beyond the Company's ability to control, and, in many cases, the Company cannot predict all of the risks and uncertainties that could cause actual results to differ materially from those expressed in the forward-looking statements. Actual results could differ materially from those expressed in the forward-looking statements, and readers should not regard those statements as a representation by the Company or any other person that the results expressed in the statements will be achieved. Important risk factors that could cause results or events to differ from current expectations are described in the Company's annual report on Form 10-K for the year ended December 31, 2012 under Item 1A Risk Factors. These factors are not intended to be an all-encompassing list of risks and uncertainties that may affect the operations, performance, development and results of the Company's business. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. The Company undertakes no obligation to release publicly the results of any revisions to these forward-looking statements which may be made to reflect events or circumstances after the date hereof, including without limitation, changes in its business strategy or planned capital expenditures, growth plans, or to reflect the occurrence of unanticipated events, although other risks and uncertainties may be described, from time to time, in the Company's periodic reports and filings with the Securities and Exchange Commission (the SEC).

**Overview**

*General.* The Hallwood Group Incorporated (the Company) (NYSE MKT: HWG) was incorporated in Delaware in 1981 and 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).

*Hallwood Financial Proposal and Merger Agreement.* As previously announced, on November 6, 2012, the Company received a proposal (the HFL Proposal) from Hallwood Financial Limited (Parent) to acquire all of the outstanding shares of Company Common Stock that it does not beneficially own at a cash purchase price of \$10.00 per share. On November 7, 2012, at the Company's regularly scheduled Board of Directors meeting, a special committee, consisting solely of independent and disinterested directors (the Special Committee), was formed to consider and negotiate the HFL Proposal and to make a recommendation to the Company's Board of Directors. Subsequently, the Special Committee retained its own independent legal representation and selected and engaged a financial advisor to assist in the review of the proposed transaction.

On June 4, 2013, the Company announced that the Company, Parent, and HFL Merger Corporation, a Delaware corporation and a wholly owned subsidiary of the Parent (Merger Sub), entered into an Agreement and Plan of Merger (the Merger Agreement). The Merger Agreement provides that, upon the terms and subject to the conditions set forth in the Merger Agreement, Merger Sub will merge with and into the Company (the Merger), with the Company continuing as the surviving corporation and a wholly owned subsidiary of Parent. Parent is controlled by Anthony J. Gumbiner, Chairman and Chief Executive Officer of the Company and Parent currently owns 1,001,575, or 65.7%, of the issued and outstanding shares of common stock, par value \$0.10 per share, of the Company (such shares, collectively, the Company Common Stock, and, each, a Share).

All of the members of the Board of Directors of the Company other than Mr. Gumbiner (who did not participate in the meeting), acting upon the unanimous recommendation of the Special Committee, have (i) determined that it is in the best interests of the Company and its stockholders (other than Parent and Merger Sub), and declared it advisable, to enter into the Merger Agreement, (ii) approved the execution, delivery and performance of the Merger Agreement and the consummation of the transactions contemplated thereby, including the Merger and (iii) resolved to recommend adoption of the Merger Agreement by the stockholders of the Company;



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At the effective time of the Merger, each Share of Company Common Stock outstanding immediately prior to the effective time of the Merger and not already owned by Parent will receive \$10.00 in cash, without interest.

Stockholders of the Company will be asked to vote on the adoption of the Merger Agreement at a special stockholders meeting that will be held on a date to be announced. The closing of the Merger is subject to a non-waivable condition that the Merger Agreement be adopted by (i) the affirmative vote of the holders of a majority of the outstanding shares of the Company Common Stock entitled to vote on the adoption of the Merger Agreement, voting together as a single class, and (ii) the affirmative vote of the holders of a majority of the outstanding shares of the Company Common Stock, voting together as a single class, excluding all shares of Company Common Stock owned by Parent, Merger Sub, Mr. Gumbiner or any of their respective affiliates (other than the Company and its subsidiaries), or by any director, officer or other employee of the Company or any of its subsidiaries.

