HALLWOOD GROUP INC
Form 10-Q
August 14, 2008

Table of Contents

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-Q

MARK ONE

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

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

FOR THE TRANSITION PERIOD FROM _________ TO _________

For the Period Ended June 30, 2008

Commission File Number: 1-8303

The Hallwood Group Incorporated

(Exact name of registrant as specified in its charter)

Delaware	**51-0261339**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)
3710 Rawlins, Suite 1500, Dallas, Texas	**75219**
(Address of principal executive offices)	(Zip Code)

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

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

Title of Class	**Name of Each Exchange On Which Registered**
Common Stock ($0.10 par value)	American Stock Exchange

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

Title of Class

Series B Redeemable Preferred Stock

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 þ NO o

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

Large accelerated filer o	Accelerated filer o	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company þ

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). YES o NO þ

The aggregate market value of the Common Stock held by non-affiliates of the registrant as of June 30, 2008, based on the closing price of $67.15 per share on the American Stock Exchange, was $32,865,000.

1,520,666 shares of Common Stock were outstanding at July 31, 2008.

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
TABLE OF CONTENTS

ITEM NO.	PART I FINANCIAL INFORMATION	PAGE
1	Financial Statements (Unaudited):	
	Condensed Consolidated Balance Sheets as of June 30, 2008 and December 31, 2007	3
	Condensed Consolidated Statements of Operations for the Six Months Ended June 30, 2008 and 2007	4
	Condensed Consolidated Statements of Operations for the Three Months Ended June 30, 2008 and 2007	5
	Condensed Consolidated Statements of Comprehensive Income (Loss) for the Three Months and Six Months Ended June 30, 2008 and 2007	6
	Condensed Consolidated Statement of Changes in Stockholders Equity for the Six Months Ended June 30, 2008	7
	Condensed Consolidated Statements of Cash Flows for the Six Months Ended June 30, 2008 and 2007	8
	Notes to Condensed Consolidated Financial Statements	9
2	Management s Discussion and Analysis of Financial Condition and Results of Operations	28
4	Controls and Procedures	47
	PART II OTHER INFORMATION	
1 thru 6	Other Information	48
	Signature Page	49
	Index to Exhibits	50

Fourth Amendment to Second Amended and Restated Revolving Credit Loan and Security Agreement
Equity Support Agreement
Certification of CEO Pursuant to Section 302
Certification of CFO Pursuant to Section 302
Certification of CEO and CFO Pursuant to Section 906

Table of Contents

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

	June 30, 2008	December 31, 2007
ASSETS		
Current Assets		
Cash and cash equivalents	$ 5,926	$ 7,260
Accounts receivable, net		
Due from factors	23,817	20,340
Trade and other	6,016	5,521
Related parties	151	249
Inventories, net	22,811	25,028
Federal income tax receivable	12,239	12,239
Deferred income tax, net	971	971
Prepaids, deposits and other assets	521	928
	72,452	72,536
Noncurrent Assets		
Investments in Hallwood Energy, net		
Property, plant and equipment, net	14,540	14,443
Deferred income tax, net	3,508	3,629
Other assets	133	137
	18,181	18,209
Total Assets	$ 90,633	$ 90,745
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities		
Accounts payable	$ 12,417	13,602
Guarantee obligation additional investment in Hallwood Energy	7,290	
Accrued expenses and other current liabilities	5,161	4,952
State income taxes payable	376	13
Current portion of loans payable	93	158
Payable additional investment in Hallwood Energy		5,000
	25,337	23,725
Noncurrent Liabilities		

Long term portion of loans payable	15,248	17,208
Redeemable preferred stock	1,000	1,000
	16,248	18,208
Total Liabilities	41,585	41,933
Stockholders Equity		
Common stock, issued 2,396,105 shares for both periods; outstanding 1,520,666 shares for both periods	240	240
Additional paid-in capital	56,469	56,469
Retained earnings	5,812	5,576
Treasury stock, 875,439 shares for both periods; at cost	(13,473)	(13,473)
Total Stockholders Equity	49,048	48,812
Total Liabilities and Stockholders Equity	$ 90,633	$ 90,745

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)

	Six Months Ended June 30,	
	2008	**2007**
Revenues		
Textile products sales	$ 91,121	$ 60,373
Expenses		
Textile products cost of sales	66,519	50,247
Administrative and selling expenses	10,766	9,331
	77,285	59,578
Operating income	13,836	795
Other Income (Loss)		
Investments in Hallwood Energy		
Equity loss	(12,120)	(12,376)
Interest income		92
Interest expense	(428)	(509)
Interest and other income	42	236
	(12,506)	(12,557)
Income (loss) before income taxes	1,330	(11,762)
Income tax expense (benefit)	1,094	(3,865)
Net Income (Loss)	$ 236	$ (7,897)
Net Income (Loss) Per Common Share		
Basic	$ 0.16	$ (5.21)
Diluted	$ 0.15	$ (5.21)
Weighted Average Shares Outstanding		
Basic	1,521	1,517

Diluted	1,523	1,517

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)

	Three Months Ended June 30, 2008	Three Months Ended June 30, 2007
Revenues		
Textile products sales	$ 47,134	$ 32,065
Expenses		
Textile products cost of sales	33,967	25,958
Administrative and selling expenses	5,553	4,727
	39,520	30,685
Operating income	7,614	1,380
Other Income (Loss)		
Investments in Hallwood Energy		
Equity loss	(9,159)	(1,873)
Interest income		80
Interest expense	(181)	(283)
Interest and other income	24	55
	(9,316)	(2,021)
Income (loss) before income taxes	(1,702)	(641)
Income tax expense (benefit)	(372)	(68)
Net Income (Loss)	$ (1,330)	$ (573)
Net Income (Loss) Per Common Share		
Basic	$ (0.87)	$ (0.38)
Diluted	$ (0.87)	$ (0.38)
Weighted Average Shares Outstanding		
Basic	1,521	1,517

Diluted	1,521	1,517

See accompanying notes to condensed consolidated financial statements.

Table of Contents

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,	
	2008	**2007**	**2008**	**2007**
Net Income (Loss)	$ (1,330)	$ (573)	$ 236	$ (7,897)
Other Comprehensive Income (Loss)				
Previously realized increase in fair value of marketable securities sold during the period				(55)
Comprehensive Income (Loss)	$ (1,330)	$ (573)	$ 236	$ (7,952))

See accompanying notes to condensed consolidated financial statements.

Table of Contents

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

	Common Stock		Additional Paid-In	Retained	Treasury Stock		Total Stockholders
	Shares	Par Value	Capital	Earnings	Shares	Cost	Equity
Balance, January 1, 2008	2,396	$ 240	$ 56,469	$ 5,576	875	$ (13,473)	$ 48,812
Net income				236			236
Balance, June 30, 2008	2,396	$ 240	$ 56,469	$ 5,812	875	$ (13,473)	$ 49,048

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,	
	2008	**2007**
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income (loss)	$ 236	$ (7,897)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Equity loss from investments in Hallwood Energy	12,120	12,376
Depreciation and amortization	1,156	904
Deferred tax expense (benefit)	121	(4,133)
Excess tax benefits from share-based payment arrangements		(275)
Proceeds from sale of marketable securities		148
Income from investments in marketable securities		(74)
Changes in assets and liabilities:		
(Increase) decrease in accounts receivable	(3,874)	(3,321)
(Increase) decrease in inventories	2,217	(2,415)
Increase (decrease) in accounts payable	(891)	2,011
Increase in income taxes receivable/payable	444	1,099
Increase (decrease) in accrued expenses and other current liabilities	209	621
Net change in other assets and liabilities	330	12
Net cash provided by (used in) operating activities	12,068	(944)
CASH FLOWS FROM INVESTING ACTIVITIES		
Investments in Hallwood Energy	(9,830)	(9,247)
Investments in property, plant and equipment, net	(1,547)	(721)
Net cash used in investing activities	(11,377)	(9,968)
CASH FLOWS FROM FINANCING ACTIVITIES		
Repayment of other bank borrowings and loans payable	(2,025)	(152)
Proceeds from revolving credit facilities, net		4,164
Purchase of common stock for treasury		(439)
Excess tax benefits from share-based payment arrangements		275
Proceeds from exercise of stock options		165
Net cash provided by (used in) financing activities	(2,025)	4,013
DECREASE IN CASH AND CASH EQUIVALENTS	(1,334)	(6,899)

CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	7,260	10,054
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 5,926	$ 3,155

See accompanying notes to condensed consolidated financial statements.

Table of Contents

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six Months Ended June 30, 2008 and 2007
(unaudited)

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

Interim Condensed Consolidated Financial Statements. The interim condensed consolidated financial statements of The Hallwood Group Incorporated and its subsidiaries (the Company) (AMEX: HWG), a Delaware corporation, have been prepared in accordance with the instructions to Form 10-Q and do not include all of the information and disclosures required by accounting principles generally accepted in the United States of America. Although condensed, in the opinion of management, all adjustments considered necessary for a fair presentation have been included. These condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and related disclosures thereto included in Form 10-K for the year ended December 31, 2007.

Organization. The Company is a holding company with interests in textile products and energy.

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

Kenyon Industries, Inc. (Kenyon). Kenyon uses the latest technologies and processes in dyeing, finishing, coating and printing of woven synthetic products. At its Rhode Island plant, 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 Incorporated (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 seven layers of textile materials can be processed using both wet and dry lamination techniques.

Strategic Technical Alliance, LLC (STA). STA is part of the Brookwood Marketing division and markets advanced breathable, waterproof laminate and other fabrics primarily for military applications. Continued development of these fabrics for military applications is a key element of Brookwood s business plan. STA s operations are gradually being transferred directly to Brookwood.

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

Energy. Effective December 31, 2005, the Company s remaining energy affiliates, Hallwood Energy II, L.P. (HE II), Hallwood Energy 4, L.P. (HE 4) and Hallwood Exploration, L.P. (Hallwood Exploration), were consolidated into HE 4, which was renamed Hallwood Energy, L.P. (Hallwood Energy). The Company accounted for the former investments using the equity method of accounting. At the consolidation date, Hallwood Energy was principally involved in acquiring oil and gas leases and drilling, gathering and sale of natural gas in the Barnett Shale formation located in Parker, Hood and Tarrant Counties in North Texas, the Barnett Shale and Woodford Shale formations in West Texas, in the Fayetteville Shale formation of Central Eastern Arkansas, and conducting 3-D seismic surveys over optioned land covering a Salt Dome in South Louisiana in order to determine how best to proceed with exploratory activity.

All of the Company s energy activities are conducted through Hallwood Energy. The Company accounts for Hallwood Energy using the equity method of accounting. See Note 4 for additional information on Hallwood Energy.

New Accounting Pronouncements. In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 157, *Fair Value Measurements* . This Statement defines fair value as used in numerous accounting pronouncements, establishes a framework for measuring fair value in

generally accepted accounting principles and expands disclosure related to the use of fair value measures in financial statements. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. The adoption of SFAS No. 157 did not have a material impact on the Company s financial position, results of operations or cash flows.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115.* SFAS No. 159 permits entities to choose to measure many financial instruments and certain other items at fair value. The FASB believes the statement will improve financial reporting by providing companies the opportunity to mitigate volatility in reported earnings by measuring related assets and liabilities differently without

Table of Contents

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six Months Ended June 30, 2008 and 2007
(unaudited)

having to apply complex hedge accounting provisions. Use of the statement will expand the use of fair value measurements for accounting for financial instruments. Although the Company has not yet elected to present any financial assets or liabilities at fair value under SFAS No. 159, it may choose to do so in the future.

The Emerging Issues Task Force (EITF) of the FASB ratified EITF Issue 06-11, *Accounting for Income Tax Benefits of Dividends on Share-Based Payment Awards* (EITF 06-11) in June 2007. In a stock-based compensation arrangement, employees may be entitled to dividends during the vesting period for nonvested shares or share units and until the exercise date for stock options. These dividend payments generally can be treated as a deductible compensation expense for income tax purposes, thereby generating an income tax benefit for the employer. At issue was how such a realized benefit should be recognized in the financial statements. The EITF has reached a conclusion that an entity should recognize the realized tax benefit as an increase in additional paid-in capital (APIC) and that the amount recognized in APIC should be included in the pool of excess tax benefits available to absorb tax deficiencies on stock-based payment awards. EITF 06-11 will be effective prospectively for the income tax benefits that result from dividends on equity-classified employee share-based payment awards that are declared in fiscal years beginning after December 15, 2007. The adoption of this EITF did not have a material impact on the Company s financial statements.

On May 9, 2008, the FASB issued SFAS No. 162, *The Hierarchy of Generally Accepted Accounting Principles* . This statement identifies a consistent framework, or hierarchy, for selecting accounting principles to be used in preparing financial statements that are presented in conformity with U.S. generally accepted accounting principles for nongovernmental entities. It establishes that the GAAP hierarchy should be directed to entities because it is the entity (not the auditor) that is responsible for selecting accounting principles for financial statements that are presented in conformity with GAAP. SFAS No. 162 is effective 60 days following the SEC s approval of the Public Company Accounting Oversight Board auditing amendments to AU Section 411, The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles. Management does not believe that implementation of SFAS No. 162 will have any effect on the Company s consolidated financial statements.

Note 2 Inventories

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

	June 30, 2008	December 31, 2007
Raw materials	$ 6,638	$ 8,084
Work in progress	8,130	8,218
Finished goods	9,131	9,475
	23,899	25,777
Less: Obsolescence reserve	(1,088)	(749)
Total	$ 22,811	$ 25,028

Note 3 Operations of Brookwood Companies Incorporated

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

One of Brookwood s factors announced in March 2008 that it had been negatively impacted by the tightening in the credit markets and was required to draw on its bank credit lines to provide additional liquidity. The factor announced in June 2008 that it acquired additional financing to strengthen its balance sheet and improve and diversify its liquidity and funding. Brookwood is monitoring its factor relationships and developing alternative strategies should economic conditions deteriorate further. As of August 1, 2008, all of Brookwood s factors were complying with payment terms in accordance with factor agreements.

Sales Concentration. Sales to one Brookwood customer, Tennier Industries, Inc. (Tennier), accounted for more than 10% of Brookwood s sales during both the 2008 and 2007 three month and six month periods. Its relationship with Tennier is ongoing. Sales to Tennier, which are included in military sales, were $15,112,000 and $29,980,000 in the 2008 second quarter and six

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six Months Ended June 30, 2008 and 2007
(unaudited)

month periods, respectively, compared to $8,675,000 and $15,570,000 in 2007. Sales to Tennier represented 32.1% and 27.1% of Brookwood s net sales in the 2008 and 2007 second quarters, respectively, and 32.9% and 25.8% in the 2008 and 2007 six month periods, respectively. Sales to another customer, ORC Industries, Inc. (ORC), accounted for more than 10% of Brookwood s sales in 2008. Its relationship with ORC is ongoing. Sales to ORC, which are included in military sales, were $5,252,000 and $9,281,000 in the 2008 second quarter and six month periods, respectively, compared to $2,024,000 and $4,230,000 in 2007. Sales to ORC represented 11.1% and 6.3% of Brookwood s net sales in the 2008 and 2007 second quarters, respectively, and 10.2% and 7.0% in the 2008 and 2007 six month periods, respectively.

Military sales accounted for $31,981,000 and $60,139,000 in the 2008 second quarters and six month periods, respectively, compared to $16,656,000 and $28,692,000 in 2007. The military sales represented 67.9% and 51.9% of Brookwood s net sales in the 2008 and 2007 quarters, respectively, and 66.0% and 47.5% in the 2008 and 2007 six month periods, respectively.

Stockholders Equity. The Company is the holder of all of Brookwood s outstanding $13,500,000 Series A, $13.50 annual dividend per share, redeemable preferred stock and all of its 10,000,000 outstanding shares of common stock. The preferred stock has a liquidation preference of $13,500,000 plus accrued but unpaid dividends. At June 30, 2008, cumulative dividends in arrears on the preferred stock amounted to approximately $664,000.

2005 Long-Term Incentive Plan for Brookwood. In December 2005, the Company adopted The Hallwood Group Incorporated 2005 Long-Term Incentive Plan for Brookwood Companies Incorporated (the 2005 Long-Term Incentive Plan for Brookwood) to encourage employees of Brookwood to increase the value of Brookwood and to be employed by Brookwood. The terms of the incentive plan provide for a total award amount to participants equal to 15% of the fair market value of consideration received by the Company in a change of control transaction, as defined, in excess of the sum of the liquidation preference plus accrued unpaid dividends on the Brookwood preferred stock (approximately $14,164,000 at June 30, 2008). The base amount will fluctuate in accordance with a formula that increases by the amount of the annual dividend on the preferred stock, currently $1,823,000, and decreases by the amount of the actual dividends paid by Brookwood to the Company. However, if the Company s board of directors determines that certain specified Brookwood officers, or other persons performing similar functions do not have, prior to the change of control transaction, in the aggregate an equity or debt interest of at lease two percent in the entity with whom the change of control transaction is completed, then the minimum amount to be awarded under the plan shall be $2,000,000. In addition, the Company agreed that, if members of Brookwood s senior management do not have, prior to a change of control transaction in the aggregate an equity or debt interest of at least two percent in the entity with whom the change of control transaction is completed (exclusive of any such interest any such individual receives with respect to his or her employment following the change of control transaction), then the Company will be obligated to pay an additional $2,600,000.

Engagement of Financial Advisor. In December 2007, a special committee of the board of directors of the Company engaged a financial advisor to assist it in developing strategic alternatives, including a potential sale, with respect to Brookwood. This initiative is continuing, but there can be no assurance that the special committee will recommend any action with respect to Brookwood or that any transaction will be completed.

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six Months Ended June 30, 2008 and 2007
(unaudited)

Note 4 Investments in Hallwood Energy, L.P.

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

	As of June 30, 2008		Amount at which carried at		Loss for the six months ended	
	Percent of Class		June 30,	December 31,	June 30,	
Description	Owned	Cost	2008	2007	2008	2007
- Class A limited partner interest	25(a)	$ 50,384	$	$	$	$ (12,374)
- Class C limited partner interest	13	11,084				
- General partner interest	50	13				(2)
- First Convertible Note	17	5,000				
- Second Convertible Note						
Cash investment	97	4,830			(4,830)	
Guarantee to invest additional funds		7,290			(7,290)	
Total		$ 78,601	$	$	$ (12,120)	$ (12,376)

(a) 18% after consideration of profit interests

The Company accounts for this investment using the equity method of accounting and records its pro rata share of Hallwood Energy s net income (loss) and partner capital transactions, as appropriate.

Hallwood Energy is a privately held independent oil and gas limited partnership and operates as an upstream energy company engaging in the acquisition, development, exploration, production, and sale of hydrocarbons, with a primary focus on natural gas assets. Hallwood Energy conducts its energy activities from its corporate office located in Dallas, Texas and production offices in Searcy, Arkansas and Lafayette, Louisiana. Hallwood Energy s results of operations are and will be largely dependent on a variety of factors, including, but not limited to fluctuations in natural gas prices; success of its drilling activities; the ability to transport and sell its natural gas; regional and national regulatory matters; and the ability to secure, and price of, goods and services necessary to develop its oil and gas leases; and the ability to raise additional capital.

Hallwood Energy s management has classified its energy investments into three identifiable geographical areas:

West Texas the Barnett Shale and Woodford Shale formations,

Central and Eastern Arkansas primary target is the Fayetteville Shale formation, and

South Louisiana various projects on and around the LaPice Salt Dome.

Certain of the Company s officers and directors are investors in Hallwood Energy. In addition, as members of management of Hallwood Energy, one director and officer and one officer of the Company hold a profit interest in Hallwood Energy.

In January 2008, the Company loaned $5,000,000 to Hallwood Energy as part of a $30,000,000 convertible subordinated note agreement (discussed below).

In May 2008 and June 2008, the Company loaned $2,961,000 and $2,039,000, respectively, (for a total of $5,000,000) pursuant to the Equity Support Agreement in connection with the Talisman Energy Transaction (discussed below).

The Company s proportionate share of Hallwood Energy s calendar year 2007 loss would have reduced the carrying value of its investment in Hallwood Energy below zero. The general rule for recording equity losses ordinarily indicates that the investor shall discontinue applying the equity method when the investment has been reduced to zero and shall not provide for additional losses, unless the investor provides or commits to provide additional funds to the investee, has guaranteed obligations of the investee, or is otherwise committed to provide further financial support to the investee. Although no guarantee or commitment

Page 12

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six Months Ended June 30, 2008 and 2007
(unaudited)

existed at December 31, 2007, the Company loaned $5,000,000 to Hallwood Energy in January 2008 in connection with Hallwood Energy s issuance of up to $30,000,000 of convertible subordinated notes due January 21, 2011 (the First Convertible Note) to provide capital to continue regular ongoing operations. Accordingly, the Company recorded an additional equity loss in 2007 to the extent of the $5,000,000 loan, as the Company had not determined to what extent, if any, that it would advance additional funds to Hallwood Energy.

In connection with the then ongoing efforts to complete the Talisman Energy Transaction, the Company loaned Hallwood Energy $2,961,000 on May 15, 2008. As of that date, the Company s management had indicated that it did not intend to make additional investments in Hallwood Energy, except in connection with Hallwood Energy s obtaining additional funds from external sources. Due to the uncertainties at that time related to the completion of the Talisman Energy Transaction and the Company s additional investment, if any, the Company recorded an equity loss for the 2008 first quarter to the extent of the $2,961,000 loan. The Company s carrying value of its Hallwood Energy investment was zero at March 31, 2008.

As a result of the completion of the Talisman Energy Transaction in June 2008, the Company entered into the Equity Support Agreement with Hallwood Energy which obligated the Company to contribute additional equity or debt capital of $2,039,000 to Hallwood Energy and guarantee an additional amount of up to $7,500,000 in certain circumstances, both of which were accounted for under the Second Convertible Note (discussed below). The Company s commitment to provide additional financial support, resulted in the recording of an equity loss in the 2008 second quarter of $9,159,000, which included accumulated equity losses that had not been previously recorded, as the Company had reduced the carrying value of its investment to zero. The Company s carrying value of its Hallwood Energy investment was zero at June 30, 2008.

Capital Transaction in 2008. As previously disclosed, Hallwood Energy is in the process of seeking additional capital from external sources. In connection with this effort, on June 10, 2008, Hallwood Energy entered into an agreement for the sale and farmout to FEI Shale, L.P. (FEI), a subsidiary of Talisman Energy, Inc., of an undivided interest in up to 33.33% of Hallwood Energy s interest in substantially all its assets for a series of payments of up to $125,000,000 (an initial payment of $60,000,000 and an option to pay up to an additional $65,000,000), and entered into an agreement to provide consulting services to the purchaser for one year (the Talisman Energy Transaction). FEI prepaid the consulting services agreement which requires two man-weeks per month of service from two senior executives. The revenues from this agreement will be recognized as earned over the course of the twelve month period.

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

The parties have agreed to use commercially reasonable efforts to agree upon a budget for each quarterly period during the term of the farmout agreement. Any material variance from the budget requires the prior approval of FEI.

If Hallwood Energy receives an authorization for expenditure from a third-party operator of its properties and either Hallwood Energy or FEI does not wish to include these operations under the farmout agreement, the other party may proceed at its sole risk and expense. If the participating party recoups its costs, the nonparticipating party will become entitled to receive an interest in the well in the amount of 66.67% if Hallwood Energy is the non-participating party, or 33.33% if FEI is the non-participating party.

If Hallwood Energy enters into discussions concerning a sale of a material portion of its assets or a change of control, FEI will have the opportunity to submit a proposal to complete the transaction. If Hallwood Energy and FEI do not enter into a definitive agreement for the transaction, Hallwood Energy may pursue other opportunities if the terms are not less favorable to Hallwood Energy than those proposed by FEI.

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six Months Ended June 30, 2008 and 2007
(unaudited)

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

In connection with the Talisman Energy Transaction, the Company loaned $2,961,000 to Hallwood Energy on May 15, 2008 on terms similar to the First Convertible Note issued in January 2008. Contemporaneously with the signing of the sale and farmout agreement, the Company entered into an Equity Support Agreement (the Equity Support Agreement) with Hallwood Energy, under which the Company committed to contribute equity or debt capital to Hallwood Energy to maintain a reasonable liquidity position for Hallwood Energy or prevent or cure any default under Hallwood Energy s credit facilities with respect to interest payments, up to a maximum amount of $12,500,000. The loan of $2,961,000 in May 2008 and an additional loan to Hallwood Energy on June 10, 2008 of $2,039,000 (for a total of $5,000,000) are treated as contributions toward the maximum amount.

Funds advanced to Hallwood Energy pursuant to the Equity Support Agreement are issued under terms of the Second Convertible Note (discussed below), which are comparable to the First Convertible Note. During June and July 2008, the Company sold $380,000 of the Second Convertible Note to other investors in Hallwood Energy. As of June 30, 2008, $5,000,000 of the Second Convertible Notes were outstanding, of which $4,830,000 was held by the Company and $170,000 was held by other Hallwood Energy investors.