Consummation of the Merger is subject to certain other customary conditions, including, among others, (i) absence of any order or injunction prohibiting the consummation of the Merger, (ii) subject to certain exceptions, the accuracy of representations and warranties with respect to the business of the Company, (iii) each of the Company and Parent having performed their respective obligations pursuant to the Merger Agreement and (iv) the absence of a Company Material Adverse Effect, which is defined in the Merger Agreement to include the occurrence of an Event of Default under that certain Loan Agreement, dated as of March 30, 2012, among Branch Banking and Trust Company, Brookwood Companies Incorporated, the Company and the other signatories thereto, filed with the SEC as Exhibit 10.20 to the Company's Annual Report on Form 10-K for the year ended December 31, 2011.

In connection with the proposed merger transaction, the Company will file with the SEC and furnish to the Company's stockholders a Proxy Statement and other relevant documents. Before making any voting decision, the Company's stockholders are urged to read the Proxy Statement in its entirety when it becomes available and any other documents to be filed with the SEC in connection with the proposed merger or incorporated by reference into the Proxy Statement because those documents will contain important information about the proposed merger and the parties to the merger. The Company's stockholders will be able to obtain a free copy of documents filed with the SEC at the SEC's website at <http://www.sec.gov>. In addition, the Company's stockholders may obtain a free copy of the Company's filings with the SEC from the Company's website at <http://www.hallwood.com/hwg/SEC.php> or by directing a request to: The Hallwood Group Incorporated, 3710 Rawlins, Suite 1500, Dallas, TX 75219; Attention: Investor Relations; Phone: (214) 528-5588 or (800) 225-0135.

On July 11, 2013, the Merger Agreement was amended to provide that it would not be commercially reasonable to file the Proxy Statement and Schedule 13E-3 prior to October 31, 2013.

The foregoing information only summarizes certain terms of the Merger Agreement, as amended, and is not a complete description of all of the parties' rights and obligations under the Merger Agreement, as amended. For the complete terms, please read: (a) the Merger Agreement as Exhibit 2.1 to the Company's Current Report on Form 8-K filed with the SEC on June 5, 2013 and (b) the amendment included as Exhibit 2.1 to the Company's Current Report on Form 8-K filed with the SEC on June 12, 2013.

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 HFL Proposal) at \$6.00 per share. The Company's shares closed on August 8, 2013 at \$9.60 per share.

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*Going Concern.* As discussed in depth throughout this Form 10-Q and on Form 10-K for the year ended December 31, 2012, the Company and its subsidiaries are involved in a number of litigation matters and have spent significant amounts in professional fees in connection with the defense of its pending legal matters. As further discussed in Note 11 of this Form 10-Q, in connection with Hallwood Energy's bankruptcy proceeding, Hallwood Energy and other parties filed a number of lawsuits against the Company, its directors and various other parties. In July 2011, the court in the Adversary Proceeding issued Proposed Findings setting forth damages totaling approximately \$18,700,000, plus prejudgment and postjudgment interest. In April 2012, the United States District Court substantially adopted the Proposed Findings. The Company satisfied the Judgment of \$21,721,000, including prejudgment and postjudgment interest, in May 2012, in part funded by a loan in the amount of \$10,000,000 from Hallwood Family (BVI) L.P., a limited partnership associated with Mr. Anthony J. Gumbiner, the Company's chairman, Chief Executive Officer and principal stockholder (the HFL Loan).

As further discussed under Item 1A, Risk Factors of Form 10-K for the year ended December 31, 2012, (i) the Company is dependent upon Brookwood for cash, (ii) the Company does not currently earn sufficient cash through its operations, directly or through Brookwood, to fund its ongoing operating costs without in part utilizing its available line of credit under the HFL Loan, and (iii) Brookwood's ability to pay the Company a dividend or other advance is dependent upon circumstances that are outside of the Company's control. The Company can give no assurance that Brookwood will have the ability to satisfy the Company's cash flow needs, or that the Company would be able to obtain other sources of funding in such a circumstance, and therefore there is substantial doubt as to the Company's ability to continue as a going concern.

The Company's audited consolidated financial statements for the fiscal year ended December 31, 2012, as included on Form 10-K for the year ended December 31, 2012, contained an audit opinion from its independent public accounting firm which included explanatory language related to going concern resulting from the uncertainty of the payment of dividends from its subsidiary to fund the Company's ongoing operations and obligations.