Hallwood Energy continues to seek additional capital from external sources.

A further description of Hallwood Energy s activities during 2007 and 2008 are provided below.

Loan Financing. In March and April 2007, the Company loaned a total of $9,000,000 to Hallwood Energy, of which $7,000,000 was in the form of demand notes bearing interest at 6% above prime rate, and $2,000,000 was an advance that was repaid four days later with interest. In April 2007, Hallwood Energy made a request for additional capital contributions in the amount of $25,000,000 (the April Call). The Company and Hallwood Energy had agreed that the $7,000,000 of loans would be applied as the Company s portion of the April Call and as such was recorded as a Class C partnership investment. In May 2007, Hallwood Energy repaid $257,000 to the Company, which represented the excess of the $7,000,000 loaned over the Company s share of the capital contribution and related oversubscription.

In April 2007, Hallwood Energy entered into a $100,000,000 loan facility (the Senior Secured Credit Facility) with a new lender (the New Lender), who is an affiliate of one of Hallwood Energy s investors and drew $65,000,000 from the Senior Secured Credit Facility. The proceeds were used to repay the $40,000,000 balance of Hallwood Energy s former credit facility, approximately $9,800,000 for a make-whole fee and approximately $500,000 for incremental interest related to the former credit facility, transaction fees of approximately $200,000 and provide working capital. The Senior Secured Credit Facility is secured by Hallwood Energy s oil and gas leases, matures on February 1, 2010, and bears interest at a rate of the defined LIBOR rate plus 10.75% per annum (increased to LIBOR + 12.75% per annum effective May 1, 2008). An additional 2% of interest is added upon continuance of any defaulting event. The New Lender may demand that Hallwood Energy prepay the outstanding loans in the event of a defined change of control, qualified sale or event of default, including a material adverse event. In conjunction with executing the Senior Secured Credit Facility, the New Lender resigned its position on Hallwood Energy s board of directors and assigned its general partner interest to the remaining members.

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

October 2007. Accordingly, the Senior Secured Credit Facility was fully funded with an outstanding balance of $100,000,000 at December 31, 2007.

The Senior Secured Credit Facility contains various financial covenants, including maximum general and administrative expenses and current and proved collateral coverage ratios. In June 2008, the proved collateral coverage ratio test was amended to be effective September 30, 2008, and each quarter thereafter. Non-financial covenants restrict the ability of Hallwood Energy to

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six Months Ended June 30, 2008 and 2007
(unaudited)

dispose of assets, incur additional indebtedness, prepay other indebtedness or amend certain debt instruments, pay dividends, create liens on assets, enter into sale and leaseback transactions, make investments, loans or advances, make acquisitions, engage in mergers or consolidations or engage in certain transactions with affiliates, and otherwise restrict certain activities by Hallwood Energy. In October 2007, Hallwood Energy entered into an amendment of the Senior Secured Credit Facility to modify the calculation of the current ratio to include certain capital funding commitments.

The Senior Secured Credit Facility contained a make-whole provision whereby Hallwood Energy is required to pay the New Lender the amount by which the present value of interest and principal from the date of prepayment through January 31, 2009, exceeds the principal amount on the prepayment date. In June 2008, the facility was amended to extend the make-whole provision to January 31, 2010. The New Lender received warrants exercisable for 2.5% of the partnership interests at an exercise price of 2.5% of 125% of the amount of the total capital contributed to Hallwood Energy at December 31, 2006.

In January 2008, Hallwood Energy entered into a $30,000,000 convertible subordinated note agreement (the First Convertible Note). The First Convertible Note bears interest which accrues at an annual rate of 16%, which is payable on a quarterly basis after the completion of a defined equity offering and subject to the prior full payment of borrowings and accrued interest under the Secured Credit Facilities. The First Convertible Note and accrued interest may be converted into Class C interests on a dollar for dollar basis. If no Class C interests are outstanding, the First Convertible Note may be converted into Class A interests or such comparable securities as may be outstanding at the same exchange ratio as the original Class C interests. Principal and unpaid interest are due on the earlier of January 21, 2011, or upon a defined change of control. A change of control redemption may also result in a make-whole provision whereby Hallwood Energy would pay a premium based on the difference between either $48,300,000 or $45,500,000 and the sum of previously made First Convertible Note principal and accrued interest payments. As of June 30, 2008, $28,839,000 of the First Convertible Notes had been subscribed for and issued, of which the Company subscribed and purchased $5,000,000 in January 2008.

In connection with the completion of the Talisman Energy Transaction, the Company entered into an option agreement with the New Lender that grants the New Lender an option to purchase the Company s interest in the First Convertible Note at face value plus accrued interest, exercisable within 90 days commencing with the date of the full and final payment of all obligations and indebtedness owed by Hallwood Energy to the New Lender.

The First Convertible Note lenders also received warrants exercisable at up to $3,750,000 for an equal dollar amount of Class C interests, or such comparable securities as are outstanding at the time of exercise at the same exchange ratio as the original Class C interests. The warrants are exercisable until January 21, 2011.

In May 2008, Hallwood Energy entered into a $12,500,000 convertible subordinated note agreement (the Second Convertible Note), which was underwritten by the Company. The Second Convertible Note was issued in connection with the completion of the Talisman Energy Transaction and the related Equity Support Agreement for $12,500,000. The Second Convertible Note contains interest terms, conversion features and repayment terms comparable to the First Convertible Note described previously. As of June 30, 2008, $5,000,000 of the Second Convertible Note was outstanding, of which $4,830,000 was held by the Company and $170,000 was held by other Hallwood Energy investors.

In January 2008, Hallwood Energy entered into the $15,000,000 Junior Credit Facility with the New Lender and drew the full amount of the facility. Proceeds were used to fund working capital requirements and future operational activities. Borrowings under both facilities are secured by Hallwood Energy s oil and gas leases, mature on February 1, 2010, and bear interest at a rate of the defined LIBOR rate plus 10.75% per annum through April 30, 2008, and thereafter increases to 12.75% per annum until loan maturity or prepayment. An additional 2% of interest is added upon continuance of any defaulting event. The New Lender may demand that Hallwood Energy prepay the outstanding loans in the event of a defined change of control, qualified sale or event of default, including a material

adverse event. Hallwood Energy remains bound to a deposit control agreement initiated with the Senior Secured Credit Facility.

The Junior Credit Facility contains various financial covenants, materially consistent with the Senior Secured Credit Facility, including maximum general and administrative expenditures and current and proved collateral coverage ratios. The proved collateral coverage ratio covenant was scheduled to become effective June 30, 2008, however, in June 2008 the coverage ratio test was amended to be effective September 30, 2008. Non-financial covenants restrict the ability of Hallwood Energy to dispose of assets, incur additional indebtedness, prepay other indebtedness or amend certain debt instruments, pay dividends, create liens on assets, enter into sale and leaseback transactions, make investments, loans or advances, make acquisitions, engage in mergers or

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six Months Ended June 30, 2008 and 2007
(unaudited)

consolidations or engage in certain transactions with affiliates, and otherwise restrict certain Hallwood Energy s activities.

The Junior Credit Facility contains a make-whole provision whereby Hallwood Energy is required to pay the New Lender the amount by which the present value of interest and principal from the date of prepayment through January 31, 2010, exceeds the principal amount on the prepayment date.

In connection with the Junior Credit Facility, the Senior Secured Credit Facility was amended to bear interest at the defined LIBOR rate plus 12.75% per annum beginning May 1, 2008.

Hallwood Energy did not meet the current ratio covenant and was in default of the Senior Secured Credit Facility as of December 31, 2007. A second default event related to a commitment agreement by three partners to fund $15,000,000 by November 1, 2007, that was only partially funded. Hallwood Energy received a waiver from the New Lender for both of these default events in January 2008.

Hallwood Energy was not in compliance with the general and administrative expense covenant at March 31, 2008 and the current ratio covenant as of April 30, 2008 required by the Senior Secured Credit Facility and the Junior Credit Facility and had entered into discussions with the New Lender to waive the default and amend by extending this covenant test into a future period. Hallwood Energy entered into an amendment of the facilities with the New Lender in June 2008 to waive the defaults and amend various covenants.

In connection with the completion of the Talisman Energy Transaction, Hallwood Energy also agreed to amendments to its credit agreements that, among other things, could result in an increase in interest paid by Hallwood Energy and provides additional covenants. The principal provisions of the amendment and related agreements include the following:

The terms of the make-whole provision of the Senior Secured Credit Facility were extended from January 31,2009 to January 31, 2010.

Pursuant to a forbearance agreement among Hallwood Energy, FEI, New Lender and others, if Hallwood Energy were in the future to default in any of its obligations under its credit agreements, the New Lender has agreed not to exercise its remedies under the Senior Secured Credit Facility while the farmout agreement is in effect and for a period of 91 days after the termination of the farmout agreement.

Hallwood Energy shall pay to the New Lender on a monthly basis, the excess net cash flow, as defined, as additional debt service. Such payments, if any, shall be applied first to repay outstanding fees and expenses, second to accrued and unpaid interest and then to unpaid debt principal. The excess net cash flow is defined as operating revenues less operating expenses, certain general and administrative expenses, and other approved expenditures as defined in the agreement.

Equity Investments. There are currently three classes of limited partnership interests held in Hallwood Energy:

Class C interests bear a 16% priority return which compounds monthly. The priority return will be accrued and become payable when, as and if declared by the general partner of Hallwood Energy. Hallwood Energy does not anticipate paying any distributions in the foreseeable future. All distributions of defined available cash and defined net proceeds from any sales or other disposition of all or substantially all of the then remaining assets of Hallwood Energy which is entered into in connection with, or which will result in, the liquidation of Hallwood Energy (the Terminating Capital Transaction) must first be used to reduce any unpaid Class C priority return and capital contributions to zero. Unpaid Class C priority return and capital contributions can be converted into Class A interests based on the ratio of Class C contributions to the sum of Class A contributions and the Class C limited partner s Class C partnership interest designated by the Class C limited partner to be converted into Class A partnership interest. The Class C capital contributions were $84,422,000 and unpaid priority returns were $13,328,000 at June 30, 2008.

Class A interests have certain voting rights and with the general partner would receive 100% of the distributions of available cash and net proceeds from Terminating Capital Transactions subsequent to the payment of all unpaid Class C priority return and of all Class C capital contributions until the unrecovered capital accounts of each Class A partner

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six Months Ended June 30, 2008 and 2007
(unaudited)

interest is reduced to zero, and thereafter share in all future distributions of available cash and net proceeds from Terminating Capital Transactions with the holders of the Class B interests.

Class B interests represent vested net profit interests awarded to key individuals by Hallwood Energy. At June 30, 2008 and December 31, 2007, outstanding Class B interests had rights to receive 20.0% and 18.6%, respectively, of distributions of defined available cash and net proceeds from Terminating Capital Transactions after the unpaid Class C priority return and capital contributions and the unreturned Class A and general partner capital contributions have been reduced to zero.

In April 2007, Hallwood Energy issued a $25,000,000 Class C equity call to its partners (the April Call) which was fully satisfied. Previously, Hallwood Energy received loans of $7,000,000 each from the Company and an affiliate of the New Lender. These loans were applied to the April Call. In May 2007, Hallwood Energy repaid $257,000 to the Company, which represented the excess of its $7,000,000 advanced over the Company s share of the capital contribution and related oversubscription.

In April 2007, Hallwood Investments Limited (HIL), a corporation associated with Mr. Anthony J. Gumbiner, the Company s chairman and principal stockholder, and the New Lender each committed to fund one-half of the April Call and potential additional equity or subordinated debt funding calls totaling $55,000,000 by Hallwood Energy, to the extent other investors, including the Company, did not respond to equity calls.

In May 2007, Hallwood Energy issued a $20,000,000 Class C equity call to its partners (the May Call), which was fully satisfied. The Company s proportionate share of the May Call was $5,091,000. Due to the fact that the Company did not have available sufficient cash, the Company contributed only $2,501,000 towards the May Call. Because of the Company s inability to meet its full equity call requirement, HIL funded $2,591,000 of the May Call that was not funded by the Company. In connection with the funding of this amount, Mr. Gumbiner agreed with a special committee of the board of directors of the Company that he would discuss the terms of this investment in the future.

In August 2007, Hallwood Energy issued a $15,000,000 Class C equity call to its partners (the August Call) which was fully satisfied. The Company s proportionate share of the August Call was $3,683,000. Due to the fact that the Company did not have available sufficient cash, the Company contributed only one-half, or $1,842,000, towards the August Call. Because of the Company s inability to meet its full equity call requirement, HIL funded $1,842,000 of the August Call that was not funded by the Company. In October 2007, the special committee appointed to consider HIL s funding of these capital calls acknowledged the terms of the funding of the capital calls by HIL and determined that, in light of the circumstances, including the Company s present inability to fund any amounts beyond those it had made, no further action was required.

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

In November 2007, Hallwood Energy issued $15,000,000 of Class C partnership interest to a new equity partner. In addition, HIL, another existing investor in Hallwood Energy, and the New Lender entered into a letter agreement providing for a total of up to $15,000,000 in additional funding. Under the terms of this letter, HIL agreed to advance $7,500,000 and the other investor agreed to advance $3,000,000 to Hallwood Energy no later than November 15, 2007. These advances constituted loans to Hallwood Energy with an interest rate of 16% per annum and a maturity of March 1, 2010. The letter agreement contained a provision that permitted Hallwood Energy to repay the advances at any time without penalty in connection with a recapitalization of Hallwood Energy providing for net proceeds not less than the amount being repaid. If any part of these advances remained outstanding on January 2, 2008, then on that date the outstanding amount would automatically be converted into preferred partnership interests having the same terms as the existing class of preferred partnership interests. In addition, if any portion of the advances was converted into preferred partnership interests on January 2, 2008, then the New Lender agreed to contribute to Hallwood Energy the same proportion of $4,500,000 in exchange for preferred partnership interests. Hallwood Energy also agreed that if any portion of the agreed funding from HIL or the other existing investor was not made, it would be an event of default under the Senior Secured Credit Facility. HIL advanced $7,500,000 in November 2007, although the other

investor did not fulfill its commitment. On January 2, 2008, as per the letter agreement, HIL s loan was converted into a Class C interest.

Litigation. In 2006, Hallwood Energy and Hallwood Petroleum entered into two two-year contracts (the Contracts) with Eagle Drilling, LLC (Eagle Drilling), under which the contractor was to provide drilling rigs and crews to drill wells in Arkansas. In August 2006, one of the masts on the rigs provided under the Contracts collapsed. Hallwood Energy and Hallwood

Table of Contents

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six Months Ended June 30, 2008 and 2007
(unaudited)

Petroleum requested the contractor to provide assurances that the mast on the other rig, and any mast provided to replace the collapsed mast, were safe and met the requirements of the Contracts. These Contracts were subsequently assigned by Eagle Drilling to Eagle Domestic Drilling Operations, L.L.C. (Eagle Domestic) in August 2006.

When the contractor refused to provide assurances, Hallwood Energy and Hallwood Petroleum notified the contractor that the Contracts were terminated and in September 2006, filed *Hallwood Petroleum, LLC and Hallwood Energy, L.P. v. Eagle Drilling, LLC and Eagle Domestic Drilling Operations, LLC,* in the 348th District Court of Tarrant County to recover funds previously deposited with the contractor under the Contracts. Eagle Domestic and its parent then filed for Chapter 11 bankruptcy protection in Texas. After the filing of its bankruptcy case, Eagle Domestic filed an adversary action against Hallwood Energy and Hallwood Petroleum in the bankruptcy proceeding to recover unspecified damages.

On April 3, 2008, Hallwood Energy and Eagle Domestic signed an agreement to settle the litigation between them. Under the agreement, Hallwood Energy agreed to pay to Eagle Domestic $2,000,000 in cash and issue to Eagle Domestic $2,750,000 in equity of Hallwood Energy or a successor entity, which was accrued by Hallwood Energy at March 31, 2008. Hallwood Energy may defer the payment of the cash and issuance of the equity until the later of the completion of a major financing, or June 30, 2008. If the major financing is in the form of an Initial Public Offering, Hallwood Energy will deliver to Eagle Domestic shares of stock. Hallwood Energy will make best efforts to deliver registered shares. If the shares cannot be registered, Hallwood Energy will deliver shares that will be freely tradeable in their principal market within 90 days of the delivery. If the major financing is in the form of a private partnership or joint venture, Hallwood Energy will deliver partnership units to Eagle Domestic. If prior to June 30, 2008, Hallwood Energy or a successor entity had not completed a major financing, but received bridge financing in the aggregate at least $20,000,000, then Hallwood Energy agreed to pay to Eagle Domestic $500,000 in cash. Such payment was made. The payment of $500,000 in cash extended the date referred to above to September 30, 2008 and will be credited against the $2,000,000 payment if the $2,000,000 cash payment and $2,750,000 in equity is received no later than September 30, 2008. If the $2,000,000 cash payment and $2,750,000 in equity is not received by September 30, 2008, then the $500,000 cash will not be credited against any future judgment or settlement of the proceeding. The trial previously set in the matter will be continued until not earlier than September 30, 2008 and, upon receipt of the amounts contemplated by the settlement agreement, all parties and their affiliates will be fully and finally mutually released from any and all claims the other parties and their affiliates may have.

In October 2006, Eagle Drilling filed a related lawsuit against Hallwood Energy and Hallwood Petroleum in Oklahoma state court (the Eagle Drilling Action) alleging damages of over $1,000,000 in connection with unpaid invoices, unpaid downtime and other damages caused as a result of the mast collapsing. Eagle Drilling has also alleged additional claims for breach of contract, negligence and tortious breach of contract. In September 2007, Eagle Drilling filed for Chapter 11 bankruptcy protection in the United States Bankruptcy Court for the Western District of Oklahoma. Hallwood Energy has brought a claim against Eagle Drilling for return of the approximately $1,688,000 in unearned pre-payment from Eagle Drilling.

Eagle Drilling has also alleged new claims, of which $22,900,000 in claims are believed to have been specifically assigned to Eagle Domestic. Specifically, these new claims seek in excess of $24,000,000 in damages for breach of the contracts, a negligence claim for damages to a drilling rig which Eagle Drilling did not own, tortious breach of contract, tortious interference with Eagle Drilling s relationships with other parties, and tortious business disparagement and defamation. Hallwood Energy believes these claims are without merit. After discussions with Hallwood Energy, Eagle Domestic has filed a motion in the Texas bankruptcy court asserting that it is the sole owner of the claims for breach of contract that it settled with Hallwood Energy and seeking to compel Eagle Drilling to show cause why it should not be held in contempt for its efforts to assert those claims in a separate court. That motion was considered by the Texas bankruptcy court on May 21, 2008. At that hearing, the Texas bankruptcy court determined that it does have jurisdiction to consider and rule on whether Eagle Drilling is violating the settlement agreement that

it entered into with Eagle Domestic in May 2007 and/or the broad injunction under Eagle Domestic s confirmed Chapter 11 Plan. In order to make this determination, the Texas bankruptcy court conducted a trial on June 17, 18 and 30, 2008, at which the court considered evidence on Eagle Drilling s allegations that Hallwood terminated the Contracts prior to the August 25th assignment of same to Eagle Domestic resulting in an Eagle Drilling account receivable, which was carved out of the assignment to Eagle Domestic. At the conclusion of the trial, the Texas bankruptcy court took the matter under advisement and has not yet ruled.

Further, in the Eagle Drilling bankruptcy proceeding in Oklahoma, Quicksilver Resources, Inc. (Quicksilver) filed a Motion to Convert the case from one under Chapter 11 to a case under Chapter 7. Hallwood Energy joined Quicksilver in the relief requested in the Motion. On May 20, 2008, the Oklahoma bankruptcy court considered the Motion to Convert, and instead of converting the case to a Chapter 7 liquidation case, ordered that an examiner/expert witness would be appointed to examine and report to the court on fraudulent transfers alleged to have been made by Eagle Drilling to, or for the benefit of Eagle Drilling s

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six Months Ended June 30, 2008 and 2007
(unaudited)

insiders and affiliates (i.e. Rodney Thornton, Second Bridge, LLC, Thornton Oilfield Holdings, LLC, et al.). The Oklahoma bankruptcy court may also authorize the examiner/expert witness to evaluate the bona fides of the claims Eagle Drilling has initiated and seeks to initiate against Hallwood and Quicksilver. On June 30, 2008, the Oklahoma bankruptcy court appointed L. Win Holbrook as the examiner/expert witness to evaluate and report to the Oklahoma bankruptcy court on the issue set forth in the preceding sentence. Although Mr. Holbrook s initial report was due by July 30, 2008, in response to a request for extension of this deadline from Mr. Holbrook, the report is now due by August 29, 2008. On August 7, 2008, Eagle Drilling filed a motion to vacate an agreed order entered in February 2008 by the Oklahoma bankruptcy court which, among other things, ordered that certain claims and causes of action by and between Hallwood Energy and Eagle Drilling were to be adjudicated in the context of a jury trial in the Oklahoma bankruptcy court. Hallwood Energy s response deadline to that motion is August 22, 2008, and no hearing has yet been set on the motion. Hallwood Energy and Hallwood Petroleum are currently unable to determine the impact that this litigation may have on its results of operations or its financial position.

Going Concern. Hallwood Energy is continuing to seek additional capital, however, there is no assurance that any such transaction will be completed. If FEI does not elect to fund a substantial portion of the remaining $65,000,000 contemplated under the farmout agreement and Hallwood Energy is unable to obtain additional funds, there is substantial doubt about Hallwood Energy s ability to continue as a going concern.

Table of Contents

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six Months Ended June 30, 2008 and 2007
(unaudited)

The following table sets forth summarized financial data for Hallwood Energy, L.P. (in thousands):

	June 30, 2008	December 31, 2007
Balance Sheet Data		
Cash and cash equivalents	$ 20,406	$ 2,372
Restricted cash	24,811	
Oil and gas properties, net	122,048	107,248
Total assets	175,580	115,678
Notes payable (including make-whole fee)	160,111	101,990
Total liabilities	220,807	146,516
Partners capital (deficiency)	(45,227)	(30,838)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
Statement of Operations Data				
Revenues				
Natural gas sales	$ 7,580	$	$ 11,815	$
Facility income	461		789	
	8,041		12,604	
Expenses				
Impairment of oil and gas properties				31,680
General and administrative expenses	2,334	1,690	6,422	3,349
Depreciation and depletion	1,903	59	3,930	122
Operating expenses	1,360	85	2,049	89
Litigation settlement	13		4,763	
	5,610	1,834	17,164	35,240
Operating income (loss)	2,431	(1,834)	(4,560)	(35,240)
Other Income and Expense Interest expense	(14,292)	(5,675)	(17,651)	(14,202)
Interest and other income	261	50	323	184
	(14,031)	(5,625))	(17,328)	(14,018)
Net Loss	$ (11,600)	$ (7,459)	$ (21,888)	$ (49,258)

Note 5 Loans Payable

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

	June 30, 2008	**December 31, 2007**
Working capital revolving credit facility, interest at Libor +1.25% - 1.75% or Prime, due January 2010	$ 15,248	$ 17,181
Equipment term loans, interest at various rates, due at various dates through April 2009	93	185
Total	15,341	17,366
Current portion	(93)	(158)
Noncurrent portion	$ 15,248	$ 17,208

Table of Contents

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six Months Ended June 30, 2008 and 2007
(unaudited)

Working Capital Revolving Credit Facility. The Company s Brookwood subsidiary has a revolving credit facility in an amount up to $25,000,000 (increased from $22,000,000 in December 2007) with Key Bank National Association (the Working Capital Revolving Credit Facility). Borrowings are collateralized by accounts receivable, certain finished goods inventory, machinery and equipment and all of the issued and outstanding capital stock of Brookwood and its subsidiaries. The facility bears interest at Brookwood s option of Prime, or Libor plus 1.25% - 1.75% (variable depending on compliance ratios) and contains various covenants. The interest rate was a blended rate of 4.37% and 6.73% at June 30, 2008 and December 31, 2007, respectively. The outstanding balance was $15,248,000 at June 30, 2008 and Brookwood had $9,752,000 of borrowing availability under this facility.

Equipment Term Loans. Brookwood has a revolving equipment credit facility in an amount up to $3,000,000 with Key Bank. Interest rates for the equipment term loans varied between 4.23% and 8.20% with a blended rate of 4.60% and 6.53% at June 30, 2008 and December 31, 2007, respectively. The outstanding balance was $93,000 at June 30, 2008 and Brookwood had $2,907,000 of borrowing availability under this facility.

Loan Covenants. The Working Capital Revolving Credit Facility provides for a maximum total debt to tangible net worth ratio and a covenant that Brookwood shall maintain a quarterly minimum net income of not less than one dollar. Cash dividends and tax sharing payments to the Company are contingent upon Brookwood s compliance with the covenants contained in the loan agreement. As of the end of all interim periods in 2008 and 2007 and as of December 31, 2007, Brookwood was in compliance with its principal loan covenants, although a waiver regarding a pro forma (inclusive of projected dividend) total debt to tangible net worth ratio for the 2007 third quarter was granted to allow a $1,500,000 dividend payment in November 2007 and an amendment to the loan agreement was entered into in June 2008 to allow a $4,800,000 dividend payment in June 2008 and restrict the total dividends from Brookwood for 2008 to $9,300,000.

Restricted Net Assets. Cash dividends and tax sharing payments by Brookwood to the Company are contingent upon compliance with the Key Bank loan covenants. This limitation on the transferability of assets constitutes a restriction of Brookwood s net assets, which were $32,622,000 and $29,180,000 as of June 30, 2008 and December 31, 2007, respectively.

Note 6 Stockholders Equity

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

At June 30, 2008, there were 4,500 fully vested outstanding options that expire in May 2010. The 1995 Stock Option Plan terminated on June 27, 2005. Options issued prior to the termination were not affected; however, no new options can be issued under the 1995 Plan.

In January 2007, one officer of the Company exercised options to purchase 2,250 shares of the Company s common stock that were scheduled to expire in February 2007. The officer paid the exercise price and related tax withholding requirement by exchanging an equivalent number of common shares valued at the fair market value of the common stock at the date of exercise. The net result of the exercise and exchange was the issuance of 1,273 shares from treasury at an average carrying value of $14.97 per share.

In June 2007, two officers of the Company exercised options to purchase a total of 7,500 shares of the Company s common stock that were scheduled to expire in September 2007. The officers paid the exercise price and related tax withholding requirement by exchanging an equivalent number of common shares valued at the fair market value of the common stock at the date of exercise. The net result of the exercises and exchanges was the issuance of 3,955 shares from treasury at an average carrying value of $15.08 per share.

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six Months Ended June 30, 2008 and 2007
(unaudited)

There was no option activity for the six months ended June 30, 2008 and status of outstanding options are as follows:

	Number of Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value
Outstanding, January 1, 2008	4,500	$ 10.31		
Granted				
Exercised				
Forfeited				
Outstanding, June 30, 2008	4,500	$ 10.31	1.92	$ 256,000
Options exercisable and vested at June 30, 2008	4,500		1.92	$ 256,000

The aggregate intrinsic value in the table above represents the total pre-tax intrinsic value (the difference between the Company s closing stock price on the last trading day of the 2008 second quarter ($67.15 per share) and the exercise price, multiplied by the number of options).

Note 7 Income Taxes

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
Federal				
Deferred	$ (686)	$ (297)	$ 121	$ (4,091)
Current				
Sub-total	(686)	(297)	121	(4,091)
State				
Deferred				(43)
Current	314	229	973	269
Sub-total	314	229	973	226
Total	$ (372)	$ (68)	$ 1,094	$ (3,865)

The net deferred tax asset was $4,479,000 and $4,600,000 at June 30, 2008 and December 31, 2007, respectively. The deferred tax asset at June 30, 2008 was comprised of $1,720,000 attributable to temporary differences that, upon reversal, can be utilized to offset income from operations, $1,915,000 attributable to a net operating loss carryforward from 2007, and $844,000 of alternative minimum credits. The December 31, 2007 amount was attributable to temporary differences of $1,720,000, a net operating loss carryforward of $2,036,000 and $844,000 of alternative minimum tax credits. The effective federal tax rate in both periods was 34%. State taxes are determined based upon taxable income apportioned to those states in which the Company does business at their respective tax rates.

The federal income tax receivable, attributable to the anticipated carryback of its 2007 taxable loss, was $12,239,000 at June 30, 2008 and December 31, 2007. The Company expects to file a carryback of its 2007 taxable loss in September 2008 to obtain the refund.

Table of Contents

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six Months Ended June 30, 2008 and 2007
(unaudited)

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

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

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

Description	Six Months Ended June 30, 2008	2007
Change in payable additional investment in Hallwood Energy	$ 7,290	$
Increase (decrease) in accrued capital expenditures in accounts payable	$ 294	$ 57
Previously realized increase in fair value of marketable securities sold during the period	$	$ (55)
Income tax effect from exercise of stock options:		
Income taxes payable	$	$ 275
Additional paid-in capital		(275)
	$	$

***Supplemental disclosures of cash payments*:**

	2008	2007
Income taxes paid (refunded)	$ 529	$ (832)
Interest paid	433	547

Table of Contents

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six Months Ended June 30, 2008 and 2007
(unaudited)

Note 9 Computation of Income (Loss) Per Common Share

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

Description	Three Months Ended June 30, 2008	Three Months Ended June 30, 2007	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007
Weighted Average Shares Outstanding				
Basic	1,521	1,517	1,521	1,517
Potential shares from assumed exercise of stock options			5	
Potential repurchase of shares from stock option proceeds			(3)	
Diluted	1,521	1,517	1,523	1,517
Net Income (Loss)				
Basic and diluted	$ (1,330)	$ (573)	$ 236	$ (7,897)

Due to the losses in the 2007 periods, potential shares from assumed exercise of stock options in the amounts of 7,000 and 7,000 shares for the three month and six month periods in 2007, respectively, were antidilutive. No shares were excluded from the calculation of diluted earnings per share for the six months ended June 30, 2008.

Note 10 Related Party Transactions

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

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

	Three Months Ended June 30, 2008	Three Months Ended June 30, 2007	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007
Consulting fees	$ 249	$ 249	$ 498	$ 498
Office space and administrative services	59	34	152	74
Travel expenses	33	8	36	16
Total	$ 341	$ 291	$ 686	$ 588

In addition, HIL and Mr. Gumbiner perform services for certain affiliated entities that are not subsidiaries of the Company, for which they receive consulting fees, bonuses, stock options, profit interests or other forms of compensation and expenses. The Company recognizes a proportionate share of such compensation and expenses, based upon its ownership percentage in the affiliated entities, through the utilization of the equity method of accounting.

HIL shares common offices, facilities and certain staff in its Dallas office with the Company. The Company pays certain common general and administrative expenses and charges HIL an overhead reimbursement fee for its allocable share of the expenses. For the three months ended June 30, 2008 and 2007, HIL reimbursed the Company $40,000 and $37,000, respectively, for such expenses. For the six months ended June 30, 2008 and 2007, HIL reimbursed the Company $80,000 and $75,000, respectively.

Table of Contents

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six Months Ended June 30, 2008 and 2007
(unaudited)

In April 2007, HIL committed to fund one-half of potential additional equity or subordinated debt funding calls by Hallwood Energy totaling $55,000,000, or $27,500,000, to the extent other investors, including the Company, did not respond to a call. In June 2007, HIL funded that portion of the Company s share of the May Call that the Company did not fund in the amount of $2,591,000 and contributed, along with the Hallwood Energy s lender, an additional amount in August 2007 to fully satisfy the May Call, to the extent other Hallwood Energy investors did not respond to the May Call. In September 2007, HIL funded that portion of the Company s share of the August Call in the amount of $1,842,000 that the Company did not fund and contributed an additional amount, along with the lender, in September 2007 to fully satisfy the August Call, to the extent other Hallwood Energy investors did not respond to the August Call. In September 2007, the $55,000,000 commitment from HIL and the lender expired as a result of the receipt of sufficient equity contributions from the April Call, May Call and August Call.

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

In January 2008, HIL loaned $5,000,000 to Hallwood Energy in connection with the $30,000,000 First Convertible Note issue. The terms of the First Convertible Note agreement are discussed in the section entitled Investments in Hallwood Energy . As of August 1, 2008, HIL and one of its affiliated entities have invested $19,156,000 in Hallwood Energy.

Hallwood Energy. Hallwood Energy shares common offices, facilities and certain staff in its Dallas office with the Company. Hallwood Energy reimburses the Company for its allocable share of the expenses and certain direct energy-related expenses. For the three months ended June 30, 2008 and 2007, Hallwood Energy reimbursed the Company $119,000 and $65,000 for such expenses, respectively. For the six months ended June 30, 2008 and 2007, Hallwood Energy reimbursed the Company $204,000 and $125,000, respectively.

Note 11 Litigation, Contingencies and Commitments

Reference is made to Note 16 to the consolidated financial statements contained in Form 10-K for the year ended December 31, 2007.

Litigation. From time to time, the Company, certain of its affiliates and others have been named as defendants in lawsuits relating to various transactions in which it or its affiliated entities participated. In the Company s opinion, no litigation in which the Company, subsidiaries or affiliates is a party is likely to have a material adverse effect on its financial condition, results of operation or cash flows.

On July 31, 2007, Nextec Applications, Inc. filed *Nextec Applications, Inc. v. Brookwood Companies Incorporated and The Hallwood Group Incorporated* in the United States District Court for the Southern District of New York (SDNY No. CV 07-6901) claiming that the defendants infringed five United States patents pertaining to internally-coated webs: U.S. Patent No. 5,418,051; 5,856,245; 5,869,172; 6,071,602 and 6,129,978. On October 3, 2007, the U.S. District Court dismissed The Hallwood Group Incorporated from the lawsuit. Brookwood timely answered the lawsuit. Nextec recently sought leave of court to add two additional patents to the lawsuit: U.S. Patent No. 5,954,902 and 6,289,841. The Court held a telephone hearing on August 7, 2008 and indicated that it intended to grant leave to Nextec to amend the complaint and allow additional time for discovery. To date, no amended complaint has been formally filed or served, and no order has been entered granting formal leave to amend the complaint. Brookwood intends to vigorously defend all claims.

Hallwood Energy. As a significant investor in Hallwood Energy, the Company may be impacted by litigation involving Hallwood Energy. Refer to Note 4 for a further description of certain litigation involving Hallwood Energy.

Environmental Contingencies. A number of jurisdictions in which the Company operates have adopted laws and regulations relating to environmental matters. Such laws and regulations may require the Company to secure governmental permits and approvals and undertake measures to comply therewith. Compliance with the requirements

imposed may be time-consuming and costly. While environmental considerations, by themselves, have not significantly affected the Company s business to date, it is possible that such considerations may have a significant and adverse impact in the future. The Company actively monitors its

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THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six Months Ended June 30, 2008 and 2007
(unaudited)

environmental compliance and while certain issues arise from time to time, management is not presently aware of any compliance issues which will significantly impact the financial position, operations or cash flows of the Company.

In August 2005, the Rhode Island Department of Health (RIDOH) issued a compliance order to Kenyon, alleging that Kenyon is a non-community water system and ordering Kenyon to comply with the RIDOH program for public water supply systems. Kenyon contested the compliance order and an administrative hearing was held in November 2005. No decision has been rendered by RIDOH. However, by letter dated July 23, 2008, the United States Environmental Protection Agency (EPA) advised Kenyon that it is the EPA s position that the Kenyon facility is a Public Water System and is subject to the regulations of the Safe Drinking Water Act . Kenyon is currently reviewing the actions necessary to comply with the aforementioned regulations. Compliance will require revamping the plant s water supply system which will require an anticipated minimum cost of $100,000.

In August 2005, Kenyon received a Notice of Alleged Violation from The Rhode Island Department of Environmental Management (RIDEM) that alleged that Kenyon had failed to comply timely with a requirement to test the destruction efficiency of a thermal oxidizer at its Kenyon plant. The notice further alleged that when the test was conducted, the equipment did not operate at the required efficiency. Since that time, Kenyon upgraded and retested the equipment and demonstrated compliance with the destruction efficiency requirement. RIDEM requested additional information regarding the testing and Kenyon s remedial actions, which Kenyon provided.

In February 2007, RIDEM issued a formal Notice of Violation (NOV) on the above matter, seeking a $14,000 fine. Kenyon requested an informal hearing to dispute the allegations in the NOV and the fine. An informal hearing was held in March 2007 and a Consent Agreement was executed. A $9,500 fine was remitted to RIDEM to close this matter.

In June 2007, RIDEM issued a NOV to Kenyon, alleging that Kenyon violated certain provisions of its wastewater discharge permit and seeking an administrative penalty of $79,000. Kenyon filed an Answer and Request for Hearing in which it disputed certain allegations in the NOV and the amount of the penalty. An informal meeting was held with RIDEM in August 2007. Following settlement negotiations, a Consent Agreement was executed which required payment of a $5,000 fine and agreement by Kenyon to perform two Supplemental Environmental Projects (SEPs) at a total cost of $161,000. As of July 31, 2008, one SEP was completed, and engineering plans for the second SEP were submitted to RIDEM for review and approval. It is anticipated that these plans will be approved and the second SEP will be completed by the fall of 2008, in accordance with the schedule set forth in the Consent Agreement.

Table of Contents

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Six Months Ended June 30, 2008 and 2007
(unaudited)

Note 12 Segments and Related Information

The following represents the Company s reportable segment operations for the three months and six months ended June 30, 2008 and 2007, respectively (in thousands):

	Textile Products	Energy	Other	Consolidated
Three months ended June 30, 2008				
Total revenue from external sources	$ 47,134			$ 47,134
Operating income (loss)	$ 8,738	$	$ (1,124)	$ 7,614
Other income (loss), net	(181)	(9,159)	24	(9,316)
Income (loss) before income taxes	$ 8,557	$ (9,159)	$ (1,100)	$ (1,702)
Three months ended June 30, 2007				
Total revenue from external sources	$ 32,065			$ 32,065
Operating income (loss)	$ 2,653	$	$ (1,273)	$ 1,380
Other income (loss), net	(284)	(1,793)	56	(2,021)
Income (loss) before income taxes	$ 2,369	$ (1,793)	$ (1,217)	$ (641)
Six months ended June 30, 2008				
Total revenue from external sources	$ 91,121			$ 91,121
Operating income (loss)	$ 16,141	$	$ (2,305)	$ 13,836
Other income (loss), net	(428)	(12,120)	42	(12,506)
Income (loss) before income taxes	$ 15,713	$ (12,120)	$ (2,263)	$ 1,330
Six months ended June 30, 2007				
Total revenue from external sources	$ 60,373			$ 60,373
Operating income (loss)	$ 3,151	$	$ (2,356)	$ 795
Other income (loss), net	(510)	(12,284)	237	(12,557)
Income (loss) before income taxes	$ 2,641	$ (12,284)	$ (2,119)	$ (11,762)

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, 2007 annual report. The total assets for the Company s operating segments have not materially changed since the December 31, 2007 annual report.

Table of Contents

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

Overview

General. The Company is a holding company with interests in textiles and energy.

Textile Products. In 2007 and 2008, the Company derived all of its operating revenues from the textile activities of its Brookwood Companies Incorporated (Brookwood) subsidiary; consequently, the Company s success is highly dependent upon Brookwood s success. Brookwood s success will be influenced in varying degrees by its ability to continue sales to existing customers, cost and availability of supplies, Brookwood s response to competition, its ability to generate new markets and products and the effect of global trade regulation. Although the Company s textile activities have generated positive cash flow in recent years, there is no assurance that this trend will continue.

While Brookwood has enjoyed substantial growth in its military business, there is no assurance this trend will continue. Brookwood s sales to the customers from whom it derives its military business have been more volatile and difficult to predict, a trend the Company believes will continue. In recent years, orders from the military for goods generally were significantly affected by the increased activity of the U.S. military. If this activity does not continue or declines, then orders from the military generally, including orders for Brookwood s products, may be similarly affected. Military sales of $31,981,000 and $60,139,000 for the 2008 second quarter and six month periods, respectively, were 92.0% and 109.6% higher than the comparable periods in 2007 of $16,656,000 and $28,692,000.

The military had limited orders in 2006 and the 2007 first quarter for existing products and adopted revised specifications for new products to replace the products for which Brookwood s customers have been suppliers. However, the U.S. government released orders in the remaining 2007 quarters and into 2008 that include Brookwood s products, which resulted in a substantial increase in military sales. Changes in specifications or orders present a potential opportunity for additional sales; however, it is a continuing challenge to adjust to changing specifications and production requirements. Brookwood has regularly conducted research and development on various processes and products intended to comply with the revised specifications and participates in the bidding process for new military products. However, to the extent Brookwood s products are not included in future purchases by the U.S. government for any reason, Brookwood s sales could be adversely affected. In addition, the U.S. government is releasing contracts for shorter periods than in the past. The Company acknowledges the unpredictability in revenues and margins due to military sales and is unable at this time to predict future sales trends.

Unstable global nylon and chemical pricing and escalating energy costs, coupled with a varying product mix, have continued to cause fluctuations in Brookwood s margins, a trend that appears likely to continue.

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

The U.S. textile industry has been and continues to be negatively impacted by existing worldwide trade practices, including the North American Free Trade Agreement (NAFTA), anti-dumping and duty enforcement activities by the U.S. Government and by the value of the U.S. dollar in relation to other currencies. The establishment of the World Trade Organization (WTO) in 1995 has resulted in the phase out of quotas on textiles and apparel, effective January 1, 2005. Notwithstanding quota elimination, China s accession agreement for membership in the WTO provides that WTO member countries (including the United States, Canada and European countries) may re-impose quotas on specific categories of products in the event it is determined that imports from China have surged and are threatening to create a market disruption for such categories of products. During 2005, the United States and China agreed to a new quota arrangement, which will impose quotas on certain textile products through the end of 2008. In addition, the European Union also agreed with China on a new textile arrangement, which imposed quotas through the end of 2007. The European Union and China have announced that they will jointly monitor the volume of trade in a number of

highly sensitive product categories during 2008. The United States may also unilaterally impose additional duties in response to a particular product being imported (from China or other countries) in such increased quantities as to cause (or threaten) serious damage to the relevant domestic industry (generally known as anti-dumping actions). In addition, China has imposed an export tax on all textile products manufactured in China; Brookwood does not believe this tax will have a material impact on its business.

Table of Contents

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

Under NAFTA there are no textile and apparel quotas between the U. S. and either Mexico or Canada for products that meet certain origin criteria. Tariffs among the three countries are either already zero or are being phased out. Also, the WTO recently phased out textile and apparel quotas.

The U.S. has also approved the Central American Free Trade Agreement (CAFTA) with several Central American countries (Costa Rica, the Dominican Republic, El Salvador, Guatemala, Honduras and Nicaragua). Under CAFTA, textile and apparel originating from CAFTA countries will be duty and quota-free, provided that yarn formed in the United States or other CAFTA countries is used to produce the fabric. In addition, the United States recently implemented bilateral free trade agreements with Bahrain, Chile, Israel, Jordan, Morocco and Singapore. Although these actions have the effect of exposing Brookwood s market to the lower price structures of the other countries and, therefore, continuing to increase competitive pressures, management is not able to predict their specific impact.

The textile products business is not interdependent with the Company s other business operations. The Company does not guarantee the Brookwood bank facilities and is not obligated to contribute additional capital.

Engagement of Financial Advisor. In December 2007, a special committee of the board of directors of the Company engaged a financial advisor to assist it in developing strategic alternatives, including a potential sale, with respect to Brookwood. This initiative is continuing, but there can be no assurance that the special committee will recommend any action with respect to Brookwood or that any transaction will be completed.

Energy. Hallwood Energy is a privately held independent oil and gas limited partnership and operates as an upstream energy company engaging in the acquisition, development, exploration, production, and sale of hydrocarbons, with a primary focus on natural gas assets. Hallwood Energy conducts its energy activities from its corporate office located in Dallas, Texas and production offices in Searcy, Arkansas and Lafayette, Louisiana. Hallwood Energy s results of operations are and will be largely dependent on a variety of factors, including, but not limited to fluctuations in natural gas prices; success of its drilling activities; the ability to transport and sell its natural gas; regional and national regulatory matters; and the ability to secure, and price of, goods and services necessary to develop its oil and gas leases. As of June 30, 2008, the Company owned approximately 22% of the blended Class A and Class C limited partner interests (18% after consideration of profit interests) of Hallwood Energy.

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

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

Presentation

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

Results of Operations

The Company reported a net loss for the 2008 second quarter of $1,330,000, compared to a net loss of $573,000 in 2007. Revenue for the 2008 second quarter was $47,134,000, compared to $32,065,000 in 2007.

Net income for the 2008 six month period was $236,000, compared to a net loss of $7,897,000 in 2007. Revenue for the 2008 six month period was $91,121,000, compared to $60,373,000 in 2007.

Revenues

Textile products sales of $47,134,000 increased by $15,069,000, or 47.0%, in the 2008 second quarter, compared to $32,065,000 in 2007. Sales for the six month period increased by $30,748,000, or 50.9%, to $91,121,000, compared to $60,373,000 in 2007. The increases in the 2008 periods were principally due to an increase of sales of specialty

fabric to U.S. military

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

contractors, as a result of increased orders from the military to Brookwood s customers. Military sales accounted for $31,981,000 and $60,139,000 in the 2008 second quarter and six month periods, respectively, compared to $16,656,000 and $28,692,000 in 2007. The military sales represented 67.9% and 51.9% of Brookwood s net sales in the 2008 and 2007 second quarters, respectively, and 66.0% and 47.5% in the 2008 and 2007 six month periods, respectively.

Sales to one customer, Tennier Industries, Inc. (Tennier) accounted for more than 10% of Brookwood s net sales during both the 2008 and 2007 three month and six month periods. Its relationship with Tennier is ongoing. Sales to Tennier, which are included in military sales, were $15,112,000 and $29,980,000 in the 2008 second quarter and six month periods, respectively, compared to $8,675,000 and $15,570,000 in 2007. Sales to Tennier represented 32.1% and 27.1% of Brookwood s net sales in the 2008 and 2007 quarters, respectively, and 32.9% and 25.8% in the 2008 and 2007 six month periods, respectively. Sales to another customer, ORC Industries, Inc. (ORC) accounted for more than 10% of Brookwood s sales in 2008. Its relationship with ORC is ongoing. Sales to ORC, which are included in military sales, were $5,252,000 and $9,281,000 in the 2008 second quarter and six month periods, respectively, compared to $2,024,000 and $4,230,000 in 2007. Sales to ORC represented 11.1% and 6.3% of Brookwood s net sales in the 2008 and 2007 quarters, respectively, and 10.2% and 7.0% in the 2008 and 2007 six month periods, respectively.

Expenses

Textile products cost of sales of $33,967,000 for the 2008 second quarter increased by $8,009,000, or 30.9%, compared to $25,958,000 in 2007. For the six month periods, textile products cost of sales of $66,519,000 for 2008 increased by $16,272,000, or 32.4%, compared to $50,247,000 in 2007. The 2008 increases principally resulted from material and labor costs associated with the higher sales volume, and changes in product mix and utility costs, which increased 59% and 56% in the 2008 second quarter and six month periods compared to the 2007 periods. Cost of sales includes all costs associated with the manufacturing process, including but not limited to, materials, labor, utilities, depreciation on manufacturing equipment and all costs associated with the purchase, receipt and transportation of goods and materials to Brookwood s facilities, including inbound freight, purchasing and receiving costs, inspection costs, internal transfer costs and other costs of the distribution network and associated manufacturer s rebates. Brookwood believes that the reporting and composition of cost of sales and gross margin is comparable with similar companies in the textile converting and finishing industry.

The increased gross profit margin for the 2008 second quarter, 27.9% versus 19.0%, and for the 2008 six month period, 27.0% versus 16.8%, principally resulted from higher sales volume, changes in product mix and manufacturing efficiencies such as reductions to material working loss.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
Textile products	$ 4,428	$ 3,454	$ 8,461	$ 6,975
Corporate	1,125	1,273	2,305	2,356
Total	$ 5,553	$ 4,727	$ 10,766	$ 9,331

Textile products administrative and selling expenses of $4,428,000 for the 2008 second quarter increased by $974,000, or 28.2%, from 2007. For the six months, selling and administrative expenses increased by $1,486,000, or 21.3%, compared to 2007. The increase for the 2008 second quarter from the 2007 quarter was primarily attributable

to $908,000 of employee related expenses (e.g. salaries and benefits) related to the higher sales volume, as well as in support of increased compliance requirements for Sarbanes-Oxley and environmental matters, $80,000 of increased factor commissions due to a higher volume of factored billings, $132,000 in research and development costs and $245,000 of legal and professional fees. Expense increases for the 2008 second quarter were partially offset by reductions of $120,000 in samples and $73,000 in bad debt provision. The increase for the 2008 six month period was primarily attributable to $1,100,000 of employee related expenses related to higher sales volume, as well as in support of increased compliance requirements for Sarbanes-Oxley and environmental matters, $161,000 of increased factor commissions, $210,000 in research and development costs and $295,000 of legal and professional fees. Expense increases for the 2008 six month period were partially offset by reductions of $93,000 in samples, $70,000 in bad debt provision, and $128,000 of one-time 2007 first quarter relocation expenses related to Brookwood Laminating s move to Connecticut. The textile products administrative and selling expenses included items such as payroll, professional fees, sales commissions, marketing, rent, insurance, travel and royalties. Brookwood conducts research and development activities related to the exploration, development and

Table of Contents

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

production of innovative products and technologies. Research and development costs were approximately $459,000 and $327,000 in the 2008 and 2007 six month periods, respectively.

Corporate administrative expenses decreased $148,000, or 11.6%, for the 2008 second quarter, compared to 2007. For the six months, corporate expenses decreased $51,000, or 2.2%, compared to 2007. The decreases were principally attributable to a decrease in Sarbanes-Oxley costs of $175,000 and $162,000 for the three and six month periods, respectively, partially offset by increased professional fees of $6,000 and $33,000 for the three month and six month periods, respectively, including costs related to the special committee s activities in considering the Company s investment in Hallwood Energy and strategic alternatives with respect to Brookwood.