Brookwood paid dividends to the Company of \$650,000 and \$250,000, respectively, in January 2013 and April 2013. Subsequent to June 30, 2013, Brookwood paid a dividend to the Company of \$1,000,000 in July 2013.

As a holding company, the Company is dependent on Brookwood to receive the cash necessary to fund its ongoing operations and its obligations. At June 30, 2013 and December 31, 2012, the Company had approximately \$126,000 and \$145,000, respectively, of cash and cash equivalents. Any failure to receive from Brookwood cash required by the Company could have a material adverse effect on the Company's financial position, results of operations and cash flows and could substantially impair the Company's ability to continue as a going concern.

As a result, the Company can give no assurance that Brookwood will have the ability to satisfy the Company's cash flow needs, nor that the Company would be able to obtain other sources of funding in such a circumstance, and therefore the aforementioned circumstances raise substantial doubt as to 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.

*Second Amendment to HFL Loan and Proceeds of IRS Refund Reduce HFL Loan.* On May 13, 2013, the promissory note associated with the HFL Loan was amended, pursuant to a Second Amendment to Promissory Note, to convert it to a revolving credit facility to provide additional liquidity to the Company. The maturity date of the promissory note continues to be June 30, 2015.

Subject to the terms and conditions of the HFL Loan, upon written request, the Company may borrow and receive advances of amounts requested by the Company (including amounts previously repaid) not to exceed either of:

- (a) The amount in each calendar quarter equal to the amount budgeted by the Company to fund general and administrative costs for that calendar quarter; or

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(b) An amount that would result in the aggregate principal amount of the HFL Loan to exceed \$10,000,000.

General and administrative costs were \$1,064,000 in the second quarter of 2013, and are estimated to be approximately \$940,000, and \$986,000 in the third and fourth quarters of 2013. These general and administrative costs are estimated based on historic recurring costs of the Company and the actual amount of general and administrative costs of the Company for these periods

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could differ significantly as a result of unforeseen and/or other non-recurring costs. Amounts borrowed may be repaid and reborrowed at any time prior to the Final Revolver Draw Date (as defined in Note 5 of this Form 10-Q). Hallwood Financial Limited shall have no obligation to advance any additional amounts to the Company on or after the Final Revolver Draw Date.

In late May 2013, the Company received a net refund of approximately \$4,300,000 from the IRS of 2010 federal taxes. The proceeds of these funds were used to pay \$4,000,000 towards principal and interest outstanding on the HFL Loan, with the balance retained for the Company's expenses and cash needs. As of June 30, 2013, the outstanding balance of the HFL Loan was \$5,411,000. As of June 30, 2013, the Company had \$695,000 of credit availability under the HFL Loan for general and administrative costs for the second quarter, and all of the availability for the third and fourth quarters of 2013 of \$940,000 and \$986,000, respectively.

*Textile Products.* In 2013 and 2012, 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.

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. Military sales of \$16,388,000 and \$32,102,000 for the 2013 second quarter and six month periods, respectively, were 16.2% and 22.1% lower than the comparable periods in 2012 of \$19,556,000 and \$41,231,000.

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, procurement entity budgets, 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 it 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 are 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 will potentially continue.

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

The textile products business is not interdependent with the Company's other business operations, if any. 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 satisfy any of the Company's liabilities nor contribute additional capital to the Company beyond dividend payments and the tax sharing agreement.





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**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**

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

**Presentation**

The discussion of Hallwood Group's financial condition and results of operations 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 \$(357,000) and \$(1,701,000) for the second quarter of 2013 and six month period ended June 30, 2013, respectively, compared to a net loss of \$(1,223,000) and \$(10,775,000) for the same periods in 2012. Revenue for the second quarter of 2013 and six month period ended June 30, 2013, respectively, was \$32,484,000 and \$63,767,000, compared to \$37,182,000 and \$73,061,000 for the same periods in 2012.

Hallwood Group had an operating income (loss) of \$41,000 and \$(1,103,000) in the second quarter of 2013 and six month period ended June 30, 2013, respectively, compared to \$(1,787,000) and \$(16,225,000) for the same periods in 2012. The results for the 2012 six month period included a litigation charge of \$13,200,000 in connection with the Hallwood Energy litigation matters.

Brookwood had operating income of \$1,105,000 and \$1,199,000 for the second quarter of 2013 and six month period ended June 30, 2013, respectively, compared to an operating loss of \$(734,000) and \$(668,000) for the same periods in 2012. The results included costs and expenses incurred by Brookwood in the Nextec litigation matters totaling \$255,000 and \$301,000 for the second quarter of 2013 and six month period ended June 30, 2013, compared to \$1,741,000 and \$3,409,000 for the same periods in 2012.

The Company had operating losses of \$(1,064,000) and \$(2,302,000) for the second quarter of 2013 and six month period ended June 30, 2013, respectively, compared to \$(1,053,000) and \$(15,557,000) for the same periods in 2012. The results for the 2012 six month period included a litigation charge of \$13,200,000 in connection with the Hallwood Energy litigation matters.

**Revenues**

Textile products sales of \$32,484,000 decreased by \$4,698,000, or 12.6%, in the 2013 second quarter, compared to \$37,182,000 for the same period in 2012. Sales for the 2013 six month period of \$63,767,000 decreased by \$9,294,000, or 12.7%, compared to \$73,061,000 in 2012. The decreases in 2013 were principally due to reduced sales of specialty fabric to U.S. military contractors as a result of decreases in orders from the military to Brookwood's customers. Military sales accounted for \$16,388,000 and \$32,102,000 in the 2013 second quarter and six month periods, compared to \$19,556,000 and \$41,231,000 in 2012, respectively. The military sales represented 50.5% and 52.6% of Brookwood's net sales in the 2013 and 2012 second quarters, respectively, and 50.3% and 56.4% in the 2013 and 2012 six 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 to one Brookwood customer, Tennier Industries, Inc. (Tennier), accounted for more than 10% of Brookwood's sales during 2013 and 2012. Brookwood's relationship with Tennier is ongoing. Sales to Tennier, which are included in military sales, were \$7,898,000 and \$14,848,000 in the 2013 second quarter and six month periods, respectively, compared to \$3,992,000 and \$10,700,000 in the 2012 comparable periods. Sales to Tennier represented 24.3% and 10.7% of Brookwood's net sales in the 2013 and 2012 second quarters, respectively, and 23.3% and 14.6% in the 2013 and 2012 six month periods, respectively.

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Textile products cost of sales of \$27,456,000 for the 2013 second quarter decreased by \$4,808,000, or 14.9%, compared to \$32,264,000 for the same period in 2012. For the six month periods, textile products cost of sales of \$54,915,000 for 2013 decreased by \$7,498,000, or 12.0%, compared to \$62,413,000 in 2012. The 2013 decreases are primarily a result of a reduction in textile product sales, principally from lower military sales, and changes in overall product mix in a quarter to quarter comparison. 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 2013 second quarter was 15.5%, compared to 13.2% for 2012, and for the 2013 six month period, 13.9% versus 14.6%. 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 June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Brookwood	\$ 3,923	\$ 5,652	\$ 7,653	\$ 11,315
Company	1,064	1,053	2,302	2,358
<b>Total</b>	<b>\$ 4,987</b>	<b>\$ 6,705</b>	<b>\$ 9,955</b>	<b>\$ 13,673</b>

Brookwood's administrative and selling expenses of \$3,923,000 for the 2013 second quarter decreased by \$1,729,000, or 30.6% from the same period in 2012. Brookwood's administrative and selling expenses of \$7,653,000 for the 2013 six month period decreased by \$3,662,000, or 32.4% from the same period in 2012. Brookwood's administrative and selling expenses included items such as payroll, professional fees, sales 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 \$147,000 and \$316,000 for the three and six months ended June 30, 2013, respectively, compared to \$164,000 and \$370,000 for the comparable 2012 periods.

Costs and expenses incurred by Brookwood in the Nextec litigation totaled \$255,000 and \$301,000 for the second quarter of 2013 and six month period ended June 30, 2013, respectively, compared to \$1,741,000 and \$3,409,000 for the same periods in 2012. 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. (For a further discussion of the Nextec litigation, see Note 11 in the accompanying condensed consolidated financial statements.)