Other Income (Loss)

Equity loss from the Company s investments in Hallwood Energy, attributable to the Company s share of loss in Hallwood Energy, was $9,159,000 in the 2008 second quarter, compared to $1,873,000 in 2007. The equity loss for the 2008 six month period was $12,120,000, compared to $12,376,000 in 2007. In the 2008 second quarter, Hallwood Energy reported a loss of $11,600,000, which included a noncash expense of $14,292,000 attributable to the potential make-whole fee that would be payable upon any future prepayment of notes payable that were amended in connection with the Talisman Energy Transaction. In the 2007 second quarter, Hallwood Energy reported a loss of $41,799,000, which included an impairment of $31,680,000 associated with its oil and gas properties and an accrual of $7,100,000 as a portion of a make-whole fee in connection with a May 2007 prepayment of Hallwood Energy s former credit facility. The make-whole fee was included in interest expense. The Company recorded the equity losses in the 2008 periods to the extent of loans it made to Hallwood Energy in 2008 of $4,830,000 and a guarantee to invest additional funds up to $7,290,000 and reduced its carrying value of its investment in Hallwood Energy to zero. For the 2008 six month period, Hallwood Energy reported a loss of $21,888,000, compared to loss of $49,258,000 for the 2007 six month period. As of June 30, 2008, the Company s proportionate share of Hallwood Energy s accumulated losses that have not been recognized is approximately $3,104,000, based upon a 25% Class A ownership percentage.

The Company earned interest income of $80,000 and $92,000 for the 2007 second quarter and six month periods, respectively, accrued but not paid in cash on loans it made to Hallwood Energy in the period from March to May 2007.

Interest expense was $181,000 and $428,000 in the 2008 second quarter and six month periods, respectively, compared to $283,000 and $509,000 in the 2007 periods. Interest expense principally relates to Brookwood s Key Bank revolving credit facility. The decreases in interest expense were principally due to lower interest rates.

Interest and other income was $24,000 and $42,000 in the 2008 second quarter and six month periods, respectively, compared to $55,000 and $236,000 in 2007. The 2008 decreases were principally due to a gain in the amount of $74,000 from the sale of a marketable security sold in March 2007, and reduced interest income earned on lower balances of cash and cash equivalents.

Income Taxes

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	**2007**	**2008**	**2007**
Federal				
Deferred	$ (686)	$ (297)	$ 121	$ (4,091)
Current				
Sub-total	(686)	(297)	121	(4,091)
State				

Deferred				(43)
Current	314	229	973	269
Sub-total	314	229	973	226
Total	$ (372)	$ (68)	$ 1,094	$ (3,865)

Table of Contents

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

At June 30, 2008, the deferred tax asset was attributable to temporary differences, that upon reversal, could be utilized to offset income from operations, a net operating loss carryforward and alternative minimum tax credits. The effective federal tax rate in both periods was 34%, while state taxes are determined based upon taxable income apportioned to those states in which the Company does business at their respective tax rates.

Investments in Hallwood Energy

At June 30, 2008, the Company owned approximately 22% of the blended Class A and Class C limited partner interests (18% after consideration of profit interests) of Hallwood Energy. The Company accounts for this investment using the equity method of accounting and records its pro rata share of Hallwood Energy s net income (loss) and partner capital transactions as appropriate.

Hallwood Energy is a privately held independent oil and gas limited partnership and operates as an upstream energy company engaging in the acquisition, development, exploration, production, and sale of hydrocarbons, with a primary focus on natural gas assets. Hallwood Energy conducts its energy activities from its corporate office located in Dallas, Texas and production offices in Searcy, Arkansas and Lafayette, Louisiana. Hallwood Energy s results of operations are and will be largely dependent on a variety of factors, including, but not limited to fluctuations in natural gas prices; success of its drilling activities; the ability to transport and sell its natural gas; regional and national regulatory matters; and the ability to secure, and price of, goods and services necessary to develop its oil and gas leases; and the ability to raise additional capital.

Hallwood Energy s management has classified its energy investments into three identifiable geographical areas:

West Texas the Barnett Shale and Woodford Shale formations,

Central and Eastern Arkansas primary target is the Fayetteville Shale formation, and

South Louisiana various projects on and around the LaPice Salt Dome.

Certain of the Company s officers and directors are investors in Hallwood Energy. In addition, as members of management of Hallwood Energy, one director and officer and one officer of the Company hold a profit interest in Hallwood Energy.

In January 2008, the Company loaned $5,000,000 to Hallwood Energy as part of a $30,000,000 convertible subordinated note agreement (discussed below).

The Company s proportionate share of Hallwood Energy s calendar year 2007 loss would have reduced the carrying value of its investment in Hallwood Energy below zero. The general rule for recording equity losses ordinarily indicates that the investor shall discontinue applying the equity method when the investment has been reduced to zero and shall not provide for additional losses unless the investor provides or commits to provide additional funds in the investee, has guaranteed obligations of the investee, or is otherwise committed to provide further financial support to the investee. Although no guarantee or commitment existed at December 31, 2007, the Company loaned $5,000,000 to Hallwood Energy in January 2008 in connection with Hallwood Energy s issuance of up to $30,000,000 of convertible subordinated note due January 21, 2011 (the First Convertible Note) to provide capital to continue regular ongoing operations. Accordingly, the Company recorded an additional equity loss in 2007 to the extent of the $5,000,000 loan, as the Company had not determined to what extent, if any, that it would advance additional funds to Hallwood Energy.

In connection with the then ongoing efforts to complete the Talisman Energy Transaction, the Company loaned Hallwood Energy $2,961,000 on May 15, 2008. As of that date, the Company s management had indicated that it did not intend to make additional investments in Hallwood Energy, except in connection with Hallwood Energy s obtaining additional funds from external sources. Due to the uncertainties at that time related to the completion of the Talisman Energy Transaction and the Company s additional investment, if any, the Company recorded an equity loss for the 2008 first quarter to the extent of the $2,961,000 loan. The Company s carrying value of its Hallwood Energy investment was zero at March 31, 2008.

As a result of the completion of the Talisman Energy Transaction in June 2008, the Company entered into the Equity Support Agreement with Hallwood Energy which obligated the Company to contribute additional equity or debt capital of $2,039,000 to Hallwood Energy and guarantee an additional amount of up to $7,500,000 in certain circumstances. The Company s commitment to provide additional financial support, resulted in the recording of an equity loss in the 2008 second quarter of $9,159,000, which

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

included accumulated equity losses that had not been previously recorded as the Company had reduced the carrying value of its investment to zero. The Company s carrying value of its Hallwood Energy investment was zero at June 30, 2008.

Capital Transaction in 2008. As previously disclosed, Hallwood Energy is in the process of seeking additional capital from external sources. In connection with this effort, on June 10, 2008, Hallwood Energy entered into an agreement for the sale and farmout to FEI Shale, L.P. (FEI), a subsidiary of Talisman Energy, Inc. of an undivided interest in up to 33.33% of Hallwood Energy s interest in substantially all its assets for a series of payments of up to $125,000,000 (an initial payment of $60,000,000 and an option to pay up to an additional $65,000,000), and entered into an agreement to provide consulting services to the purchaser for one year (the Talisman Energy Transaction). FEI prepaid the consulting services agreement which requires two man-weeks per month of service from two senior executives. The revenues from this agreement will be recognized as earned over the course of the twelve month period.

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

The parties have agreed to use commercially reasonable efforts to agree upon a budget for each quarterly period during the term of the farmout agreement. Any material variance from the budget requires the prior approval of FEI.

If Hallwood Energy receives an authorization for expenditure from a third-party operator of its properties and either Hallwood Energy or FEI does not wish to include these operations under the farmout agreement, the other party may proceed at its sole risk and expense. If the participating party recoups its costs, the nonparticipating party will become entitled to receive an interest in the well in the amount of 66.67% if Hallwood Energy is the non-participating party, or 33.33% if FEI is the non-participating party.

If Hallwood Energy enters into discussions concerning a sale of a material portion of its assets or a change of control, FEI will have the opportunity to submit a proposal to complete the transaction. If Hallwood Energy and FEI do not enter into a definitive agreement for the transaction, Hallwood Energy may pursue other opportunities if the terms are not less favorable to Hallwood Energy than those proposed by FEI.

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

In connection with the Talisman Energy Transaction, the Company loaned $2,961,000 to Hallwood Energy on May 15, 2008 on terms similar to the First Convertible Note issued in January 2008. Contemporaneously with the signing of the sale and farmout agreement, the Company entered into an Equity Support Agreement (the Equity Support Agreement) with Hallwood Energy, under which the Company committed to contribute equity or debt capital to Hallwood Energy to maintain a reasonable liquidity position for Hallwood Energy or prevent or cure any default

under Hallwood Energy s credit facilities with respect to interest payments, up to a maximum amount of $12,500,000. The loan of $2,961,000 in May 2008 and an additional loan to Hallwood Energy on June 10, 2008 of $2,039,000 (for a total of $5,000,000) are treated as contributions toward the maximum amount.

Funds advanced to Hallwood Energy pursuant to the Equity Support Agreement are issued under terms of the Second Convertible Note (discussed below), which are comparable to the First Convertible Note. During June and July 2008, the Company sold $380,000 of the Second Convertible Notes to other investors in Hallwood Energy. As of June 30, 2008, $5,000,000 of the

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

Second Convertible Notes were outstanding, of which $4,830,000 was held by the Company and $170,000 was held by other Hallwood Energy investors.

Hallwood Energy continues to seek additional capital from external sources.

A description of Hallwood Energy s activities during 2007 and 2008 are provided below.

Loan Financing. In March and April 2007, the Company loaned a total of $9,000,000 to Hallwood Energy, of which $7,000,000 was in the form of demand notes bearing interest at 6% above prime rate, and $2,000,000 was an advance that was repaid four days later with interest. In April 2007, Hallwood Energy made a request for additional capital contributions in the amount of $25,000,000 (the April Call). The Company and Hallwood Energy had agreed that the $7,000,000 of loans would be applied as the Company s portion of the April Call and as such was recorded as a Class C partnership investment. In May 2007, Hallwood Energy repaid $257,000 to the Company, which represented the excess of the $7,000,000 loaned over the Company s share of the capital contribution and related oversubscription.

In April 2007, Hallwood Energy entered into a $100,000,000 loan facility (the Senior Secured Credit Facility) with a new lender (the New Lender), who is an affiliate of one of Hallwood Energy s investors and drew $65,000,000 from the Senior Secured Credit Facility. The proceeds were used to repay the $40,000,000 balance of Hallwood Energy s former credit facility, approximately $9,800,000 for a make-whole fee and approximately $500,000 for incremental interest related to Former Credit Facility, transaction fees of approximately $200,000 and provide working capital. The Senior Secured Credit Facility is secured by Hallwood Energy s oil and gas leases, matures on February 1, 2010, and bears interest at a rate of the defined LIBOR rate plus 10.75% per annum (increased to LIBOR + 12.75% per annum effective May 1, 2008). An additional 2% of interest is added upon continuance of any defaulting event. The New Lender may demand that Hallwood Energy prepay the outstanding loans in the event of a defined change of control, qualified sale or event of default, including a material adverse event. In conjunction with executing the Senior Secured Credit Facility, the New Lender resigned its position on Hallwood Energy s board of directors and assigned its general partner interest to the remaining members.

The Senior Secured Credit Facility provided that, if Hallwood Energy raised $25,000,000 through an equity call or through debt subordinate to the Senior Secured Credit Facility, the New Lender would match subsequent amounts raised on a dollar for dollar basis up to the remaining $35,000,000 under the Senior Secured Credit Facility through the availability termination date of July 31, 2008. During the 2007 third quarter, Hallwood Energy borrowed an additional $20,000,000 under the Senior Secured Credit and borrowed the remaining $15,000,000 availability in October 2007. Accordingly, the Senior Secured Credit Facility was fully funded with an outstanding balance of $100,000,000 at December 31, 2007.

The Senior Secured Credit Facility contains various financial covenants, including maximum general and administrative expenses and current and proved collateral coverage ratios. In June 2008, the proved collateral coverage ratio test was amended to be effective September 30, 2008, and each quarter thereafter. Non-financial covenants restrict the ability of Hallwood Energy to dispose of assets, incur additional indebtedness, prepay other indebtedness or amend certain debt instruments, pay dividends, create liens on assets, enter into sale and leaseback transactions, make investments, loans or advances, make acquisitions, engage in mergers or consolidations or engage in certain transactions with affiliates, and otherwise restrict certain activities by Hallwood Energy. In October 2007, Hallwood Energy entered into an amendment of the Senior Secured Credit Facility to modify the calculation of the current ratio to include certain capital funding commitments.

The Senior Secured Credit Facility contained a make-whole provision whereby Hallwood Energy is required to pay the New Lender the amount by which the present value of interest and principal from the date of prepayment through January 31, 2009, exceeds the principal amount on the prepayment date. In June 2008, the facility was amended to extend the make-whole provision to January 31, 2010. The New Lender received warrants exercisable for 2.5% of the partnership interests at an exercise price of 2.5% of 125% of the amount of the total capital contributed to Hallwood Energy at December 31, 2006.

In January 2008, Hallwood Energy entered into a $30,000,000 convertible subordinated note agreement (the First Convertible Note). The First Convertible Note bears interest which accrues at an annual rate of 16%, which is payable on a quarterly basis after the completion of a defined equity offering and subject to the prior full payment of borrowings and accrued interest under the secured credit facilities. The First Convertible Note and accrued interest may be converted into Class C interests on a dollar for dollar basis. If no Class C interests are outstanding, the Convertible Note may be converted into Class A interests or such comparable securities as may be outstanding at the same exchange ratio as the original Class C interests. Principal and unpaid interest are due on the earlier of January 21, 2011, or upon a defined change of control. A change of control redemption may also

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

result in a make-whole provision whereby Hallwood Energy would pay a premium based on the difference between either $48,300,000 or $45,500,000 and the sum of previously made First Convertible Note principal and accrued interest payments. As of June 30, 2008, $28,839,000 of the First Convertible Notes had been subscribed for and issued. The Company subscribed for $5,000,000 of the First Convertible Note and provided the funds to Hallwood Energy in January 2008.

The First Convertible Note lenders also received a warrant exercisable at up to $3,750,000 for an equal dollar amount of Class C interests, or such comparable securities as are outstanding at the time of exercise at the same exchange ratio as the original Class C interests. The warrant is exercisable until January 21, 2011.

In connection with the completion of the Talisman Energy Transaction, the Company entered into an option agreement with the New Lender that grants the new lender an option to purchase the First Convertible Note at face value plus accrued interest, exercisable within 90 days commencing with the date of the full and final payment of all obligations and indebtedness owed by Hallwood Energy to the New Lender

In May 2008, Hallwood Energy entered into a $12,500,000 convertible subordinated note agreement (the Second Convertible Note), which was underwritten by the Company. The Second Convertible Note was issued in connection with the completion of the Talisman Energy Transaction and the related Equity Support Agreement for $12,500,000. The Second Convertible Note contains interest terms, conversion features and repayment terms comparable to the First Convertible Note described previously. As of June 30, 2008, $5,000,000 of the Second Convertible Note had been issued, of which $4,830,000 was held by the Company and $170,000 was held by other Hallwood Energy investors.

In January 2008, Hallwood Energy entered into the $15,000,000 Junior Credit Facility with the Senior Secured Credit Facility s New Lender and drew the full $15,000,000 available. The proceeds were used to fund working capital requirements and future operational activities. Borrowings under both facilities are secured by Hallwood Energy s oil and gas leases, mature on February 1, 2010, and bear interest at a rate of the defined LIBOR rate plus 10.75% per annum through April 30, 2008, and thereafter increases to 12.75% per annum until loan maturity or prepayment. An additional 2% of interest is added upon continuance of any defaulting event. The New Lender may demand that Hallwood Energy prepay the outstanding loans in the event of a defined change of control, qualified sale or event of default, including a material adverse event. Hallwood Energy remains bound to a deposit control agreement initiated with the Senior Secured Credit Facility.

The Junior Credit Facility contains various financial covenants, materially consistent with the Senior Secured Credit Facility, including maximum general and administrative expenditures and current and proved collateral coverage ratios. The proved collateral coverage ratio covenant was scheduled to become effective June 30, 2008, however, in June 2008 the coverage ratio test was amended to be effective September 30, 2008. Non-financial covenants restrict the ability of Hallwood Energy to dispose of assets, incur additional indebtedness, prepay other indebtedness or amend certain debt instruments, pay dividends, create liens on assets, enter into sale and leaseback transactions, make investments, loans or advances, make acquisitions, engage in mergers or consolidations or engage in certain transactions with affiliates, and otherwise restrict certain Hallwood Energy s activities.

The Junior Credit Facility contains a make-whole provision whereby Hallwood Energy is required to pay the New Lender the amount by which the present value of interest and principal from the date of prepayment through January 31, 2010, exceeds the principal amount on the prepayment date.

In connection with the Junior Credit Facility, the Senior Secured Credit Facility was amended to bear and interest at the defined LIBOR rate plus 12.75% per annum beginning May 1, 2008.

Hallwood Energy did not meet the current ratio covenant and was in default of the Senior Secured Credit Facility as of December 31, 2007. A second default event related to a commitment agreement by three partners to fund $15,000,000 by November 1, 2007, that was only partially funded. Hallwood Energy received a waiver from the New Lender for both of these default events in January 2008.

Hallwood Energy was not in compliance with the general and administrative expense covenant at March 31, 2008 and the current ratio covenant as of April 30, 2008 required by the Senior Secured Credit Facility and Junior Credit Facility and had entered into discussions with the New Lender to waive the current default and amend by extending this covenant test into a future period. Hallwood Energy entered into an amendment of the facilities with the New Lender in June 2008 to waive the defaults and amend various covenants.

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

In connection with the completion of the Talisman Energy Transaction, Hallwood Energy also agreed to amendments to its credit agreements that, among other things, could result in an increase in interest paid by Hallwood Energy and provides additional covenants. The principal provisions of the amendment and related agreements include the following:

The terms of the make-whole provision of the Senior Secured Credit Facility were extended from January 31,2009 to January 31, 2010.

Pursuant to a forbearance agreement among Hallwood Energy, FEI, New Lender and others, if Hallwood Energy were in the future to default in any of its obligations under its credit agreements, the New Lender has agreed not to exercise its remedies under the Senior Secured Credit Facility while the farmout agreement is in effect and for a period of 91 days after the termination of the farmout agreement.

Hallwood Energy shall pay to the New Lender on a monthly basis, the excess net cash flow, as defined, as additional debt service. Such payments, if any, shall be applied first to repay outstanding fees and expenses, second to accrued and unpaid interest and then to unpaid debt principal. The excess net cash flow is defined as operating revenues less operating expenses, certain general and administrative expenses, and other approved expenditures as defined in the agreement.

Equity Investments. There are currently three classes of limited partnership interests held in Hallwood Energy:

Class C interests bear a 16% priority return which compounds monthly. The priority return will be accrued and become payable when, as and if declared by the general partner of Hallwood Energy. Hallwood Energy does not anticipate paying any distributions in the foreseeable future. All distributions of defined available cash and defined net proceeds from any sales or other disposition of all or substantially all of the then remaining assets of Hallwood Energy which is entered into in connection with, or which will result in, the liquidation of Hallwood Energy (the Terminating Capital Transaction) must first be used to reduce any unpaid Class C priority return and capital contributions to zero. Unpaid Class C priority return and capital contributions can be converted into Class A interests based on the ratio of Class C contributions to the sum of Class A contributions and the Class C limited partner s Class C partnership interest designated by the Class C limited partner to be converted into Class A partnership interest. The Class C capital contributions were $84,422,000 and unpaid priority returns $13,328,000 at June 30, 2008.

Class A interests have certain voting rights and with the general partner would receive 100% of the distributions of available cash and net proceeds from Terminating Capital Transactions subsequent to the payment of all unpaid Class C priority return and of all Class C capital contributions until the unrecovered capital accounts of each Class A partner interest is reduced to zero, and thereafter share in all future distributions of available cash and net proceeds from Terminating Capital Transactions with the holders of the Class B interests.

Class B interests represent vested net profit interests awarded to key individuals by Hallwood Energy. At June 30, 2008 and December 31, 2007, outstanding Class B interests had rights to receive 20.0% and 18.6%, respectively, of distributions of defined available cash and net proceeds from Terminating Capital Transactions after the unpaid Class C priority return and capital contributions and the unreturned Class A and general partner capital contributions have been reduced to zero.

In April 2007, Hallwood Energy issued a $25,000,000 Class C equity call to its partners (the April Call) which was fully satisfied. Previously, Hallwood Energy received loans of $7,000,000 each from the Company and an affiliate of the New Lender. These loans were applied to the April Call. In May 2007, Hallwood Energy repaid $257,000 to the Company, which represented the excess of its $7,000,000 advanced over the Company s share of the capital

contribution and related oversubscription.

In April 2007, Hallwood Investments Limited (HIL), a corporation associated with Mr. Anthony J. Gumbiner, the Company s chairman and principal stockholder, and the New Lender each committed to fund one-half of the April Call and potential additional equity or subordinated debt funding calls totaling $55,000,000 by Hallwood Energy, to the extent other investors, including the Company, did not respond to equity calls.

In May 2007, Hallwood Energy issued a $20,000,000 Class C equity call to its partners (the May Call), which was fully satisfied. The Company s proportionate share of the May Call was $5,091,000. Due to the fact that the Company did not have

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

available sufficient cash, the Company contributed only $2,501,000 towards the May Call. Because of the Company s inability to meet its full equity call requirement, HIL funded $2,591,000 of the May Call that was not funded by the Company. In connection with the funding of this amount, Mr. Gumbiner agreed with a special committee of the board of directors of the Company that he would discuss the terms of this investment in the future.

In August 2007, Hallwood Energy issued a $15,000,000 Class C equity call to its partners (the August Call) which was fully satisfied. The Company s proportionate share of the August Call was $3,683,000. Due to the fact that the Company did not have available sufficient cash, the Company contributed only one-half, or $1,842,000, towards the August Call. Because of the Company s inability to meet its full equity call requirement, HIL funded $1,842,000 of the August Call that was not funded by the Company. In October 2007, the special committee appointed to consider HIL s funding of these capital calls acknowledged the terms of the funding of the capital calls by HIL and determined that, in light of the circumstances, including the Company s present inability to fund any amounts beyond those it had made, no further action was required.

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

In November 2007, Hallwood Energy issued $15,000,000 of Class C partnership interest to a new equity partner. In addition, HIL, another existing investor in Hallwood Energy, and the New Lender entered into a letter agreement providing for a total of up to $15,000,000 in additional funding. Under the terms of this letter, HIL agreed to advance $7,500,000 and the other investor agreed to advance $3,000,000 to Hallwood Energy no later than November 15, 2007. These advances constituted loans to Hallwood Energy with an interest rate of 16% per annum and a maturity of March 1, 2010. The letter agreement contained a provision that permitted Hallwood Energy to repay the advances at any time without penalty in connection with a recapitalization of Hallwood Energy providing for net proceeds not less than the amount being repaid. If any part of these advances remained outstanding on January 2, 2008, then on that date the outstanding amount would automatically be converted into preferred partnership interests having the same terms as the existing class of preferred partnership interests. In addition, if any portion of the advances was converted into preferred partnership interests on January 2, 2008, then the New Lender agreed to contribute to Hallwood Energy the same proportion of $4,500,000 in exchange for preferred partnership interests. Hallwood Energy also agreed that if any portion of the agreed funding from HIL or the other existing investor was not made, it would be an event of default under the Senior Secured Credit Facility. HIL advanced $7,500,000 in November 2007, although the other investor did not fulfill its commitment. On January 2, 2008, as per the letter agreement, HIL s loan was converted into a Class C interest.

Litigation. In 2006, Hallwood Energy and Hallwood Petroleum entered into two two-year contracts (the Contracts) with Eagle Drilling, LLC (Eagle Drilling), under which the contractor was to provide drilling rigs and crews to drill wells in Arkansas. In August 2006, one of the masts on the rigs provided under the Contracts collapsed. Hallwood Energy and Hallwood Petroleum requested the contractor to provide assurances that the mast on the other rig, and any mast provided to replace the collapsed mast, were safe and met the requirements of the Contracts. These Contracts were subsequently assigned by Eagle Drilling to Eagle Domestic Drilling Operations, L.L.C. (Eagle Domestic) in August 2006.

When the contractor refused to provide assurances, Hallwood Energy and Hallwood Petroleum notified the contractor that the Contracts were terminated and in September 2006, filed a lawsuit in Texas to recover funds previously deposited with the contractor under the Contracts. Eagle Domestic and its parent then filed for Chapter 11 bankruptcy protection in Texas. After the filing of its bankruptcy case, Eagle Domestic filed an adversary action against Hallwood Energy and Hallwood Petroleum in the bankruptcy proceeding to recover unspecified damages.