The Company's administrative expenses increased \$11,000, or 1.0%, for the 2013 second quarter, compared to the 2012 second quarter. The Company's administrative expenses decreased \$56,000, or 2.4%, for the six month period ended June 30, 2013, compared to the same period in 2012. The six month decrease was attributable to lower costs and expenses associated with the defense in the Hallwood Energy litigation matters, partially offset by increases in certain other professional fees related to the HFL Proposal.

*Litigation charge.* In connection with the Hallwood Energy litigation matters discussed in Note 11, 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 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

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Judgment, the Company recorded an additional charge of \$13,200,000 in the first quarter of 2012.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Brookwood	\$ 44	\$ 32	\$ 106	\$ 57
Company	112	80	243	80
<b>Total</b>	<b>\$ 156</b>	<b>\$ 112</b>	<b>\$ 349</b>	<b>\$ 137</b>

Brookwood's interest expense principally relates to its revolving credit facility. The Company's interest expense substantially relates to the HFL Loan, which was entered into in May 2012.

Interest and other income were \$67,000 and \$67,000 in the second quarter of 2013 and six month period ended June 30, 2013, respectively, compared to \$1,000 and \$2,000 for the same periods in 2012. In the second quarter of 2013, the Company received net proceeds of approximately \$113,000 from the sale of a parcel of vacant land; the property sale resulted in a gain of \$67,000.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Federal				
Current	\$ 265	\$ 1,045	\$ 265	\$ (8)
Deferred		(1,698)		(5,566)
Sub-total	265	(653)	265	(5,574)
State				
Current	44	(22)	51	(11)
Deferred				
Sub-total	44	(22)	51	(11)
Total	\$ 309	\$ (675)	\$ 316	\$ (5,585)

The Company recorded no federal deferred tax benefit for the six months ended June 30, 2013 since the deferred tax asset resulting from the estimated tax loss for the same period in the amount of \$496,000 was offset by a full valuation allowance. The federal current tax expense in the second quarter of 2013 and six month period ended June 30, 2013 of \$265,000 is attributable to the receipt of federal tax refund of \$4,305,000, compared to the estimated refund amount of \$4,570,000 reported at December 31, 2012.

At June 30, 2013, the deferred tax asset, before valuation allowance, was comprised principally of \$4,971,000 related to the anticipated carryforward of the 2012 remaining taxable loss not eligible for carryback and the estimated taxable loss for the first six months of 2013 to future periods; \$265,000 of alternative minimum tax credits; and \$520,000 of net temporary differences, including \$707,000 related to loss reserves on litigation matters. Due to continuing uncertainty related to taxable income to be reported in future periods (after consideration of historical results, current business trends, and other objectively verifiable information), the Company continues to record a valuation allowance on substantially all of its deferred tax assets at June 30, 2013.

**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, 2012.

**Related Party Transactions**

*Hallwood Investments Limited.* The Company has entered into a financial consulting contract with Hallwood Investments Limited (HIL), an entity associated with Mr. Anthony J. Gumbiner, the Company's chairman, Chief Executive Officer 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

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Company pursuant to the financial consulting agreement and for travel and related expenses 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 is detailed below (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Consulting fees	\$ 249	\$ 249	\$ 498	\$ 498
Interest expense on HFL Loan	111	80	241	80
Office space and administrative services	47	88	117	153
Travel and other expenses	4	9	19	27
<b>Total</b>	<b>\$ 411</b>	<b>\$ 426</b>	<b>\$ 875</b>	<b>\$ 758</b>

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 \$111,000 and \$133,000 at June 30, 2013 and December 31, 2012, respectively. See Note 5 for more information.

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 have received consulting fees, bonuses, stock options, profit interests or other forms of compensation and expenses. No such services were performed, or compensation earned, during 2013 or 2012. 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 Dallas 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 June 30, 2013 and 2012, these companies reimbursed the Company \$26,000 and \$27,000, respectively, for such expenses. For the six months ended June 30, 2013 and 2012, these companies reimbursed the Company \$56,000 and \$53,000, respectively.

**Litigation**

Refer to Note 11 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 June 30, 2013 (in thousands):

	Payments Due During the Years Ending December 31,						Total
	2013*	2014	2015	2016	2017	Thereafter	
<b>Contractual Obligations</b>							
Revolving Credit Facility	\$	\$ 1,500	\$	\$	\$	\$	\$ 1,500
HFL Loan			5,411				5,411
Operating leases	381	747	583	212			1,923
<b>Total</b>	<b>\$ 381</b>	<b>\$ 2,247</b>	<b>\$ 5,994</b>	<b>\$ 212</b>	<b>\$</b>	<b>\$</b>	<b>\$ 8,834</b>

\* For the six months ending December 31, 2013.

Interest costs associated with Brookwood's Revolving Credit Facility, which bears interest at variable rates, are not a material component of the Company's consolidated expenses. Estimated interest payments, based on the principal balance as of June 30, 2013 and weighted average interest rates, assuming the renewal of the Revolving Credit Facility, are \$84,000, for each of the years ending December 31, 2013 through December 31, 2017, respectively. Estimated interest payments associated with the Company's HFL Loan, based on the principal balance as of June 30, 2013, are approximately \$327,000 per year.

*Other Loan Payable.* On July 31, 2012, the Company entered into a promissory note to finance \$237,000 of premiums (net of a down payment of \$27,000) related to certain insurance policies with premiums equal to a total of \$264,000. The promissory note had an interest rate of 2.99%, required nine equal monthly payments of approximately \$27,000 beginning August 31, 2012, and incurred approximately \$3,000 of finance charges, or interest, over the term until its maturity on April 30, 2013. The promissory note was paid in full on May 2, 2013. The outstanding balance as of June 30, 2013 and December 31, 2012 was \$-0 and \$105,000, respectively.

*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 Plan) to incentivize employees of Brookwood to increase the value of Brookwood and to continue their employment with Brookwood. The terms of the 2005 Plan provide for a total award amount to participants equal to 15% of the net fair market value of all consideration received by the Company or its stockholders in a change of control transaction (as defined in the 2005 Plan and further explained below), in excess of the sum of the liquidation preference plus accrued but unpaid dividends on Brookwood's Series A Preferred Stock (the Preferred Stock) (\$14,161,000 at June 30, 2013). The base amount will fluctuate in accordance with a formula that increases by the amount of the annual dividend on the preferred stock of \$1,823,000, and decreases by the amount of the cash dividends actually paid. The 2005 Plan generally defines a change of control transaction as a transaction that (i) is approved by the Company's board of directors or by the holders of at least 50% of the Company's voting capital stock then-entitled to vote generally in the election of directors, (ii) is a transaction in which either the Company or its stockholders receive consideration, and (iii) results in: (x) a change in beneficial ownership of the Company or Brookwood of at least 50% of the combined voting power of the Company's or Brookwood's then-outstanding stock then-entitled to vote generally in the election of directors, (y) the sale of all or substantially all of the assets of Brookwood, or (z) any other transaction that, in the discretion of the Company's board of directors has substantially the same effect as the transactions specified in clauses (x) and (y), above. Pursuant to the terms of the 2005 Plan, certain transfers, generally among existing stockholders and their related parties, do not fall within the

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meaning of "change in control" under the 2005 Plan.

However, if the Company's board of directors determines that certain specified Brookwood officers, or other persons performing similar functions do not have, in the aggregate and prior to the change of control transaction 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 certain members of Brookwood's senior management do not have, in the aggregate and prior to a change of control transaction, 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. As of June 30, 2013, no amounts have been accrued or paid under the 2005 plan.

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Hallwood Group has no off-balance sheet arrangements.

**Financial Covenants**

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

Description	Requirement	Quarters Ended			
		June 30, 2013	Mar 31, 2013	Dec 31, 2012	Sept 30, 2012
Current ratio	must be greater than ratio of 1.40	2.62	2.54	2.66	2.35
Total liabilities to tangible net worth	must be less than ratio of 1.50	0.41	0.43	0.41	0.50
Total funded debt to EBITDA	must be less than ratio of 4.00 (a)	0.43	1.53	3.07	2.44

- (a) On August 24, 2012, the 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.

As of June 30, 2013, March 31, 2013 and for each of the quarterly periods during 2012, Brookwood was in compliance with loan covenants of the Revolving Credit Facility. In order to maintain compliance with such covenants in the future, Brookwood may be required to limit aggregate borrowings under the 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 Revolving Credit Facility. This limitation on the transferability of assets constitutes a restriction of Brookwood's net assets, which were \$47,548,000 and \$47,751,000 at June 30, 2013 and December 31, 2012, respectively.