On April 3, 2008, Hallwood Energy and Eagle Domestic signed an agreement to settle the litigation between them. Under the agreement, Hallwood Energy agreed to pay to Eagle Domestic $2,000,000 in cash and issue to Eagle Domestic $2,750,000 in equity of Hallwood Energy or a successor entity, which was accrued by Hallwood Energy at March 31, 2008. Hallwood Energy may defer the payment of the cash and issuance of the equity until the later of the

completion of a major financing, or June 30, 2008. If the major financing is in the form of an Initial Public Offering, Hallwood Energy will deliver to Eagle Domestic shares of stock. Hallwood Energy will make best efforts to deliver registered shares. If the shares cannot be registered, Hallwood Energy will deliver shares that will be freely tradeable in their principal market within 90 days of the delivery. If the major financing is in the form of a private partnership or joint venture, Hallwood Energy will deliver partnership units to Eagle Domestic. If prior to June 30, 2008, Hallwood Energy or a successor entity had not completed a major financing, but received bridge financing in the aggregate at least $20,000,000, then Hallwood Energy agreed to pay to Eagle Domestic $500,000 in cash. Such payment was made in June 2008. The payment of $500,000 in cash will extend the date referred to above to September 30, 2008 and will be credited against the $2,000,000 payment if the $2,000,000 cash payment and $2,750,000 in equity is received no later than September 30, 2008. If the $2,000,000 cash payment

Table of Contents

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

and $2,750,000 in equity is not receiv ed by September 30, 2008, then the $500,000 cash will not be credited against any future judgment or settlement of the proceeding. The trial previously set in the matter will be continued until not earlier than September 30, 2008 and, upon receipt of the amounts contemplated by the settlement agreement, all parties and their affiliates will be fully and finally mutually released from any and all claims the other parties and their affiliates may have.

In October 2006, Eagle Drilling filed a related lawsuit against Hallwood Energy and Hallwood Petroleum in Oklahoma state court (the Eagle Drilling Action) alleging damages of over $1,000,000 in connection with unpaid invoices, unpaid downtime and other damages caused as a result of the mast collapsing. Eagle Drilling has also alleged additional claims for breach of contract, negligence and tortious breach of contract. In September 2007, Eagle Drilling filed for Chapter 11 bankruptcy protection in the United States Bankruptcy Court for the Western District of Oklahoma. Hallwood Energy has brought a claim against Eagle Drilling for return of the approximately $1,688,000 in unearned pre-payment from Eagle Drilling.

Eagle Drilling has also alleged new claims, of which $22,900,000 in claims are believed to have been specifically assigned to Eagle Domestic. Specifically, these new claims seeking in excess of $24,000,000 in damages for breach of the contracts, a negligence claim for damages to a drilling rig which Eagle Drilling did not own, tortious breach of contract, tortious interference with Eagle Drilling s relationships with other parties, and tortious business disparagement and defamation. Hallwood Energy believes these claims are without merit. After discussions with Hallwood Energy, Eagle Domestic has filed a motion in the Texas bankruptcy court asserting that it is the sole owner of the claims for breach of contract that it settled with Hallwood Energy and seeking to compel Eagle Drilling to show cause why it should not be held in contempt for its efforts to assert those claims in a separate court. That motion was considered by the Texas bankruptcy court on May 21, 2008. At that hearing, the Texas bankruptcy court determined that it does have jurisdiction to consider and rule on whether Eagle Drilling is violating the settlement agreement that it entered into with Eagle Domestic in May 2007 and/or the broad injunction under Eagle Domestic s confirmed Chapter 11 Plan. In order to make this determination, the Texas bankruptcy court conducted a trial on June 17, 18 and 30, 2008, at which the court considered evidence on Eagle Drilling s allegations that Hallwood terminated the Contracts prior to the August 25th assignment of same to Eagle Domestic resulting in an Eagle Drilling account receivable, which was carved out of the assignment to Eagle Domestic. At the conclusion of the trial, the Texas bankruptcy court took the matter under advisement and has not yet ruled.

Further, in the Eagle Drilling bankruptcy proceeding in Oklahoma, Quicksilver Resources, Inc. (Quicksilver) filed a Motion to Convert the case from one under Chapter 11 to a case under Chapter 7. Hallwood Energy joined Quicksilver in the relief requested in the Motion. On May 20, 2008, the Oklahoma bankruptcy court considered the Motion to Convert, and instead of converting the case to a Chapter 7 liquidation case, ordered that an examiner/expert witness would be appointed to examine and report to the court on fraudulent transfers alleged to have been made by Eagle Drilling to, or for the benefit of Eagle Drilling s insiders and affiliates (i.e. Rodney Thornton, Second Bridge, LLC, Thornton Oilfield Holdings, LLC, et al.). The Oklahoma bankruptcy court may also authorize the examiner/expert witness to evaluate the bona fides of the claims Eagle Drilling has initiated and seeks to initiate against Hallwood and Quicksilver. On June 30, 2008, the Oklahoma bankruptcy court appointed L. Win Holbrook as the examiner/expert witness to evaluate and report to the Oklahoma bankruptcy court on the issue set forth in the preceding sentence. Although Mr. Holbrook s initial report was due by July 30, 2008, in response to a request for extension of this deadline from Mr. Holbrook, the report is now due by August 29, 2008. On August 7, 2008, Eagle Drilling filed a motion to vacate an agreed order entered in February 2008 by the Oklahoma bankruptcy court which, among other things, ordered that certain claims and causes of action by and between Hallwood Energy and Eagle Drilling were to be adjudicated in the context of a jury trial in the Oklahoma bankruptcy court. Hallwood Energy s response deadline to that motion is August 22, 2008, and no hearing has yet been set on the motion. Hallwood Energy and Hallwood Petroleum are currently unable to determine the impact that this litigation may have on its results of operations or its financial position.

Table of Contents

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

The following table reflects the status of Hallwood Energy s oil and gas investments as of August 1, 2008:

Description	Central and Eastern Arkansas	South Louisiana	West Texas (a)	Total
Principal focus	Fayetteville Shale	Salt Dome	Barnett and Woodford Shale	
Initial funding	3rd Quarter 2005	1st Quarter 2004	3rd Quarter 2004	
Company investment				$71,311,000(b)
Company ownership percentage (c)				22%/18%
Net acres held (d)	262,200	(e)	15,611	
Operator	Hallwood Energy/ Others	Hallwood Energy	Chesapeake/ Hallwood Energy	
Well type: (f)				
Horizontal / directional	31	6	5	42
Vertical	20		4	24
Well status:				
Producing	30		5	35
Drilling	6		1	7
Successful / waiting pipeline				
Evaluating/completing	5		2	7
Unsuccessful	10	6	1	7
Net production (Mcf/day)	3,200(g)		1,800	5,000

a) Hallwood Energy owns an approximate 32% working interest in the Chesapeake-operated properties. Hallwood Energy is now operating/drilling certain wells with approximately 66% working interest.

b) Represents $40,961,000 in 2005, $9,427,000 in 2006, $11,093,000 in 2007, $5,000,000 in January 2008,

$2,961,000 in May 2008 and $1,869,000 in June 2008.

c) Before and after consideration of profit interests held by management of Hallwood Energy.

d) Net acres held is the sum of the total number of acres in which Hallwood Energy owns a working interest multiplied by Hallwood Energy s fractional working interest.

e) Hallwood Energy holds leases on approximately 14,000 acres. Based on the results of 3-D seismic data that have been analyzed, approximately 2,000-4,000 acres are expected to be retained for future development.

f) Hallwood Energy also participates in non-operated wells in Arkansas and Louisiana. All wells are natural gas wells. Represents the gross number of wells in which Hallwood Energy holds a working interest, including co-owner operated well that Hallwood Energy has a minority interest.

g) The Dismang well, producing at 4,800 mcf/d at the time, will be shut in from July 2008 through December 2008 due to over production of its allowable rate.

A description of activities in each area is provided below. Forward looking information is from current estimates by the management of Hallwood Energy, based on existing and anticipated conditions and assume Hallwood Energy is successful in securing additional capital as discussed below.

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

Central and Eastern Arkansas

The primary objective formation is the Fayetteville Shale, which appears to range in depth from approximately 2,700 to 9,400 feet and to have a thickness of 300 to 700 feet.

Hallwood Energy commenced drilling activities in the 2006 first quarter and is currently drilling pursuant to a long term contract providing for two rigs through 2008, one of which is currently available and being used. Hallwood Energy s management currently anticipates six to ten gross wells to be drilled in 2008 in this area utilizing the two rigs. Hallwood Gathering, L.P. has in service a 36-mile six, eight and twelve inch gathering system in White County with a capacity of 15 million cubic feet of gas per day (Mcf/d), with expansion potential to 60 Mcf/d. Natural gas sales began in July 2007. Hallwood Energy will also participate in co-owner operated properties where they hold a minority interest.

South Louisiana

Hallwood Energy holds leases over approximately 14,000 acres to exploit a salt dome oil and gas opportunity in St. James, Ascension and Assumption parishes. Based on the results of the 3-D seismic data that has been analyzed, approximately 2,000 to 4,000 acres are expected to be retained for future development. Hallwood Energy utilized two rigs on this property. The first rig started in October 2006 and fulfilled its two well commitment. The second rig began drilling in December 2006 and is under contract for two years. The expectations for 2008 are that two to four wells will be drilled. Additional drilling equipment and funding will be assessed and determined based on the results of the wells.

West Texas

Hallwood Energy sold a 60% interest and transferred operations in these properties to Chesapeake in July 2006. Chesapeake has drilled to total depth on five wells. Four of these wells are currently producing and selling gas and four wells are being evaluated or waiting on completion. The 2008 budget calls for these rigs to drill eight or nine gross wells in West Texas.

Critical Accounting Policies

There have been no changes to the critical accounting policies identified and set forth in the Company s Form 10-K for the year ended December 31, 2007.

Related Party Transactions

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

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,	
	2008	2007	2008	2007
Consulting fees	$ 249	$ 249	$ 498	$ 498
Office space and administrative services	59	34	152	74
Travel expenses	33	8	36	16

Total	$ 341	$ 291	$ 686	$ 588

In addition, HIL and Mr. Gumbiner perform services for certain affiliated entities that are not subsidiaries of the Company, for which they receive consulting fees, bonuses, stock options, profit interests or other forms of compensation and expenses. The

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

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 shares common offices, facilities and certain staff in its Dallas office with the Company. The Company pays certain common general and administrative expenses and charges HIL an overhead reimbursement fee for its allocable share of the expenses. For the three months ended June 30, 2008 and 2007, HIL reimbursed the Company $40,000 and $37,000, respectively, for such expenses. For the six months ended June 30, 2008 and 2007, HIL reimbursed the Company $80,000 and $75,000, respectively.

In April 2007, HIL committed to fund one-half of potential additional equity or subordinated debt funding calls totaling $55,000,000, or $27,500,000, by Hallwood Energy, to the extent other investors, including the Company, did not respond to a call. In June 2007, HIL funded that portion of the Company s share of the May Call that the Company did not fund in the amount of $2,591,000 and contributed, along with the Hallwood Energy s lender, an additional amount in August 2007 to fully satisfy the May Call, to the extent other Hallwood Energy investors did not respond to the May Call. In September 2007, HIL funded that portion of the Company s share of the August Call in the amount of $1,842,000 that the Company did not fund and contributed an additional amount, along with the lender, in September 2007 to fully satisfy the August Call, to the extent other Hallwood Energy investors did not respond to the August Call. In September 2007, the $55,000,000 commitment from HIL and the lender expired as a result of the receipt of sufficient equity contributions from the April Call, May Call and August Call.

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

In January 2008, HIL loaned $5,000,000 to Hallwood Energy in connection with the $30,000,000 First Convertible Note issue. The terms of the Convertible Note agreement are discussed in the section entitled Investments in Hallwood Energy . As of August 1, 2008, HIL and one of its affiliated entities have invested $19,156,000 in Hallwood Energy.

Hallwood Energy. Hallwood Energy shares common offices, facilities and certain staff in its Dallas office with the Company. Hallwood Energy reimburses the Company for its allocable share of the expenses and certain direct energy-related expenses. For the three months ended June 30, 2008 and 2007, Hallwood Energy reimbursed the Company $119,000 and $65,000 for such expenses, respectively. For the six months ended June 30, 2008 and 2007, Hallwood Energy reimbursed the Company $204,000 and $125,000, respectively.

Contractual Obligations and Commercial Commitments

The Company and its subsidiaries have entered into various contractual obligations and commercial commitments in the ordinary course of conducting its business operations, which are provided below as of June 30, 2008 (in thousands):

	Payments Due During the Year Ending December 31,						
	2008*	**2009**	**2010**	**2011**	**2012**	**Thereafter**	**Total**
Contractual Obligations							
Long term debt	$ 66	$ 27	$ 15,248	$	$	$	$ 15,341
Redeemable preferred stock			1,000				1,000
Operating leases	586	1,080	758	357	371	1,361	4,513
Total	$ 652	$ 1,107	$ 17,006	$ 357	$ 371	$ 1,361	$ 20,854

* For the six months ended December 31, 2008.

Interest costs associated with the Company s debt, which principally bears interest at variable rates, are not a material component of the Company s expenses. Estimated interest payments, based on the current principal balances and weighted average interest rates, assuming the contractual repayment of the term loan debt and a renewal of the revolving credit facilities at their loan balances as of June 30, 2008, are $335,000 for the six months ending December 31, 2008 and $667,000 for each the years ending December 31, 2009 through December 31, 2012, respectively.

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

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

2005 Long-Term Incentive Plan for Brookwood. In December 2005, the Company adopted The Hallwood Group Incorporated 2005 Long-Term Incentive Plan for Brookwood Companies Incorporated (2005 Long-Term Incentive Plan for Brookwood) to encourage employees of Brookwood to increase the value of Brookwood and to continue to be employed by Brookwood. The terms of the incentive plan provide for a total award amount to participants equal to 15% of the fair market value of consideration received by the Company in a change of control transaction, as defined, in excess of the sum of the liquidation preference plus accrued unpaid dividends on the Brookwood preferred stock (approximately $14,164,000 at June 30, 2008). The base amount will fluctuate in accordance with a formula that increases by the annual amount of the dividend on the preferred stock accrued, currently $1,823,000, and decreases by the amount of the cash dividends actually paid. However, if the Company s board of directors determines that certain specified Brookwood officers, or other persons performing similar functions do not have, prior to the change of control transaction, in the aggregate an equity or debt interest of at lease two percent in the entity with whom the change of control transaction is completed, then the minimum amount to be awarded under the plan shall be $2,000,000. In addition, the Company agreed that, if members of Brookwood s senior management do not have, prior to a change of control transaction, in the aggregate an equity or debt interest of at least two percent in the entity with whom the change of control transaction is completed (exclusive of any such interest any such individual receives with respect to his or her employment following the change of control transaction), then the Company will be obligated to pay an additional $2,600,000.

Hallwood Energy. The Company s Hallwood Energy affiliate has various contractual obligations and commercial commitments. At June 30, 2008, such obligations and commitments included $115,000,000 for long-term debt, $44,706,000 for interest, $14,854,000 for long-term rig commitments, $4,750,000 for settlement of litigation and $76,000 for operating leases.

Financial Covenants

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

Description	Requirement	Quarters Ended June 30, 2008	March 31, 2008	December 31, 2007	September 30, 2007
Total debt to tangible net worth	must be less than ratio of 1.50	1.13	1.31	1.32	1.41
Net income	must exceed $1.00	Yes	Yes	Yes	Yes

Brookwood was in compliance with its principal loan covenants under the Working Capital Revolving Credit Facility for the first two quarters in 2008 and for all interim periods in 2007, although a waiver regarding a pro forma (inclusive of projected dividend) total debt to tangible net worth ratio for the 2007 third quarter was granted to allow a $1,500,000 dividend payment in November 2007 and an amendment to the loan agreement was entered into in June 2008 to allow a $4,800,000 dividend payment in June 2008 and restrict the total dividends from Brookwood for 2008 to $9,300,000.

Cash dividends and tax sharing payments by Brookwood to the Company are contingent upon compliance with the Key Bank loan covenants. This limitation on the transferability of assets constitutes a restriction of Brookwood s net assets, which were $32,622,000 and $29,180,000 as of June 30, 2008 and December 31, 2007, respectively.

Hallwood Energy. The principal ratios and covenants required to be maintained by Hallwood Energy under its Senior Secured Credit Facility, as amended in June 2008, are provided below:

General and administrative costs, excluding certain legal fees, can not exceed $1,700,000 for any quarter, beginning the earlier of the end of the first fiscal quarter after the completion or termination of FEI s funding obligations under the farmout agreement or June 30, 2009

Current ratio must exceed 1.00 to 1.00 each quarter, beginning June 30, 2007

Proved collateral coverage ratio (including cash) must exceed 0.75 to 1.00, beginning September 30, 2008 and increases over time

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Table of Contents

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

Non-financial covenants restrict the ability of Hallwood Energy to dispose of assets, incur additional indebtedness, prepay other indebtedness or amend certain debt instruments, pay dividends, create liens on assets, enter into sale and leaseback transactions, make investments, loans or advances, make acquisitions, engage in mergers or consolidations or engage in certain transactions with affiliates, and otherwise restrict certain activities by Hallwood Energy. The new lender may demand that Hallwood Energy prepay the outstanding loan, including the make-whole fee, in the event of a defined change of control, qualified sale or event of default, including a material adverse event.

Hallwood Energy was not in compliance with the Senior Secured Credit Facility as of December 31, 2007 in regards to meeting the current ratio test of 1:1. A second default event related to a commitment agreement by three of Hallwood Energy s partners to fund $15,000,000 by November 1, 2007 that was only partially funded. The lender waived these defaults in January 2008 and amended the loan agreement for the Senior Secured Credit Facility, which established the next current ratio test at April 30, 2008.

In January 2008, Hallwood Energy entered into the Junior Credit Facility and borrowed the full $15,000,000 available under the facility. The Junior Credit Facility contains various financial covenants materially consistent with the Senior Secured Credit Facility.

Hallwood Energy was not in compliance with the general and administrative expense covenant at March 31, 2008 and the current ratio covenant as of April 30, 2008 required by the Senior Secured Credit Facility and Junior Credit Facility and had entered into discussions with the New Lender to waive the current default and amend by extending this covenant test into a future period. Hallwood Energy entered into an amendment of the facilities with the New Lender in June 2008 to waive the defaults and amend various covenants.

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

Liquidity and Capital Resources

General. The Company principally operates in the textile products and energy business segments. The Company s cash position decreased by $1,334,000 during the 2008 six month period to $5,926,000 as of June 30, 2008. The principal source of cash was $12,068,000 from operating activities. The primary uses of cash were $9,830,000 for additional investments in Hallwood Energy, $1,547,000 for property, plant and equipment and repayment of $2,025,000 in bank borrowings.

Textiles. The Company s textile products segment generates funds from the dyeing, laminating and finishing of fabrics and their sale to customers in the consumer, industrial, medical and military markets. Brookwood maintains a $25,000,000 working capital revolving credit facility and a $3,000,000 equipment facility with Key Bank. The facilities have a maturity date of January 2010. At June 30, 2008, Brookwood had approximately $9,752,000 of unused borrowing capacity on its working capital revolving line of credit facility and $2,907,000 on its equipment credit facility.

Brookwood paid cash dividends to the Company of $6,300,000 through June 30, 2008 and $6,000,000 for all of 2007. In addition, Brookwood made payments to the Company of $4,453,000 through June 30, 2008 and $1,591,000 for all of 2007 under its tax sharing agreement. Future cash dividends and tax sharing payments are contingent upon Brookwood s continued compliance with the covenants contained in the Key Bank credit facility. As Brookwood s total tangible net worth ratio (1.13 at June 30, 2008) approaches the maximum allowable ratio of 1.50, future payments from Brookwood may be limited. Brookwood was in compliance with the covenants as of June 30, 2008 and March 31, 2008 and for all interim periods in 2007 although a waiver regarding a pro forma (inclusive of projected dividend) total debt to tangible net worth ratio for the 2007 third quarter was granted to allow a $1,500,000 dividend payment in November 2007 and an amendment to the loan agreement was entered into in June 2008 to allow a $4,800,000 dividend payment in June 2008 and restrict the total dividends from Brookwood for 2008 to $9,300,000. There were no significant additional capital requirements as of June 30, 2008.

Energy. During 2008, 2007, 2006 and 2005, the Company invested $9,830,000, $11,093,000, $9,427,000 and $40,961,000, respectively in Hallwood Energy, as part of a total equity and debt funding to Hallwood Energy of $71,311,000.

In April 2007, Hallwood Energy entered into a $100,000,000 Senior Secured Credit Facility and had drawn $65,000,000 under the new Senior Secured Credit Facility, including $40,000,000 for repayment of the outstanding balance of its former loan. Prior to the April 2007 funding of the Senior Secured Credit Facility, the Company had loaned $7,000,000 to Hallwood Energy pursuant to demand notes bearing interest at 6% above prime rate. In April 2007, Hallwood Energy made a request for additional capital contributions in the amount of $25,000,000. The Company and Hallwood Energy had agreed that the $7,000,000 amount previously loaned would be applied as the Company s portion of this capital call. In May 2007, Hallwood Energy repaid $257,000 to the Company, which represented the excess of $7,000,000 advanced over the Company s share of the capital contribution and related oversubscription.

In April 2007, HIL and the New Lender each committed to fund one-half of the April Call and potential additional equity or subordinated debt funding calls totaling $55,000,000 by Hallwood Energy, to the extent other investors, including the Company, do not respond to a call. In May 2007, Hallwood Energy issued a $20,000,000 equity call, the May Call, to its partners, which was due on July 1, 2007, of which the Company s proportionate share was $5,091,000. The Company funded $2,500,000 of the May Call since the Company did not have funds available to fully subscribe to its proportionate share. In August 2007, Hallwood Energy issued a $15,000,000 equity call, the August Call, to its partners which was due September 14, 2007, of which the Company s proportionate share was $3,684,000. The Company funded one-half, or $1,842,000, of the August Call since the Company did not have funds available to fully subscribe to its proportionate share and does not anticipate it will have funds to contribute substantial capital in connection with future calls.

In November 2007, Hallwood Energy received $15,000,000 from a new equity partner. In addition, HIL, another existing investor and the New Lender entered into a letter agreement providing up to $15,000,000 of additional funding to Hallwood Energy. HIL funded $7,500,000 under the letter agreement, executing a promissory note bearing 16% per annum. Two of the partners did not fund under this agreement which constituted a default condition under the Senior Secured Credit Facility, as stipulated in the letter agreement. This default condition was subsequently waived and on January 2, 2008, as per the letter agreement, HIL s loan and accrued interest was converted into a Class C interest.

In January 2008, Hallwood Energy entered into the $30,000,000 Convertible Note agreement, of which $28,839,000 of the convertible subordinated notes had been subscribed for and issued. In addition, Hallwood Energy entered into the $15,000,000 Junior Credit Facility in January 2008 and drew the full $15,000,000 available.

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

Hallwood Energy was not in compliance with the Senior Secured Credit Facility as of December 31, 2007 in regards to meeting the current ratio test of 1:1. A second default event related to a commitment agreement by three of Hallwood Energy s partners to fund $15,000,000 by November 1, 2007 that was only partially funded. The lender waived these defaults in January 2008 and amended the loan agreement for the Senior Secured Credit Facility, which established the next current ratio test at April 30, 2008.

Hallwood Energy was not in compliance with the general and administrative expense covenant at March 31, 2008 and the current ratio covenant as of April 30, 2008 required by the Senior Secured Credit Facility and the Junior Credit Facility and had entered into discussions with the New Lender to waive the default and amend by extending this covenant test into a future period. Hallwood Energy entered into an amendment of the facilities with the New Lender in June 2008 to waive the defaults and amend various covenants.

On June 10, 2008, Hallwood Energy completed the Talisman Energy Transaction for the sale and farmout to a subsidiary of Talisman Energy, Inc. of an undivided interest in up to 33.33% of Hallwood Energy s interest in substantially all its assets for a series of payments of up to $125,000,000 (an initial payment of $60,000,000 and an option to pay an additional $65,000,000) and entered into an agreement to provide consulting services to the purchaser for one year.

In connection with the Talisman Energy Transaction, the Company loaned $2,961,000 to Hallwood Energy on May 15, 2008 on terms similar to the First Convertible Note issued in January 2008. Contemporaneously with the signing of the sale and farmout agreement, the Company entered into the Equity Support Agreement with Hallwood Energy. The Company committed to contribute equity or debt capital to Hallwood Energy to maintain a reasonable liquidity position for Hallwood Energy or prevent or cure any default under Hallwood Energy s credit facilities with respect to interest payments, up to a maximum amount of $12,500,000. The loan of $2,961,000 in May 2008 and an additional loan to Hallwood Energy on June 10, 2008 of $2,039,000 (for a total of $5,000,000) are treated as contributions toward the maximum amount.