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**Liquidity and Capital Resources**

*General.* The Company, through its Brookwood subsidiary, principally operates in the textile products segment. The Hallwood Group's cash position decreased by \$33,000 during the 2013 six month period to \$160,000 as of June 30, 2013. The principal source of cash in the 2013 six month period was \$8,024,000 provided by operations (including a net refund of approximately \$4,300,000 from the IRS of 2010 federal taxes). The primary uses of cash were \$786,000 for property, plant and equipment, principally at Brookwood, \$3,830,000 of net repayment of the Revolving Credit Facility, \$3,336,000 of net repayment on the HFL Loan, and \$105,000 of repayment of other loans payable. Additionally, the results included costs and expenses incurred by the Company and Brookwood in the Hallwood Energy and Nextec litigation matters totaling \$272,000 and \$3,540,000 for the 2013 and 2012 six month periods, respectively. The amounts outstanding under the Revolving Credit Facility and HFL Loan were \$1,500,000 and \$5,411,000, respectively, at June 30, 2013.

The Company is dependent on fees, dividends, payments under a tax sharing agreement, advances from Brookwood, and the HFL Loan 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. Any failure to receive cash from Brookwood or funding under the HFL Loan as required by the Company could have a material adverse effect on the Company's financial position, results of operations and cash flows and could substantially impair the Company's ability to continue as a going concern.

The Company's audited consolidated financial statements for the fiscal year ended December 31, 2012, included on Form 10-K, contained an audit opinion from its independent public accounting firm which included explanatory language related to going concern resulting from the uncertainty of the payment of dividends from its subsidiary to fund the Company's ongoing operations and obligations.

*Impact of the Judgment and Dependency upon Brookwood for Dividends on the Company's Liquidity.* The Company and its subsidiaries are involved in a number of litigation matters and have spent significant amounts in professional fees in connection with the defense of its pending legal matters. As further discussed in Note 11 of this Form 10-Q, in connection with Hallwood Energy's bankruptcy proceeding, Hallwood Energy and other parties filed a number of lawsuits against the Company, its directors and various other parties. In July 2011, the court in the Adversary Proceeding issued Proposed Findings setting forth damages totaling approximately \$18,700,000, plus prejudgment and postjudgment interest. In April 2012, the United States District Court substantially adopted the Proposed Findings. The Company satisfied the Judgment of \$21,721,000, including prejudgment and postjudgment interest, in May 2012.

As a holding company, the Company is dependent on Brookwood to receive the cash necessary to fund its ongoing operations and its obligations. At June 30, 2013 and December 31, 2012, the Company had approximately \$126,000 and \$145,000, respectively, of cash and cash equivalents. This amount is not sufficient to fund the Company's ongoing operations and obligations. Any failure to receive from Brookwood cash required by the Company could have a material adverse effect on the Company's financial position, results of operations and cash flows and could substantially impair the Company's ability to continue as a going concern. In the event that Brookwood is unable to pay sufficient dividends to the Company to fund its ongoing operating costs, the Company will utilize its available line of credit under the HFL Loan.

*Second Amendment to HFL Loan and Proceeds of IRS Refund Reduce HFL Loan.* On May 13, 2013, the promissory note associated with the HFL Loan was amended, pursuant to a Second Amendment to Promissory Note, to convert it to a revolving credit facility to provide additional liquidity to the Company. The maturity date of the promissory note continues to be June 30, 2015.

Subject to the terms and conditions of the HFL Loan, upon written request, the Company may borrow and receive advances of amounts requested by the Company (including amounts previously repaid) not to exceed either of:

- (a) The amount in each calendar quarter equal to the amount budgeted by the Company to fund general and administrative costs for that calendar quarter; or

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- (b) An amount that would result in the aggregate principal amount of the HFL Loan to exceed \$10,000,000.

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

General and administrative costs were \$1,064,000 in the second quarter of 2013, and are estimated to be approximately \$940,000, and \$986,000 in the third and fourth quarters of 2013. These general and administrative costs are estimated based on historic recurring costs of the Company and the actual amount of general and administrative costs of the Company for these periods could differ significantly as a result of unforeseen and/or other non-recurring costs. Amounts borrowed may be repaid and reborrowed at any time prior to the Final Revolver Draw Date (as defined in Note 5 of this Form 10-Q). Hallwood Financial Limited shall have no obligation to advance any additional amounts to the Company on or after the Final Revolver Draw Date.