In connection with entering into these agreements, Hallwood Energy also agreed to amendments to its existing credit agreements that, among other things, could result in an increase in interest paid by Hallwood Energy and provides additional covenants. Hallwood Energy anticipates that the payments by the purchaser under the sale and farmout agreement will likely pay substantially all Hallwood Energy s capital costs and the majority of its general and administrative expenses, as long as those payments continue to be made. However, Hallwood Energy s remaining expenses will likely exceed its revenues for the remainder of 2008. Therefore it is likely that the Company will be required to contribute additional funds to Hallwood Energy pursuant to the Equity Support Agreement during 2008. To the extent the Company does not make future capital contributions in proportion to its interest in Hallwood Energy, its percentage ownership interest will be reduced. The actual level of Hallwood Energy s capital requirements during 2008 and thereafter will depend on a number of factors that cannot be determined at this time, including future gas prices, costs of field operations, the ability to successfully identify and acquire prospective properties and drill and complete wells, access to gathering and transportation infrastructure, and the availability of alternative sources of capital, such as loans from third parties or equity contributions from new investors.

In addition to the Talisman Energy Transaction, Hallwood Energy is continuing to seek additional capital, however there is no assurance that any such transaction will be completed. If FEI does not elect to fund a substantial portion of the remaining $65,000,000 contemplated under the farmout agreement and Hallwood Energy is unable to obtain additional funds, there is substantial doubt about Hallwood Energy s ability to continue as a going concern.

Future Liquidity. The Company s ability to generate cash flow from operations will depend on its future performance and its ability to successfully implement business and growth strategies. The Company s performance will also be affected by prevailing economic conditions. Many of these factors are beyond the Company s control. Considering its current cash position, its anticipated cash flow from operations and anticipated income tax refund of approximately $12,230,000 in the 2008 fourth quarter, the Company believes it has sufficient funds to meet its liquidity needs, including any contribution to Hallwood Energy required under the Equity Support Agreement.

Hallwood Energy has not requested that the Company contribute any funds pursuant to the Equity Support Agreement. Furthermore, Hallwood Energy has not requested the Company to contribute, and therefore the Company has not considered whether it would contribute, any funds in excess of those contemplated by the Equity Support Agreement. If Hallwood Energy were to request funding of any amounts other than pursuant to the Equity Support Agreement, the Company would consider the request in light of the circumstances and conditions of the Company and Hallwood Energy at the time.

Table of Contents

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

Forward-Looking Statements

In the interest of providing stockholders with certain information regarding the Company s future plans and operations, certain statements set forth in this Form 10-Q relate to management s future plans, objectives and expectations. Such statements are forward-looking statements. Although any forward-looking statement expressed by or on behalf of the Company is, to the knowledge and in the judgment of the officers and directors, expected to prove true and come to pass, management is not able to predict the future with absolute certainty. Forward-looking statements involve known and unknown risks and uncertainties, which may cause the Company s actual performance and financial results in future periods to differ materially from any projection, estimate or forecasted result. Among others, these risks and uncertainties include those described in the Company s Form 10-K for the year ended December 31, 2007 in the section entitled Business Competition, Risks and Other Factors . These risks and uncertainties are difficult or impossible to predict accurately and many are beyond the control of the Company. Other risks and uncertainties may be described, from time to time, in the Company s periodic reports and filings with the Securities and Exchange Commission.

Table of Contents

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

Item 4. CONTROLS AND PROCEDURES

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

In August 2003, the Company s independent registered public accounting firm provided written communications to management and the audit committee on the need to improve the financial closing process at the Brookwood subsidiary. In April 2004, the Company received a further written communication from the independent registered public accounting firm to management and the audit committee on the continued need to improve the Brookwood financial closing process. In March 2005, April 2006, May 2007 and May 2008, the Company received communications from its independent registered public accounting firm that further improvements in the financial systems and processes at its Brookwood subsidiary are still required. With the addition of new staff, Brookwood s management believes it has made substantial progress both in the timeliness and accuracy of the closing process. Brookwood has implemented a new order processing, manufacturing cost and inventory control system and it has updated its general ledger system, which is integrating various accounting processes. The new systems will further aid in accelerating and automating the financial closing process.

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

Table of Contents

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
PART II OTHER INFORMATION

Item

1 Legal Proceedings

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

1A	Risk Factors	N/A
2	Unregistered Sales of Equity Securities and Use of Proceeds	None
3	Defaults upon Senior Securities	None
4	Submission of Matters to a Vote of Security Holders	None
5	Other Information	None

6 Exhibits

10.24 Fourth Amendment to Second Amended and Restated Revolving Credit Loan and Security Agreement, dated as of May 30, 2008, by and among Key Bank National Association, Brookwood Companies Incorporated and certain subsidiaries.

10.25 Equity Support Agreement, dated as of June 9, 2008, by and between The Hallwood Group Incorporated and Hallwood Energy, L.P.

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.

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, 2008

By: /s/ Melvin J. Melle
Melvin J. Melle, Vice President
(Duly Authorized Officer and
Principal Financial and
Accounting Officer)

Table of Contents

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
INDEX TO EXHIBITS

Exhibit Number	Description
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Page 50

WRAP VALIGN="bottom"> 132,527 132,527

Derek A. Rice

31,112 70,000 70,000 59,936

James W. Rogers

31,112 70,000 70,000 18,109 21,852 31,216 31,216

As of December 31, 2014, approximately 55.55% of the NGP Holdings Legacy Tier incentive units have vested; the remaining units will vest, in monthly increments, over the next 16 months (through April 18, 2016). The Legacy Tier II units will vest when NGP RE Holdings L.L.C. (NGP I), one of the investors in NGP Holdings, has received additional distributions of $104,931,591.76 (as noted below, this amount constitutes a threshold above which holders of Legacy Tier II Units will begin participating in distributions). The Legacy Tier III units will vest upon NGP I receiving additional distributions of $205,937,443.60 (including the amount set forth in the previous sentence; as noted below, this amount constitutes a threshold above which holders of Legacy Tier III units will begin to participate in distributions). Thirty percent of the New Tier I Units and New Tier II Units have vested; the remaining units will vest, in monthly increments, over the next 42 months (through June 11, 2018). The New Tier III Units will vest when NGP RE Holdings II, L.L.C. (NGP II), the other investor in NGP Holdings, has received an additional $275,707,928 in distributions from NGP Holdings (as noted below, this amount constitutes a threshold above which holders of New Tier III Units will begin participating in distributions). The New Tier IV Units will vest when NGP II receives an additional $375,707,928 in distributions form NGP Holdings, including the amount set forth in the preceding sentence (as noted below, this amount constitutes a threshold above which holders of New Tier IV Units will begin participating in distributions).

Under the Amended and Restated Limited Liability Company Agreement of NGP Holdings, distributions subsequent to December 31, 2014 will be made concurrently in two discrete portions as follows:

1. With respect to 41.1953092% of the NGP Holdings distributions, NGP I and the holders of the Legacy Tier Units will participate as indicated below:

Upon the Receipt by NGP I of Additional Distributions Totaling	**NGP I**	**Legacy Tier I Units**	**Legacy Tier II Units**	**Legacy Tier III Units**
Up to $3,925,739.92	100%			
Above $3,925,739.92 to $104,931,591.76	90%	10%		
Above $104,931,591.76 to $205,937,443.60	80%	10%	10%	
Above $205,937,443.60	70%	10%	10%	10%

37

2. With respect to 58.8046908% of the distributions, NGP II and the holders of the New Tier Units will participate as indicated below:

	NGP II	New Tier I Units	New Tier II Units	New Tier III Units	New Tier IV Units
As of December 31, 2014	80%	20%			
Upon the Receipt by NGP II of Additional Distributions Totaling					
Above $282,886,637,32 (the New Tier II Payout Threshold[a]) to $375,707,928	70%	20%	5%	5%	
Above $375,707,928	65%	20%	5%	5%	5%
Alternative Distribution Schedule to be in Effect if the New Tier II Distribution Threshold has not Occurred and Until the New Tier Unit II Distribution Threshold has Occurred:					
Upon the Receipt by NGP II of Additional Distribution Totaling					
Above $275,707,928 to $375,707,928	75%	20%		5%	
Above $375,707,928	75%	20%		5%	5%

(a) This amount is based on an assumed distribution on December 31, 2014. The required amount to reach the New Tier II Payout Threshold will increase at the rate of 20% per annum until the distribution satisfying the threshold has occurred.

The percentage interest of each NEO in the various tiers of NGP Holdings incentive units as of December 31, 2014 was as follows:

	NGP Holdings Incentive Units						
Name	**Legacy Tier I Units (%)**	**Legacy Tier II Units (%)**	**Legacy Tier III Units (%)**	**New Tier I Units (%)**	**New Tier II Units (%)**	**New Tier III Units (%)**	**New Tier IV Units (%)**
Daniel J. Rice IV	7.00%	7.00%	7.00%	8.56%			
Grayson T. Lisenby	10.00%	10.00%	10.00%	12.57%	15.17%	15.17%	15.17%
Toby Z. Rice	4.00%	4.00%	4.00%	10.98%	13.25%	13.25%	13.25%

Derek A. Rice	7.00%	7.00%	7.00%	8.56%			
James W. Rogers	7.00%	7.00%	7.00%	2.59%	3.12%	3.12%	3.12%

(4) The amount shown is the number of unvested Rice Holdings incentive units. Because the value of an incentive unit does not increase or decrease in proportion to increases or decreases in the price of our common stock, the number of shares of our common stock underlying an incentive unit will change as the market price of our common stock changes.

38

The following table provides information regarding the number of unvested incentive units of each tier of Rice Holdings incentive units held by each NEO at December 31, 2014:

	Rice Holdings Incentive Units		
Name	Tier I Units (#)	Tier II Units (#)	Tier III Units (#)
Daniel J. Rice IV	31,112	70,000	70,000
Grayson T. Lisenby	44,445	100,000	100,000
Toby Z. Rice	17,778	40,000	40,000
Derek A. Rice	31,112	70,000	70,000
James W. Rogers	31,112	70,000	70,000

As of December 31, 2014, approximately 55.55% of the Rice Holdings Tier I incentive units have vested; the remaining units will vest, in monthly increments, over the next 16 months (through April 18, 2016). The Tier II units will vest following the receipt by the Rice Trust of additional distributions from Rice Holdings, in the form of cash or shares of Rice Energy common stock valued, in accordance with the terms of the Amended and Restated Limited Liability Company Agreement of Rice Holdings, at $410,080,637 (as noted below, this amount constitutes a threshold above which holders of Tier II units will begin participating in distributions). The Tier III units will vest upon the receipt by the Rice Trust of additional distributions, in the form of cash or shares of Rice Energy common stock valued, in accordance with the terms of the Amended and Restated Limited Liability Company Agreement of Rice Holdings, at $637,484,844 (including the amount set forth in the previous sentence) (as noted below, this amount constitutes a threshold above which holders of Tier III units will begin participating in distributions). Under the Amended and Restated Limited Liability Company Agreement of Rice Holdings, for purposes of determining if vesting thresholds have been achieved, distributions of our common stock are valued based on the volume-weighted average trading price of a share of our common stock on the NYSE over the 30-trading day period ending on and including the trading day immediately preceding such date of determination.

Under the Amended and Restated Limited Liability Company Agreement of Rice Holdings, distributions will be made on August 15, 2015, 2016 and 2017. The Rice Trust and the holders of the several tiers of incentive units will participate as follows:

Upon the Receipt by the Rice Trust of Additional Distributions Totaling	Rice Trust	Tier I	Tier II	Tier III
Up to $182,676,431	100%			
Above $182,676,431 to $410,080,637	90%	10%		
Above $410,080,637 to $637,484,844	80%	10%	10%	
Above $637,484,844	70%	10%	10%	10%

The percentage interest of each NEO in the three tiers of Rice Holdings incentive units as of December 31, 2014 was as follows:

Rice Holdings Incentive Units

Name	Rice Holdings Tier I Units (%)	Rice Holdings Tier II Units (%)	Rice Holdings Tier III Units (%)
Daniel J. Rice IV	7.00%	7.00%	7.00%
Grayson T. Lisenby	10.00%	10.00%	10.00%
Toby Z. Rice	4.00%	4.00%	4.00%
Derek A. Rice	7.00%	7.00%	7.00%
James W. Rogers	7.00%	7.00%	7.00%

(5) The amount shown is the number of unvested RMP phantom units granted under the RMP LTIP. All RMP phantom units vest on December 19, 2016.

Table of Contents

(6) The market value of the restricted stock units is based on the $20.97 closing market price per underlying share of our common stock on December 31, 2014, as reported by the NYSE.

(7) There is no trading market for the NGP Holdings incentive units. In determining market value for purposes of the table, we assumed the sale of all shares of our common stock held by NGP Holdings at the $20.97 per share closing price on December 31, 2014, and distribution of the proceeds of the sale in accordance with the terms of the Amended and Restated Limited Liability Company Agreement of NGP Holdings.

(8) There is no trading market for the Rice Holdings incentive units. In determining *market value* for purposes of the table, we assumed the distribution (or deemed distribution) on December 31, 2014 by Rice Holdings of shares of our common stock, in accordance with the terms of the Amended and Restated Limited Liability Company Agreement of Rice Holdings. Under the Amended and Restated Limited Liability Company Agreement of Rice Holdings, for purposes of determining if vesting thresholds have been achieved, distributions of our common stock are valued based on the volume-weighted average trading price of a share of our common stock on the NYSE over the 30-trading day period ending on and including the trading day immediately preceding such date of determination. After determining the number of shares that would have been distributed to each NEO with respect to the assumed distribution under the Amended and Restated Limited Liability Company Agreement of Rice Holdings, we valued the shares of our common stock assumed to be distributed at the $20.97 per share closing price of our common stock on December 31, 2014.

(9) The market value of the RMP phantom units is based on the $16.75 closing market price per unit on December 31, 2014, as reported by the NYSE.

(10) This column shows the number of unvested performance stock units as of December 31, 2014. The performance stock units will vest, based on performance achieved during the 2014-2016 performance period, on the date that the compensation committee certifies the performance achievement and, for purposes of this table, assume performance goals were achieved at target levels.

(11) The amounts in this column are based on the $20.97 per share closing price of our common stock on December 31, 2014, as reported by the NYSE and assuming performance goals were achieved at target levels.

Stock Vested in 2014

The following table provides information regarding the NGP Holdings and Rice Holdings incentive units that vested in 2014, and the values realized (calculated in the manner described in the footnotes to the table). No Rice Energy or RMP equity awards vested in 2014.

	Stock Awards	
Name	**Number of Shares/Units Acquired on Vesting (#)[1]**	**Value Realized on Vesting ($)[2]**
Daniel J. Rice IV	111,240	4,876,636
Grayson T. Lisenby	205,450	7,837,385
Toby Z. Rice	121,595	4,770,378
Derek A. Rice	111,240	4,876,636
James W. Rogers	102,679	3,779,392

(1) Includes the following Rice Holdings and NGP Holdings incentive units that vested during 2014:

Name

	NGP Holdings Legacy Tier I in 2014[a][b]	NGP Holdings New Tier I in 2014[a][b]	NGP Holdings New Tier II in 2014[a][b]	Rice Holdings Tier I Units in 2014[a][b]
Daniel J. Rice IV	38,888	25,686		38,888
Grayson T. Lisenby	55,555	37,718	45,511	55,555
Toby Z. Rice	22,222	32,949	39,758	22,222
Derek A. Rice	38,888	25,686		38,888
James W. Rogers	38,888	7,761	9,364	38,888

(a) All Rice Holdings and NGP Holdings incentive units are successor instruments to REA Incentive Units. Under the master reorganization agreement, Rice Holdings and NGP Holdings incentive units were issued in exchange for most of the REA Incentive Units. Under the Amended and Restated Limited Liability Company Agreement of NGP Holdings, the holding period for all incentive units subject to time-lapsed vesting (Legacy Tier I Units, New Tier I Units and New Tier II Units) includes the holding period of the predecessor REA Incentive Units. Similarly, under the Amended and Restated Limited Liability Agreement of Rice Holdings, the holding period for all incentive units subject to time-lapsed vesting (Tier I Units) includes the holding period of the predecessor REA Incentive Units. To the extent that REA Incentive Units would have been vested prior to the January 29, 2014 effective date of the master reorganization agreement, the incentive units issued in exchange of the vested REA Incentive Units are deemed to have vested on January 29, 2014 for purposes of the information in the table and the related footnotes.

(b) NGP Holdings Legacy Tier I Units, New Tier I Units and New Tier II Units, and Rice Holdings Tier 1 Units vest in monthly increments; the amounts shown constitute the aggregate number of units that vested during 2014. See footnote (a) above.

(2) For purposes of computing the value realized upon vesting with regard to NGP incentive units, we assumed that, on each vesting date, all of the shares of our common stock held by NGP Holdings were sold, and proceeds distributed, in accordance with the terms of the Amended and Restated Limited Liability Company Agreement of NGP Holdings on the applicable dates of vesting. For purposes of computing the value realized upon vesting with regard to the Rice Holdings incentive units, we assumed that, on each vesting date, all of the shares of our common stock held by Rice Holdings (including the shares held by the Rice Trust that would be deemed distributed to the Rice Trust) were distributed in accordance with the terms of the Amended and Restated Limited Liability Company Agreement of Rice Holdings on the applicable dates of vesting. In each case, we determined the portion of the distribution that would have been allocable to the incentive units that vested on the particular vesting date. The amounts shown in the table represent the sum of distributions that would have been allocable to the vesting incentive units on each applicable vesting date.

Potential Payments Upon Termination or Change in Control

The following tables set forth information concerning the change in control and severance payments to be made to each of our NEOs in connection with a change in control or termination of employment, presuming a termination or change in control date of December 31, 2014 and a valuation of our common stock based on its closing market price on December 31, 2014 of $20.97 per share. The below tables only include information for employment termination or change in control events that trigger vesting or severance-related payments, and assume that each executive will take all action necessary or appropriate for such person to receive the maximum available benefit, such as execution of a release of claims and compliance with restrictive covenants described below. Additional descriptions of the terms of our agreements, plans and arrangements with our NEOs are set forth in *Compensation Discussion and Analysis* and *Additional Information Regarding Our Summary Compensation and Grants of Plan-Based Awards Tables*.

The payments and benefits detailed in the tables below are in addition to any payments and benefits under our plans or arrangements which are offered or provided generally to all salaried employees on a non-discriminatory basis and any accumulated vested benefits for each NEO.

The definitions of terms used in the agreements, plans and arrangements described below are set forth in *Definitions* under *Additional Information Regarding the Tables Relating to Potential Payments Upon Employment Termination or Change in Control*.

Employment Agreements

Under the Employment Agreements, each NEO is entitled to receive the following amounts upon a termination by the executive for *good reason* (as such term is defined below) or by the Company without *cause* (as such term is defined below): (i) accrued and earned amounts, (ii) a prorated annual bonus for the year of termination, (iii) a severance payment equal to one times (two times in the event of a qualifying termination within the 12-month period following a *change in control* (as such term is defined below)) the sum of the executive s base salary on the date of termination and the average annual bonus for the three prior calendar years, and (iv) vesting of the unvested portion of any outstanding LTIP awards. The NEOs are also entitled to continued coverage under our group health plan for the COBRA period (up to 18 months) elected for the executive and the executive s spouse and eligible dependents, at no greater premium cost than that which applies to our active senior executive employees.

Table of Contents

The Employment Agreements with our NEOs do not provide for payment to cover excise taxes imposed under Section 4999 of the Code (e.g. no change in control gross-up payments). Rather, payments due upon a change of control will be reduced to the extent necessary to avoid such excise tax, unless it is determined that the net after tax benefits to an NEO would be greater if such reductions were not imposed.

In the event of a termination of employment due to death or disability, the unvested portion of an NEO s LTIP awards will vest, and he (or his estate) will receive any accrued amounts.

The Employment Agreements also include certain confidentiality, non-competition and non-solicitation obligations. These provisions generally provide that: (i) NEOs shall refrain, both during and after termination of employment, from publishing any oral or written statements about the Company, or its affiliates, customers, suppliers or consultants (A) that are disparaging, slanderous, libelous, or defamatory, (B) disclose confidential information, or (C) place the Company and such persons in a false light before the public and (ii) for a period of one year following employment termination, they will (A) refrain from carrying on or engaging in, directly or indirectly, any business in competition with the Company or its affiliates, (B) not engage or employ, or solicit or contact with a view to the engagement or employment of, any person who is an officer or employee of the Company or any of its affiliates, or (C) not canvass, solicit, approach, or entice away, or cause to be canvassed, solicited, approached, or enticed away, from the Company or any of its affiliates any person who or which is a customer of any of such entities during the period during which the NEO was employed by the Company.

Daniel J. Rice IV*

	Termination without Cause or for Good Reason ($)	Termination in Connection with a Change in Control ($)[1]	Death ($)	Disability ($)
Compensation				
Cash Severance	679,220	1,358,440		
Pro-Rata Bonus	493,440	493,440		
Long Term Incentives				
Restricted Stock Units Unvested & Accelerated	288,757	288,757	288,757	288,757
Performance Stock Units Unvested & Accelerated[2]	1,630,000	1,630,000	1,630,000	1,630,000
Benefits and Perquisites				
Health Insurance[3]	18,386	18,386		
Total	3,109,803	3,789,023	1,918,757	1,918,757

* Footnotes follow the last table in this section of the proxy statement.

Grayson T. Lisenby*

	Termination without Cause or for Good Reason ($)	Termination in Connection with a Change in Control ($)[(1)]	Death ($)	Disability ($)
Compensation				
Cash Severance	719,220	1,438,440		
Pro-Rata Bonus	493,440	493,440		
Long Term Incentives				
Restricted Stock Units Unvested & Accelerated	288,757	288,757	288,757	288,757
Performance Stock Units Unvested & Accelerated[(2)]	1,130,000	1,130,000	1,130,000	1,130,000
Benefits and Perquisites				
Health Insurance[(3)]	18,386	18,386		
Total	2,649,803	3,369,023	1,418,757	1,418,757

* Footnotes follow the last table in this section of the proxy statement.

Table of Contents

Toby Z. Rice*

	Termination without Cause or for Good Reason ($)	Termination in Connection with a Change in Control ($)[1]	Death ($)	Disability ($)
Compensation				
Cash Severance	679,220	1,358,440		
Pro-Rata Bonus	493,440	493,440		
Long Term Incentives				
Restricted Stock Units Unvested & Accelerated	288,757	288,757	288,757	288,757
Performance Stock Units Unvested & Accelerated[2]	1,630,000	1,630,000	1,630,000	1,630,000
Benefits and Perquisites				
Health Insurance[3]	18,386	18,386		
Total	3,109,803	3,789,023	1,918,757	1,918,757

* Footnotes follow the last table in this section of the proxy statement.

Derek A. Rice*

	Termination without Cause or for Good Reason ($)	Termination in Connection with a Change in Control ($)[1]	Death ($)	Disability ($)
Compensation				
Cash Severance	679,220	1,358,440		
Pro-Rata Bonus	493,440	493,440		
Long Term Incentives				
Restricted Stock Units Unvested & Accelerated	288,757	288,757	288,757	288,757
Performance Stock Units Unvested & Accelerated[2]	1,630,000	1,630,000	1,630,000	1,630,000
Benefits and Perquisites				
Health Insurance[3]	6,129	6,129		
Total	3,097,546	3,776,766	1,918,757	1,918,757

* Footnotes follow the last table in this section of the proxy statement.

James W. Rogers*

	Termination without Cause or for Good Reason ($)	Termination in Connection with a Change in Control ($)[1]	Death ($)	Disability ($)
Compensation				
Cash Severance	609,021	1,218,041		
Pro-Rata Bonus	391,291	391,291		
Long Term Incentives				
Restricted Stock Units Unvested & Accelerated	252,668	252,668	252,668	252,668
Performance Stock Units Unvested & Accelerated[2]	638,000	638,000	638,000	638,000
Benefits and Perquisites				
Health Insurance[3]	18,386	18,386		
Total	1,909,366	2,518,386	890,668	890,668

(1) If a change in control occurred and the NEO s employment did not terminate, the NEO would not be entitled to additional payments or benefits. The narrative following these tables contains a description of events that constitute a *change in control*.

(2) The amounts reflect an assumption that performance was achieved at the target award level.

(3) *Health Insurance* benefit expense reflects cumulative COBRA costs for the applicable continuation period based on 2015 and expected 2016 COBRA rates.

Additional Information Regarding the Tables Relating to Potential Payments Upon Employment Termination or Change in Control

The following narrative provides additional information of the plans, arrangements, and agreements that relate to the potential payments set forth in the tables above. The definitions of terms used in such plans, arrangements and agreements are set forth below under *Definitions.* This summary, however, does not purport to be a complete description of all the provisions of the agreements with the executives.

Vesting Provisions Regarding Rice Energy Performance Stock Unit and Restricted Stock Unit Awards, and Rice Midstream Partners Phantom Unit Awards

With respect to performance stock unit awards, except as otherwise provided in another Company plan or agreement or described below, in the event of a participant s employment termination during the applicable performance period or the participant s breach of certain confidentiality covenants set forth in the award agreement, any performance stock units, whether earned or unearned, will automatically be cancelled and forfeited in their entirety. Generally, if, during the performance period, the participant ceases to be employed by us as a result of the participant s disability or death, the participant will vest in full and the number of shares earned pursuant to the award will be determined at the end of

the performance period.