In late May 2013, the Company received a net refund of approximately \$4,300,000 from the IRS of 2010 federal taxes. The proceeds of these funds were used to pay \$4,000,000 towards principal and interest outstanding on the HFL Loan, with the balance retained for the Company's expenses and cash needs. As of June 30, 2013, the outstanding balance of the HFL Loan was \$5,411,000. As of June 30, 2013, the Company had \$695,000 of credit availability under the HFL Loan for general and administrative costs for the second quarter, and all of the availability for the third and fourth quarters of 2013 of \$940,000 and \$986,000, respectively.

If for any reason Brookwood is unable to pay a cash dividend or other advance to the Company, or if sufficient funding is unavailable under the HFL Loan when requested by the Company, the Company would be required to seek alternative sources of funding. The Company has not yet determined what, if any, sources would be available to it, but will consider such alternatives as an additional or new facility or term loan and potential sales of assets or additional securities. No assurance can be given that any such additional sources of funding will be available to the Company.

Additionally, any payment of a dividend or advance by Brookwood to the Company is dependent on a number of other factors including compliance with the loan covenants in the Revolving Credit Facility with BB&T, the approval of Brookwood's board of directors, Brookwood's ability to meet the requirements of the Delaware corporate laws for payment of dividends, and compliance with other applicable laws and requirements. As a result, no assurance can be given that these amounts will be available when needed or required.

The Company can give no assurance that Brookwood will have the ability to satisfy the Company's cash flow needs, nor that the Company would be able to obtain other sources of funding in such a circumstance, and therefore the aforementioned circumstances raise substantial doubt as to 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.

*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 Revolving Credit Facility with BB&T, which has a maturity date of March 30, 2014. As of June 30, 2013, subject to the existing loan covenants, Brookwood had approximately \$13,137,000 of additional borrowing availability on its Revolving Credit Facility.

Brookwood maintains factoring agreements which provide that receivables resulting from credit sales to customers, excluding the U.S. Government, may be assigned for collection 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 August 14, 2013, all of Brookwood's factors were complying with payment terms in accordance with factor agreements.

Brookwood paid dividends to the Company of \$650,000 and \$250,000, respectively, in January 2013 and April 2013. Subsequent to June 30, 2013, Brookwood paid a dividend to the Company of \$1,000,000 in July 2013. Brookwood paid cash dividends to the Company of \$11,350,000 for all of 2012. In addition, Brookwood made tax sharing payments to the Company of \$239,000 in the 2013 six month period and \$472,000 for all of 2012 under its tax sharing agreement.

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 2013 six month period and for all of 2012, Brookwood met its capital expenditure and equipment maintenance requirements from its operating cash flows and availability under its Revolving Credit Facility. There were no material capital commitments as of June 30, 2013. It is anticipated that Brookwood's future capital expenditure projects will be funded

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from operations and, if necessary, availability under its Revolving Credit Facility. Brookwood estimates its 2013 capital expenditures will be within a range of \$2,000,000 to \$2,500,000, having incurred approximately \$786,000 of net costs in the first six months of 2013.

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**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**

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

**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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## Item

## 1 Legal Proceedings

Reference is made to Note 11 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	

10.1	Agreement and Plan of Merger, dated as of June 4, 2013, among Hallwood Financial Limited, HFL Merger Corporation, and The Hallwood Group Incorporated, is incorporated herein by reference to Exhibit 2.1 to the Company's Form 8-K dated June 5, 2013, File No. 001-08303.
10.2	Amendment to Agreement and Plan of Merger, dated as of July 11, 2013, among Hallwood Financial Limited, HFL Merger Corporation, and The Hallwood Group Incorporated, is incorporated herein by reference to Exhibit 2.1 to the Company's Form 8-K dated July 12, 2013, File No. 001-08303.
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 Additional 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: August 14, 2013

By: /s/ Richard Kelley

Richard Kelley  
Vice President - Chief Financial Officer  
(Principal Financial and Accounting Officer)

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**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**

**INDEX TO EXHIBITS**

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