With respect to restricted stock unit awards, except as otherwise provided in another Company plan or agreement or described below, in the event a participant s employment is terminated, any unvested restricted stock units will be automatically forfeited. In the event a participant s termination is due to death or disability, any unvested restricted stock units will vest.

With respect to RMP phantom units awards, in the event a participant experiences a separation from service with RMP and its affiliates, any unvested phantom units will be automatically forfeited.

Definitions

The following terms are defined under the Employment Agreements or the LTIP:

Cause is defined under the Employment Agreements generally to mean a determination by the board of directors (or its delegates) that the executive (i) has engaged in gross negligence, gross incompetence, or misconduct in the performance of the executive s duties to us, (ii) has failed without proper legal reason to perform the executive s duties and responsibilities to us, (iii) has breached any material provision of the employment agreement or any written agreement or corporate policy or code of conduct established by us, (iv) has engaged in conduct that is, or could reasonably expected to be, materially injurious to us, (v) has committed an act of theft, fraud, embezzlement, misappropriation, or breach of a fiduciary duty to us, or (vi) has been convicted of, pleaded no contest to, or received adjudicated probation or deferred adjudication in connection with a crime involving fraud, dishonesty, or moral turpitude or any felony (or a crime of similar import in a foreign jurisdiction).

Good Reason is defined under the Employment Agreements generally to mean (i) a material diminution in the executive s base salary, other than as a part of one or more decreases that (A) does not exceed, in the aggregate, more than 10% of the base salary as in effect on the date

immediately prior to such decrease, and (B) are applied similarly to all of our similarly situated executives; (ii) a material diminution in the executive s authority, duties, or responsibilities; or (iii) the involuntary relocation of the geographic location of the executive s principal place of employment by more than 75 miles from the location of the executive s principal place of employment as of the effective date of the Employment Agreement.

Change in Control is defined under the Employment Agreements generally to mean (i) a merger, consolidation, or sale of all or substantially all of our assets if (A) our stockholders prior to the transaction do not continue to own equity securities with 50% or more of the voting power eligible to be cast in the election of directors after the transaction in substantially the same proportion or (B) the members of our board immediately prior to the transaction do not constitute at least a majority of the board of directors of the resulting entity immediately after the transaction; (ii) the dissolution or liquidation of the Company; (iii) when any person, entity, or group, other than certain persons, acquires or gains ownership or control of more than 50% of the combined voting power of the outstanding securities of the Company, or (iv) as a result of, or in connection with, a contested election of directors, the persons who were members of our board immediately before such election cease to constitute a majority of the board.

Disability is defined under the LTIP to mean a disability that entitles an employee to disability benefits under the Company s long-term disability plan.

PROPOSAL 2 APPROVAL OF ANNUAL INCENTIVE BONUS PLAN

The second proposal item to be voted on is the approval of the Annual Incentive Bonus Plan.

You are being asked to approve the Annual Incentive Bonus Plan (the AIB Plan) to allow the AIB Plan to provide for performance incentives in a manner that preserves, for tax purposes, Rice Energy s ability to deduct the compensation awarded under the AIB Plan. Under the AIB Plan, the compensation committee or the CEO (solely with respect to non-executive officer participants) is authorized to award annual incentive compensation that is conditioned upon achievement of performance goals. The AIB Plan is structured to satisfy the requirements for performance-based compensation within the meaning of Section 162(m) of the Code and related Internal Revenue Service regulations, and is being submitted for stockholder approval at the Annual Meeting primarily to satisfy the stockholder approval requirement of Section 162(m) of the Code.

The amounts and benefits to be paid under the AIB Plan are not determinable at this time since no awards have been made under the AIB Plan, and, when awarded will be wholly dependent upon the achievement of annual performance goals.

The material terms of the AIB Plan are described below and the AIB Plan is attached to this proxy statement as Appendix A. To the extent this summary description differs from the AIB Plan attached as Appendix A, the text of the AIB Plan governs the terms and provisions of the AIB Plan. Because our executive officers are eligible to receive awards under the AIB Plan, they may be deemed to have a personal interest in the approval of this proposal by the Company s stockholders.

The purpose of the AIB Plan is to advance the interests of Rice Energy and its stockholders by providing incentives to key employees and officers with significant responsibility for achieving performance goals critical to Rice Energy s success and growth, which number of participants is not determinable as the decisions regarding the participants will not be considered until after approval of the AIB Plan by stockholders at the Annual Meeting. The AIB Plan is

designed to: (i) promote the attainment of Rice Energy s significant business objectives, (ii) encourage and reward management teamwork across the entire Company, and (iii) assist in the attraction and retention of employees vital to Rice Energy s long-term success.

Officers and key employees of the Company shall be eligible to participate in the AIB Plan. No employee shall have the right to participate in the AIB Plan, and participation in the AIB Plan in any one performance period does not entitle an individual to participate in the future.

The AIB Plan is administered by the compensation committee with respect to awards to be granted to the Company s executive officers and by the CEO with respect to awards to be granted to other participants thereunder (as applicable, the Plan Administrator). The AIB Plan provides performance-based cash incentive compensation to employees and officers based on their service to Rice Energy, and their performance and other factors with respect to a performance period. The Plan Administrator has authority and discretion under the AIB Plan to determine

eligibility for participation in the AIB Plan; to make awards under the AIB Plan; to establish the terms and conditions of such awards, including specifying the performance goals and performance measures applicable to each award; and to determine whether the performance goals applicable to any performance measures for any awards have been achieved. The AIB Plan has a maximum limit of $3 million that may be paid to any individual for any one calendar year period under the plan. The AIB Plan may from time to time be amended, suspended or terminated, in whole or in part. No amendment or termination of the AIB Plan, without the consent of a participant, may materially adversely affect the rights of a participant to any payments that have been determined by the Plan Administrator to be due and owing to such participant under the plan. Additionally, no amendment that requires stockholder approval in order for the AIB Plan to continue to comply with Code Section 162(m) shall be effective unless the same shall be approved by the requisite vote of the stockholders of the Company.

The AIB Plan includes the following performance measures (including variations thereof): earnings per share, increase in revenues, increase in cash flow, increase in cash flow from operations, increase in cash flow return, return on net assets, return on assets, return on investment, return on capital, return on equity, economic value added, operating margin, contribution margin, net income, net income per share, pre-tax earnings, pre-tax earnings before interest, depreciation and amortization, pre-tax operating earnings after interest expense and before incentives, service fees and extraordinary or special items, total or relative stockholder return, debt reduction, market share, change in the fair market value of stock price, operating income, amount of oil and natural gas reserves, oil and natural gas reserves additions, cost of finding oil and natural gas reserves, oil and natural gas reserve replacement ratios, oil and natural gas production amounts, oil and natural gas production sales amounts, safety targets, regulatory compliance, any of the above goals as compared to the performance of a published or special index deemed applicable by the Committee, including, but not limited to, the Standard & Poor s 500 Stock Index or a group of comparable companies, and other non-financial operating and management performance objectives. To the extent consistent with Section 162(m) of the Code and the regulations promulgated thereunder, the compensation committee may determine that certain adjustments shall apply, in whole or in part, in such manner as specified by the Committee, to exclude or include the effect of specified events that occur during a performance period, including the following: asset write-downs, litigation, claims, judgments or settlements, the effect of changes in tax law, accounting principles or other such laws or regulations affecting reporting results, accruals for business combinations, reorganization and restructuring programs, including but not limited to reductions in force and early retirement incentives, any extraordinary, unusual, or nonrecurring items, including, but not limited to, such items described in management s discussion and analysis of financial condition and results of operations or the financial statements and/or notes thereto appearing in the Company s annual report for the applicable period, goodwill impairment charges, operating results for any business acquired during the calendar year, third party expenses associated with any acquisitions, any change in accounting principles or accounting charges, any loss from discontinued operations, and any other extraordinary events or occurrences identified by the compensation committee, to the extent set forth with reasonable particularity in connection with the establishment of performance goals. The Plan Administrator believes that the performance measures provide it flexibility to make awards that reward achievement of Rice Energy s strategic goals and are consistent with the compensation philosophy discussed in *Compensation Discussion and Analysis*.

The Plan Administrator, in its sole discretion, may also establish such additional restrictions or conditions that must be satisfied as a condition precedent to the payment of all or a portion of any awards. Such additional restrictions or conditions need not be performance-based and may include, among other things, the receipt by a participant of a specified annual performance rating, the continued employment by the participant and/or the achievement of specified performance goals by the Company, business unit or participant. Furthermore and notwithstanding any provision of the AIB Plan to the contrary, the Plan Administrator may reduce the amount of any award to a participant if it concludes that such reduction is necessary or appropriate based upon: (i) an evaluation of such participant s performance, (ii) comparisons with compensation received by other similarly situated individuals working within the Company s industry, (iii) the Company s financial results and conditions, or (iv) such other factors or conditions that

the Plan Administrator deems relevant. Notwithstanding any provision of the AIB Plan to the contrary, the Plan Administrator may not use its discretionary authority to increase any award that is intended to be performance-based compensation under Section 162(m) of the Code.

Unless otherwise determined by the compensation committee or as otherwise provided, if a participant in the AIB Plan Separates from Service (as defined in the AIB Plan) prior to the end of a performance period of an award (i) by reason of death or Total and Permanent Disability (as defined in the AIB Plan), the participant s award will be prorated to reflect the period of service during the performance period prior to his/her death or Total and

Permanent Disability; (ii) on account of an involuntary Separation from Service by the Company other than for Cause (as defined in the AIB Plan) (A) within the 90-day period immediately preceding a Change in Control (as defined in the AIB Plan), or (B) on or within the one (1) year period following a Change in Control, the award will be deemed earned at a target award level; or (iii) on account of an involuntary Separation from Service by the Company other than for Cause which occurs on or after July 1st of an annual performance period, the participant s award will be prorated to reflect the period of service during the performance period prior to his/her Separation from Service. Participants who have a Separation from Service for any reason other than those provided above prior to the end of a performance period of an award, will forfeit any and all rights to payment under such award then outstanding and will not be entitled to any cash payment for the applicable period.

A participant generally will not recognize income upon the grant of an award. Upon payment of the award, a participant will recognize ordinary income in an amount equal to the cash received. When the participant recognizes ordinary income upon payment of an award, Rice Energy will generally be entitled to a tax deduction on the same amount.

With certain exceptions, Section 162(m) of the Code limits our deduction for compensation in excess of $1,000,000 paid to certain covered employees (generally our CEO and three other highest-paid executive officers). Compensation paid to covered employees is not subject to the deduction limitation if it is considered *qualified performance-based compensation* within the meaning of Section 162(m) of the Code. If our stockholders approve the AIB Plan, we believe that certain awards granted to covered employees under the AIB Plan will satisfy the requirements of qualified performance-based compensation and therefore we will be entitled to a deduction with respect to such awards. The Plan Administrator strives to grant certain awards that will preserve deductibility to the extent reasonably practicable and to the extent consistent with its compensation objectives. However, the Plan Administrator believes that stockholder interests are best served by not restricting the Plan Administrator s discretion and flexibility in structuring, determining and ultimately approving payment with respect to its awards to employees, even if the programs or such decisions may result in certain non-deductible compensation.

In addition, if a change of control of Rice Energy causes awards under the AIB Plan to accelerate vesting or is deemed to result in the attainment of performance goals, the participants could, in some cases, be considered to have received *excess parachute payments*, which could subject participants to a 20% excise tax on the excess parachute payments and could result in a disallowance of our deductions under Section 280G of the Code.

The benefits provided under the AIB Plan are intended to be excepted from coverage under Section 409A of the Code and the regulations promulgated thereunder and will be construed accordingly. Notwithstanding any provision of the AIB Plan to the contrary, if any benefit provided under the AIB Plan is subject to the provisions of Section 409A of the Code and the regulations issued thereunder (and not excepted therefrom), the provisions of the AIB Plan shall be administered, interpreted and construed in a manner necessary to comply with Section 409A of the Code and the regulations issued thereunder (or disregarded to the extent such provision cannot be so administered, interpreted, or construed).

In the event the AIB Plan is not approved by stockholders at the Annual Meeting, annual incentive awards will continue to be made under the LTIP.

THE BOARD OF DIRECTORS UNANIMOUSLY RECOMMENDS THAT YOU VOTE FOR THE

APPROVAL OF THE ANNUAL INCENTIVE BONUS PLAN

PROPOSAL 3 ADVISORY APPROVAL OF THE COMPANY S EXECUTIVE COMPENSATION

The third proposal item to be voted on is the advisory approval of the Company s executive compensation.

As described in detail in *Compensation Discussion and Analysis,* our executive compensation program is designed to attract, motivate and retain key executives who drive our success and industry leadership. We achieve these goals by being committed to *paying for performance*.

The compensation committee continually reviews the compensation programs for our executive officers to ensure they achieve the desired goals of aligning our executive compensation structure with our stockholders interests and current market practices. Please read *Compensation Discussion and Analysis,* which describes the Company s executive compensation program and the decisions made by the compensation committee in 2014 in more detail, including information about the fiscal year 2014 compensation paid to our NEOs.

Table of Contents

The Company has delivered solid financial results for our stockholders since our IPO in January 2014. For a discussion of the Company s significant achievements in 2014, see *Compensation Discussion and Analysis.* We believe that our executive compensation programs have played a material role in our ability: (i) to drive the strong financial results described in *Compensation Discussion and Analysis* and (ii) to attract and retain a highly experienced, successful team to manage the Company.

We are asking our stockholders to indicate their support for the compensation paid to our NEOs as described in this proxy statement. This proposal gives our stockholders the opportunity to express their views on the compensation paid to our executive officers. This vote is not intended to address any specific item of compensation, but rather the overall compensation paid to our executive officers and the philosophy, policies and practices described in this proxy statement.

Accordingly, we ask our stockholders to vote FOR, on an advisory basis, the compensation paid to our executive officers by adopting the following resolution:

RESOLVED, that the compensation paid to the Company s named executive officers, as disclosed pursuant to Item 402 of Regulation S-K, including the *Compensation Discussion and Analysis*, compensation tables and narrative discussion is hereby APPROVED.

As an advisory vote, your vote will not be binding on the Company or the board of directors. However, our board of directors and our compensation committee, which is responsible for designing and administering the Company s executive compensation program, value the opinions of our stockholders and to the extent there is any significant vote against the compensation paid to our executive officers, we will consider our stockholders concerns and the compensation committee will evaluate whether any actions are necessary to address those concerns.

THE BOARD OF DIRECTORS UNANIMOUSLY RECOMMENDS THAT YOU VOTE FOR THE ADVISORY APPROVAL OF THE COMPANY S EXECUTIVE COMPENSATION AS DISCLOSED UNDER *COMPENSATION DISCUSSION AND ANALYSIS* AND THE ACCOMPANYING COMPENSATION TABLES UNDER *EXECUTIVE COMPENSATION* CONTAINED IN THIS PROXY STATEMENT

Table of Contents

PROPOSAL 4 ADVISORY VOTE ON FREQUENCY OF FUTURE ADVISORY VOTES ON THE

COMPANY S EXECUTIVE COMPENSATION

The fourth proposal item to be voted on is the frequency of future advisory votes on the Company s executive compensation.

Rice Energy is also providing its stockholders with the opportunity to cast an advisory vote to determine the frequency of the advisory stockholder vote on compensation paid to our executive officers. By voting on this Proposal 4, stockholders may indicate whether they would prefer an advisory vote on executive officer compensation every one, two or three years, or abstain from voting. Stockholders are not voting to approve or disapprove the board s recommendation but rather may choose among the four choices.

After careful consideration, our board of directors has determined that an advisory vote on executive compensation that occurs once every year is the most appropriate alternative for the Company, and therefore our board of directors recommends that you vote for once every year interval for the advisory vote on executive compensation.

THE BOARD OF DIRECTORS UNANIMOUSLY RECOMMENDS A VOTE FOR *ONCE EVERY YEAR*

ON THE FREQUENCY OF FUTURE ADVISORY VOTES ON THE

COMPANY S EXECUTIVE COMPENSATION

EQUITY COMPENSATION PLAN INFORMATION TABLE

This table provides information about our common stock subject to our equity compensation plan as of December 31, 2014:

Plan Category	Number of Securities to be Issued Upon Exercise of Outstanding Options, Warrants and Rights (a)	Weighted-Average Exercise Price of Outstanding Options, Warrants and Rights (b)	Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in Column (a)) (c)
Equity compensation plans approved by security holders	622,191(1)		16,877,809(2)
Equity compensation plans not approved by security holders			

	622,191	16,877,809

(1) Of this total related to the LTIP, 323,823 are restricted stock units and 298,368 are performance stock units (assuming performance at a target level).

(2) The entire amount available for awards under the LTIP is 17,500,000. The awards under the LTIP may be granted in the form of bonus stock, restricted stock, restricted stock units, options, stock appreciation rights, dividend equivalent rights, performance awards, annual incentive awards and other stock-based awards.

SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The following table and accompanying footnotes show information as of April 6, 2015, regarding the beneficial ownership of our common stock by:

each person who is known by us to own beneficially more than five percent of our common stock;

each member of our board of directors and each of our NEOs; and

all members of our board of directors and our executive officers as a group.

49

Table of Contents

The table also presents the ownership of common units of RMP owned of record or beneficially as of April 6, 2015, by:

each member of our board of directors and each of our NEOs; and

all members of our board of directors and our executive officers as a group.

The Company owns a majority interest in RMP. The number of shares and percentages of beneficial ownership set forth below are based on 28,753,623 common units of RMP and 136,297,909 shares of our common stock issued and outstanding as of April 6, 2015.

	Rice Energy Inc.			
Name of Beneficial Owner	**Number of Shares Owned[1]**	**Right to Acquire[2]**	**Total**	**Percentage**
5% Stockholders:				
Rice Energy Irrevocable Trust[3][4] 400 Woodcliff Drive Canonsburg, PA 15317	19,800,000		19,800,000	14.5%
Rice Energy Holdings LLC[3][5] 400 Woodcliff Drive Canonsburg, PA 15317	20,300,923		20,300,923	14.9%
NGP Rice Holdings LLC[3][6] 5221 N. O Connor Boulevard, Suite 1100 Irving, TX 75039	20,337,725		20,337,725	14.9%
Alpha Natural Resources, Inc.[3][7] One Alpha Place, P.O. Box 16429, Bristol, VA 24209	6,047,666		6,047,666	4.4%
Citadel Advisors LLC[8] c/o Citadel LLC, 131 S. Dearborn Street, 32nd Floor Chicago, IL 60603	10,706,397		10,706,397	7.9%
Boston Partners[9] One Beacon Street 30th Floor Boston, MA 02108	7,721,660		7,721,660	5.7%

	Rice Energy Inc.				Rice Midstream Partners LP	
Name of Beneficial Owner	**Number of Shares Owned[1]**	**Right to Acquire[2]**	**Total**	**Percentage**	**Number of Common Units**	**Percentage of Common Units Beneficially**

					Beneficially Owned[19]	Owned
Directors and Named Executive Officers:						
Daniel J. Rice IV[10]	11,239	4,590	15,829	*	1,000	*
Grayson T. Lisenby[11]	16,244	4,590	20,834	*	6,500	*
Toby Z. Rice[12]	13,824	4,590	18,414	*	12,500	*
Derek A. Rice[13]	11,239	4,590	15,829	*		*
James W. Rogers[14]	11,039	4,016	15,055	*	2,000	*
Robert F. Vagt	14,905	10,964	25,869	*		
Daniel J. Rice III	2,556,844		2,556,844	1.9%		
Scott A. Gieselman	40,000		40,000	*		
James W. Christmas[15]	180,238	7,456	187,694	*		
Steven C. Dixon[16]	10,000		10,000	*		
John McCartney[17]	2,000		2,000	*		
All Executive Officers and Directors of Rice Energy as a Group (13 persons)	2,919,021	45,549	2,964,570[18]	2.2%	39,500	*

* Less than 1% of shares outstanding

50

(1) The shares of our common stock beneficially owned are reported on the basis of regulations of the SEC governing the determination of beneficial ownership of securities. Under the rules of the SEC, a person is deemed to be a *beneficial owner* of a security if that person has or shares voting power, which includes the power to vote, or direct the voting of, such security, or investment power, which includes the power to dispose of, or to direct the disposition of, such security. A person is also deemed to be a beneficial owner of any securities of which that person has a right to acquire beneficial ownership within 60 days. Securities that can be so acquired are deemed to be outstanding for purposes of computing such person s ownership percentage, but not for purposes of computing any other person s percentage. Under these rules, more than one person may be deemed beneficial owner of the same securities and a person may be deemed to be a beneficial owner of securities as to which such person has no economic interest. Except as otherwise indicated in these footnotes, each of the beneficial owners has, to our knowledge, sole voting and investment power with respect to the indicated shares of common stock.

(2) The numbers in this column represent shares underlying restricted stock units which are exercisable or may be settled within 60 days of April 6, 2015.

(3) The Company, Rice Holdings, NGP Holdings, Alpha, and the Rice Trust are a party to the Stockholders Agreement with regard to the shares of common stock held by each. Among other things, the Stockholders Agreement requires the parties thereto to take all necessary actions, including voting their shares of common stock, for the election of the nominees designated by such principal stockholders. The Stockholders Agreement will terminate on the earlier of the date on which (i) none of our principal stockholders beneficially own at least 2.5% of our outstanding common stock and (ii) we receive written notice from each principal stockholder requesting the termination of the Stockholders Agreement. The Stockholders Agreement terminates with respect to a particular principal stockholder party thereto when such principal stockholder beneficially owns less than 2.5% of our outstanding common stock. Pursuant to the information contained in the most recently filed Schedules 13G and/or Schedules 13D of each, in the aggregate, the parties to the Stockholder Agreement beneficially own approximately 48.8% of the common stock of the Company. For more information regarding the Stockholders Agreement, see *Stockholder Proposals for the 2016 Annual Meeting*.

(4) Based solely on the Schedule 13D/A filed on January 14, 2015 by the Rice Trust, and Kathleen L. Peto and Jay D. Rosenbaum, as co-trustees of the Rice Trust, in which the Rice Trust reported that it had (i) sole voting power with respect to zero shares of our common stock, (ii) shared voting power with respect to 66,486,314 shares of our common stock, (iii) sole dispositive power with respect to zero shares of our common stock and (iv) shared dispositive power with respect to 19,800,000 shares of our common stock. Mr. Jay D. Rosenbaum and Ms. Kathleen L. Peto are co-trustees of the Rice Trust. Ms. Kathleen L. Peto is the spouse of Mr. Daniel J. Rice III. On December 15, 2014, the trust entered into line of credit and financial assets security agreements with Morgan Stanley for up to $50,000,000, pursuant to which the Rice Trust pledged 6,750,000 shares of the Company s common stock as security for its obligations under the line of credit agreement. The Rice Trust also holds 8,000,000 shares of Rice Energy common stock in a brokerage account with UBS and pursuant to UBS s standard client account agreement, UBS holds a lien on all assets in the account (including the 8,000,000 shares of Rice Energy common stock) as security for amounts borrowed from time to time on margin.

(5) Based solely on the Schedule 13D/A filed on January 14, 2015 by Rice Holdings in which it reported that it had (i) sole voting power with respect to zero shares of our common stock, (ii) shared voting power with respect to 66,486,314 shares of our common stock, (iii) sole dispositive power with respect to 20,300,923 shares of our common stock and (iv) shared dispositive power with respect to zero shares of our common stock.

(6) Based solely on the Schedule 13D/A filed on January 14, 2015 by NGP Holdings, NGP Natural Resources X, L.P., NGP X Parallel Holdings, L.P., G.F.W. Energy X, L.P., GFW X, L.L.C., Natural Gas Partners IX, L.P., NGP IX Offshore Holdings, L.P., G.F.W. Energy IX, L.P., GFW IX, L.L.C., and NGP Energy Capital Management, L.L.C. in which the entities reported that they had (i) sole voting power with respect to zero shares of our common stock, (ii) shared voting power with respect to 66,486,314 shares of our common stock, (iii) sole dispositive power with respect to zero shares of our common stock and (iv) shared dispositive power with respect to 20,337,725 shares of our common stock.

Table of Contents

(7) Based solely on the Schedule 13D/A filed on January 14, 2015 by Alpha and its indirect wholly owned subsidiary, Foundation PA Coal Company, LLC in which the entities reported that they had (i) sole voting power with respect to zero shares of our common stock, (ii) shared voting power with respect to 66,486,314 shares of our common stock, (iii) sole dispositive power with respect to 6,047,666 shares of our common stock and (iv) shared dispositive power with respect to zero shares of our common stock.

(8) Based solely on the Schedule 13G/A filed on February 17, 2015 by Citadel Advisors LLC, Citadel Advisors Holdings II LP, Citadel GP LLC and Mr. Kenneth Griffin in which such persons reported that they had (i) sole voting power with respect to zero shares of our common stock, (ii) shared voting power with respect to 10,706,397 shares of our common stock, (iii) sole dispositive power with respect to zero shares of our common stock and (iv) shared dispositive power with respect to 10,706,397 shares of our common stock.

(9) Based solely on the Schedule 13G filed on February 11, 2015 by Boston Partners in which the entity reported that it had (i) sole voting power with respect to 5,686,266 shares of our common stock, (ii) shared voting power with respect to 11,755 shares of our common stock, (iii) sole dispositive power with respect to 7,721,660 shares of our common stock and (iv) shared dispositive power with respect to zero shares of our common stock.

(10) This number does not include 30,289 restricted stock units or any unearned performance stock units that have been issued to Mr. Daniel J. Rice IV under the LTIP.

(11) This number does not include 30,289 restricted stock units or any unearned performance stock units that have been issued to Mr. Lisenby under the LTIP.

(12) This number does not include 30,289 restricted stock units or any unearned performance stock units that have been issued to Mr. Toby Z. Rice under the LTIP.

(13) This number does not include 30,289 restricted stock units or any unearned performance stock units that have been issued to Mr. Derek A. Rice under the LTIP.

(14) This number does not include 26,503 restricted stock units or any unearned performance stock units that have been issued to Mr. Rogers under the LTIP.

(15) With regard to 75,000 shares, Mr. Christmas disclaims beneficial ownership of the shares as these shares are held in trusts which have previously been established for his children.

(16) This number does not include 3,684 restricted stock units that have been issued to Mr. Dixon under the LTIP.

(17) This number does not include 2,146 restricted stock units that have been issued to Mr. McCartney under the LTIP.

(18) This number does not include an aggregate of 210,026 unvested restricted stock units granted to all directors and executive officers of the Company.

(19) The numbers in this column do not include 15,152 RMP phantom units received by each of Daniel J. Rice IV, Grayson T. Lisenby, Toby Z. Rice, Derek A. Rice and James W. Rogers or 4,546 RMP phantom units received by James W. Christmas. As of April 6, 2015, the directors and executive officers of the Company owned, as a group, 128,792 RMP phantom units.

Brokerage account agreements may grant security interests in securities held at the broker to secure payment and performance obligations of the brokerage account holder in the ordinary course. Shares shown in the table for directors, director nominees and executive officers may be subject to this type of security interest.

SECTION 16(A) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE

The Company s directors and certain officers are required to file reports with the SEC when they engage in transactions in the Company s securities pursuant to Section 16(a) of the Exchange Act. Although the Company may generally assist its directors and Section 16 officers in preparing and filing the required reports, directors and Section 16 officers retain responsibility for the reports. Based solely on its review of the copies of such forms received by it, or written representations from certain reporting persons that no Forms 5 were required for those persons, Rice Energy believes that all reporting requirements under Section 16(a) for the fiscal year ended

December 31, 2014, were met in a timely manner by its directors, executive officers, and greater than ten percent beneficial owners, except that Mr. Dixon inadvertently filed a late Form 4 on December 10, 2014 for 3,684 restricted stock units he received on December 5, 2014 upon joining the board. In addition, with regard to the current fiscal year, Mr. Wingo filed a Form 3 on February 11, 2015 that inadvertently omitted 1,695 restricted stock units, which was corrected with the filing of an amended Form 3 on April 10, 2015.

POLICY WITH RESPECT TO RELATED PERSON TRANSACTIONS

Our board approved and adopted a written policy which details the procedures for the review, approval and monitoring of transactions involving us and *related persons* (directors or director nominees of the Company; senior officers of the Company, which, among others, includes Section 16 officers; stockholders owning more than 5% of the Company or its controlled affiliates; any immediate family member of any of the foregoing persons, or an entity that is owned or controlled by someone listed above, or an entity in which someone listed above has a substantial ownership interest or control of the entity). The policy covers any related person transaction where the Company is a participant that, in the aggregate, involves or may be expected to exceed $120,000 in any calendar year (an Interested Transaction).

Approval Procedures

Prior to entering into an Interested Transaction, the audit committee should review the material facts of the Interested Transaction and either approve or disapprove of the entry into the Interested Transaction, unless standing pre-approval exists for the Interested Transaction. If advance committee approval of an Interested Transaction is not feasible, then the Interested Transaction should be considered and ratified (if the audit committee determines it to be appropriate) at the audit committee s next regularly scheduled meeting. In determining whether to approve or ratify an Interested Transaction, the audit committee will take into account, among other factors it deems appropriate:

- whether the Interested Transaction is on terms no less favorable than terms generally available to an unaffiliated third-party under the same or similar circumstances,
- the extent of the related person s interest in the transaction, and
- whether the Interested Transaction is material to the Company.

In addition, the audit committee s chairman has been delegated the authority to pre-approve or ratify (as applicable) any Interested Transaction with a related person in which the aggregate amount involved is expected to be less than $120,000.

Standing Pre-Approval for Certain Interested Transactions

The audit committee has reviewed the types of Interested Transactions described below and determined that each are deemed to be pre-approved or ratified (as applicable) by the audit committee, even if the aggregate amount involved exceeds or will exceed $120,000:

Employment of Executive Officers. Any employment by the Company of an executive officer of the Company is pre-approved or ratified (as applicable) if: (i) the related compensation is required to be reported in the Company s proxy statement or (ii) the executive officer is not an immediate family member of another executive officer or director of the Company, the related compensation would be reported in the Company s proxy statement if the executive officer was a *named executive officer* and the compensation committee approved (or recommended that the board approve) the compensation.

Director Compensation. Any compensation paid to a director is pre-approved or ratified (as applicable) if the compensation is required to be reported in the Company s proxy statement and the compensation is approved by the board or a committee thereof.

Certain Transactions with Other Companies. Any transaction with another company at which a related person s only relationship is as an employee (other than an executive officer), director or beneficial owner of less than 10% of that company s shares is pre-approved or ratified (as applicable) if the aggregate amount involved does not exceed the greater of $1.0 million or 5% of that company s total annual revenues.

Certain Company Charitable Contributions. Any charitable contribution, grant or endowment by the Company to a charitable organization, foundation or university at which a related person s only relationship is as an employee (other than an executive officer) or a director is pre-approved or ratified (as applicable) if the aggregate amount involved does not exceed the lesser of $200,000 or 5% of the charitable organization s total annual receipts.

Transactions where All Stockholders Receive Proportional Benefits. Any transaction where the related person s interest arises solely from the ownership of the Company s common stock and all holders of the Company s common stock received the same benefit on a pro rata basis (e.g., dividends) is pre-approved or ratified (as applicable).

Transactions Involving Competitive Bids. Any transaction involving a related person where the rates or charges involved are determined by competitive bids is pre-approved or ratified (as applicable).

Regulated Transactions. Any transaction with a related person involving the rendering of services as a common or contract carrier, or public utility, at rates or charges fixed in conformity with law or governmental authority is pre-approved or ratified (as applicable).

Certain Banking-Related Services. Any transaction with a related person involving services as a bank depositary of funds, transfer agent, registrar, trustee under a trust indenture or similar services is pre-approved or ratified (as applicable).

Ongoing Transactions

In connection with each regularly scheduled meeting of the audit committee, a summary of each new Interested Transaction deemed pre-approved and each new Interested Transaction pre-approved by the chairman should be provided to the audit committee for its review.

RELATED PERSON TRANSACTIONS

Marcellus JV Buy-In Transaction Agreement

On January 29, 2014, in connection with the closing of our IPO, we completed our acquisition of Alpha s 50% indirect interest in our Marcellus joint venture in exchange for total consideration of $322 million, consisting of $100 million of cash and our issuance to Alpha of 9,523,810 shares of our common stock.

Registration Rights Agreement

In connection with the closing of our IPO, we entered into a registration rights agreement with Rice Holdings, Rice Partners, Daniel J. Rice III, NGP Holdings and an affiliate of Alpha, (collectively, the Initial Holders). Pursuant to the registration rights agreement, we have agreed to register the sale of shares of our common stock under certain circumstances.

Demand Rights

Subject to the limitations set forth below, any Initial Holder (or their permitted transferees) has the right to require us by written notice to prepare and file a registration statement registering the offer and sale of a number of their shares of common stock. Generally, we are required to provide notice of the request within five business days following the receipt of such demand request to all additional holders of our common stock, who may, in certain circumstances, participate in the registration. In no event shall more than one demand registration occur during any six-month period or within 180 days (with respect to our IPO) or 90 days (with respect to any public offering other than our IPO) after the effective date of a final annual report we file. Further, we are not obligated to effect:

(i) through December 31, 2016, more than a total of three demand registrations or (ii) on or after January 1, 2017, more than a total of one demand registration per calendar year at the request of Rice Holdings;

more than one demand registration for Daniel J. Rice III;

(i) through December 31, 2016, more than a total of three demand registrations or (ii) on or after January 1, 2017, more than a total of one demand registration per calendar year at the request of NGP Holdings; or

more than one demand registration for Alpha (which occurred in August 2014).

We are also not obligated to affect any demand registration in which the anticipated aggregate offering price included in such offering is less than $30 million. Once we are eligible to affect a registration on Form S-3, any such demand registration may be for a shelf registration statement. Any demand for an underwritten offering pursuant to an effective shelf registration statement shall constitute a demand request subject to the limitations set forth above. We will be required to maintain the effectiveness of any such registration statement until the earlier of 180 days (or two years if a *shelf registration* is requested) after the effective date and the consummation of the distribution by the participating holders.

Piggy-back Rights

If, at any time, we propose to register an offering of common stock (subject to certain exceptions) for our own account, then we must give at least five business days notice to all holders of the right addressed in the registration rights agreement to allow them to include a specified number of their shares in that registration statement.

Conditions and Limitations; Expenses

These registration rights are subject to certain conditions and limitations, including the right of the underwriters to limit the number of shares to be included in a registration and our right to delay or withdraw a registration statement under certain circumstances. We will generally pay all registration expenses in connection with our obligations under the registration rights agreement, regardless of whether a registration statement is filed or becomes effective.

Rice Family Employees

Ryan Rice, brother of the Rice brothers (the CEO, COO and EVP of Exploration) and son of Daniel J. Rice III, is employed by Rice Energy as a Petroleum Engineer. During the fiscal year ended December 31, 2014, Rice Energy paid Ryan Rice aggregate compensation in the amount of $132,923, including the value of Rice Energy and RMP equity awards.

Aileen Rice, spouse of Toby Z. Rice, COO of Rice Energy, sister-in-law of the Rice brothers (CEO and EVP of Exploration) and daughter-in-law of Daniel J. Rice III, is employed with Rice Energy as the Senior Land Manager, Appalachia. During the fiscal year ended December 31, 2014, Rice Energy paid Aileen Rice aggregate compensation in the amount of $161,577, including the value of Rice Energy and RMP equity awards. Similar to the NEOs, Aileen Rice also holds incentive units issued to her by NGP Holdings and Rice Holdings which have an aggregate grant date fair value of $6,204,776 computed in accordance with FASB ASC Topic 718. As described elsewhere in this proxy statement, the obligations relating to the incentive units are pre-IPO legacy obligations of Rice Holdings, NGP Holdings and their predecessor entity (and not those of Rice Energy). Rice Energy is not obligated to, or responsible for, any cash or Rice Energy share distributions in connection with the incentive units. All of such distributions are to be made either by NGP Holdings or Rice Holdings. Additionally, as described elsewhere in this proxy statement, in connection with the IPO and related corporate reorganization, Daniel J. Rice III satisfied his obligations to the REA Incentive Unit holders under the Rice Appalachia LLC Agreement by distributing shares of Rice Energy common stock to them. Aileen Rice received a distribution of 7,008 shares of Rice Energy common stock with a value of $163,356, calculated based on the closing market price per share of Rice Energy s common stock on January 29, 2014

of $23.31.

Ryan Rice and Aileen Rice continue to be employees of Rice Energy in 2015 with similar compensatory arrangements as in 2014.

REPORT OF THE AUDIT COMMITTEE

The audit committee of the Company s board of directors is currently composed of three non-employee directors and operates under a written charter adopted by the board of directors. The committee charter is available on the Company s web site (*www.riceenergy.com*).

55

The Company s management is responsible for the Company s financial reporting processes, including the system of internal controls. The independent registered public accounting firm is responsible for performing an audit of the Company s consolidated financial statements and for issuing an opinion on the conformity of those financial statements with United States generally accepted accounting principles. The independent registered public accounting firm is also responsible for performing an audit of the effectiveness of internal controls over financial reporting and expressing an opinion on internal control over financial reporting. The audit committee oversees the Company s financial reporting processes on behalf of the board of directors.

In this context, the audit committee has met and held discussions with management, the Company s internal auditors and the independent registered public accounting firm. Management represented to the audit committee that the Company s consolidated financial statements were prepared in accordance with United States generally accepted accounting principles, and the audit committee has reviewed and discussed the consolidated financial statements with management and the independent registered public accounting firm. The audit committee has also discussed internal control over financial reporting with management and the independent registered public accounting firm. The audit committee discussed with the independent registered public accounting firm matters required to be discussed by Auditing Standard No. 16, Communications with Audit Committees, issued by the Public Company Accounting Oversight Board, regarding the independent accountant s communications with the audit committee concerning independence, the quality, not just the acceptability, of the accounting principles, the reasonableness of significant judgments, and the clarity of the disclosures in the financial statements.

In addition, the audit committee has received the written disclosures and the letter from the independent registered public accounting firm required by the applicable requirements of the Public Accounting Oversight Board and has discussed with the independent registered public accounting firm the firm s independence from the Company and its management. In concluding that the firm is independent, the audit committee considered, among other factors, whether any non-audit services provided by the firm were compatible with its independence.

The audit committee discussed with the Company s independent registered public accounting firm and the Company s internal auditors the overall scope and plans for their respective audits. The audit committee meets with the independent registered public accounting firm at least quarterly, with and without management present, to discuss the results of their audit, their evaluations of the Company s internal controls and the overall quality of the Company s financial reporting.

In reliance on the reviews and discussions referred to above, the audit committee recommended to the board of directors, and the board of directors has approved, that the audited consolidated financial statements be included in the Company s Annual Report on Form 10-K for the year ended December 31, 2014 for filing with the SEC. The audit committee approved, and the board of directors ratified, the selection of the Company s independent registered public accounting firm.

James W. Christmas, *Chairman*
Robert F. Vagt
John McCartney*
Steven C. Dixon*

* Mr. McCartney was appointed to the Audit Committee on April 10, 2015 and did not participate in the reviews, discussions or recommendation referred to above. Mr. Dixon served on the Audit Committee until April 10, 2015

and participated in such reviews, discussions and recommendation.

INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The following table presents fees billed for professional audit services rendered by Ernst & Young LLP (E&Y) for the audit of Rice Energy s annual financial statements for the years ended December 31, 2014 and December 31, 2013, and fees for other services rendered by E&Y during those periods.

Fees of Independent Registered Public Accounting Firm

For work performed in regard to fiscal years 2014 and 2013, Rice Energy paid E&Y the following fees for services, as categorized:

Table of Contents

	Fiscal 2014 (In thousands)	Fiscal 2013 (In thousands)
Audit fees[(1)]	$ 2,027	$ 1,370
Audit-related fees[(2)]	$ 75	
Tax fees[(3)]		$ 169
All other fees		
Total	$ 2,102	$ 1,539

(1) For fiscal years 2013 and 2014, includes E&Y fees for professional services provided in connection with (i) audit of our financial statements, (ii) review of our quarterly consolidated financial statements and (iii) review of our filings with the SEC, including review of registration statements, comfort letters and consents. For 2014, $653,000 of the audit fees was associated with the audit of RMP prior to RMP s initial public offering in December 2014.

(2) Includes fees for internal control procedures.

(3) Tax fees primarily represent advice related to structuring of corporate reorganization.

Policy for Approval of Audit and Permitted Non-Audit Services

Before the independent registered public accounting firm is engaged by the Company or its subsidiaries to render audit or non-audit services, the audit committee must pre-approve the engagement. Audit committee pre-approval of audit and non-audit services is not required if the engagement for the services is entered into pursuant to pre-approval policies and procedures established by the audit committee. The chairman of the audit committee has the authority to grant pre-approvals, provided such approvals are within the pre-approval policy and presented to the audit committee at a subsequent meeting. In 2013 and 2014, all of E&Y s professional fees were pre-approved in accordance with the Company s pre-approval policies then in place.

PROPOSAL 5 RATIFICATION OF APPOINTMENT OF INDEPENDENT REGISTERED PUBLIC

ACCOUNTING FIRM

The fifth proposal item to be voted on is to ratify the appointment of E&Y as our independent registered public accounting firm for the fiscal year ending December 31, 2015.

The audit committee approved, and the board of directors has ratified, that E&Y act as Rice Energy s independent registered public accounting firm for the fiscal year ending December 31, 2015. The board of directors has directed that such appointment be submitted to Rice Energy s stockholders for further ratification at the Annual Meeting.

Stockholder ratification of the appointment of E&Y as Rice Energy s independent registered public accounting firm is not required. The board of directors, however, is submitting the appointment to the stockholders for ratification as a matter of good corporate governance practice. If the stockholders do not ratify the appointment, the audit committee will reconsider whether to retain E&Y.

Representatives of E&Y are expected to be present at the Annual Meeting and will have an opportunity to make a statement if they so desire. They will be available to respond to appropriate questions.

THE BOARD OF DIRECTORS UNANIMOUSLY RECOMMENDS THAT YOU VOTE FOR THE

RATIFICATION OF ERNST & YOUNG LLP AS OUR INDEPENDENT REGISTERED PUBLIC

ACCOUNTING FIRM FOR THE FISCAL YEAR ENDING DECEMBER 31, 2015.

Table of Contents

YOUR VOTE IS VERY IMPORTANT. WE URGE YOU TO VOTE IN ANY ONE OF THE FOLLOWING THREE WAYS:

VIA THE INTERNET

USE THE TOLL-FREE TELEPHONE NUMBER

MARK, SIGN, DATE AND PROMPTLY RETURN A PROXY CARD BY MAIL

Any proxy may be revoked at any time before your shares are voted at the Annual Meeting.

By Order of the Board of Directors

William E. Jordan
Senior Vice President, General Counsel

and Corporate Secretary

April 17, 2015

Canonsburg, Pennsylvania

58

APPENDIX A

RICE ENERGY INC.

ANNUAL INCENTIVE BONUS PLAN

1. ***Purpose of the Plan***
The purpose of the Rice Energy Inc. Annual Incentive Bonus Plan (the **Plan**) is to advance the interests of the Company and its stockholders by providing incentives to key employees with significant responsibility for achieving performance goals critical to the success and growth of the Company. The Plan is designed to: (i) promote the attainment of the Company s significant business objectives; (ii) encourage and reward management teamwork across the entire Company; and (iii) assist in the attraction and retention of employees vital to the Company s long-term success.

2. ***Definitions***
For the purpose of the Plan, the following definitions shall apply:

(a) **Board** means the Board of Directors of Rice Energy.

(b) **Cause** means **Cause** as set forth in any employment agreement between the Participant and the Company or, in the absence of such an agreement, **Cause** as defined by the Company s plans applicable to the Participant or employment policies in effect at the time of the Participant s Separation from Service and/or a violation of the Company s Corporate Code of Business Conduct and Ethics or Financial Code of Ethics.

(c) **Change in Control** means the occurrence of any of the following events:

(1) The consummation of an agreement to acquire, or a tender offer for beneficial ownership (within the meaning of Rule 13d-3 promulgated under the Securities Exchange Act of 1934, as amended) by any person of, 50% or more of either (x) the then outstanding shares of Rice Energy s common stock (the **Outstanding Stock**) or (y) the combined voting power of the then outstanding voting securities of Rice Energy entitled to vote generally in the election of directors (the **Outstanding Voting Securities**); provided, however, that for purposes of this subsection (1), the following acquisitions shall not constitute a Change in Control: (A) any acquisition directly from Rice Energy, (B) any acquisition by Rice Energy, (C) any acquisition by any employee benefit plan (or related trust) sponsored or maintained by Rice Energy or any entity controlled by Rice Energy, or (D) any acquisition by any entity pursuant to a transaction that complies with clauses (A), (B), and (C) of paragraph (3) below;

(2) Individuals who constitute the Incumbent Board cease for any reason to constitute at least a majority of the Board;

(3) Consummation of a reorganization, merger, or consolidation or sale or other disposition of all or substantially all of the assets of the Company, or an acquisition of assets of another entity (a **Business Combination**), in each case, unless, following such Business Combination, (A) the Outstanding Stock and Outstanding Voting Securities immediately prior to such Business Combination represent or are converted into or exchanged for securities which represent or are convertible into more than 50% of, respectively, the then outstanding shares of common stock or common equity interests and the combined voting power of the then outstanding voting securities entitled to vote

generally in the election of directors or other governing body, as the case may be, of the entity resulting from such Business Combination (including, without limitation, an entity which as a result of such transaction owns the Company, or all or substantially all of the Company s assets either directly or through one or more subsidiaries), (B) no person (excluding any employee benefit plan (or related trust) of the Company or the entity resulting from such

Business Combination) beneficially owns, directly or indirectly, 20% or more of, respectively, the then outstanding shares of common stock or common equity interests of the entity resulting from such Business Combination or the combined voting power of the then outstanding voting securities entitled to vote generally in the election of directors or other governing body of such entity except to the extent that such ownership results solely from ownership of Rice Energy that existed prior to the Business Combination, and (C) at least a majority of the members of the board of directors or similar governing body of the entity resulting from such Business Combination were members of the Board at the time of the execution of the initial agreement, or of the action of the Board, providing for such Business Combination; or

(4) Approval by the stockholders of Rice Energy of a complete liquidation or dissolution of Rice Energy.

Notwithstanding the foregoing, for purposes of any award that provides for a deferral of compensation under Section 409A, to the extent the impact of a Change in Control on such an award would subject a Participant to additional taxes under Section 409A, a Change in Control for purposes of such award will mean a Change in Control that is also a change in the ownership or effective control of a corporation, or a change in the ownership of a substantial portion of the assets of a corporation within the meaning of Section 409A.

(d) **Code** means the Internal Revenue Code of 1986, as amended, including any successor law thereto.

(e) **Committee** means the Compensation Committee of the Board, or such other committee as is appointed or designated by the Board to administer the Plan, in each case which shall be comprised solely of two or more **outside directors** (as defined under Section 162(m) of the Code and the regulations promulgated thereunder); provided, however, that with respect to Participants who Rice Energy has determined not to be subject to Section 162(m) of the Code, to the extent permitted by the Committee s charter, the powers and authority of the Committee under the Plan are hereby delegated to Rice Energy s Chief Executive Officer and, in connection therewith, all references to Committee in this Plan shall be deemed references to Rice Energy s Chief Executive Officer as it relates to those aspects of the Plan that have been so delegated.

(f) **Company** means Rice Energy and any subsidiary entity or affiliate thereof, including subsidiaries or affiliates which become such after adoption of the Plan.

(g) **Forfeit, Forfeiture, Forfeited** means the loss by a Participant of any and all rights to an award granted under the Plan, including the loss to any payment of compensation by the Company under the Plan or any award granted thereunder.

(h) **Incumbent Board** means the portion of the Board constituted of the individuals who are members of the Board as of the Effective Date (set forth in Section 15 hereof) and any other individual who becomes a director of Rice Energy after the Effective Date and whose election or appointment by the Board or nomination for election by Rice Energy s stockholders was approved by a vote of at least a majority of the directors then comprising the Incumbent Board, but excluding, for this purpose, any such individual whose initial assumption of office occurs as a result of an actual or threatened election contest with respect to the election or removal of directors or other actual or threatened solicitation of proxies or consents by or on behalf of a person other than the Incumbent Board.

(i) **Participant** means any person: (1) who satisfies the eligibility requirements set forth in Section 4; (2) to whom an award has been made by the Committee; and (3) whose award remains outstanding under the Plan.

(j) **Performance Goal** means, in relation to any Performance Period, the level of performance that must be achieved with respect to a Performance Measure.

A-2

Table of Contents

(k) **Performance Measures** means any one or more of the following performance criteria, either individually, alternatively or in any combination, and subject to such modifications or variations as specified by the Committee, applied to either the Company as a whole or to a business unit or subsidiary entity thereof, either individually, alternatively or in any combination, and measured over a period of time including any portion of a year, annually or cumulatively over a period of years, on an absolute or relative basis, to previous years results or to a designated comparison group, in each case as specified by the Committee: (1) earnings per share, (2) increase in revenues, (3) increase in cash flow, (4) increase in cash flow from operations, (5) increase in cash flow return, (6) return on net assets, (7) return on assets, (8) return on investment, (9) return on capital, (10) return on equity, (11) economic value added, (12) operating margin, (13) contribution margin, (14) net income, (15) net income per share, (16) pre-tax earnings, (17) pre-tax earnings before interest, depreciation and amortization, (18) pre-tax operating earnings after interest expense and before incentives, service fees and extraordinary or special items, (19) total or relative stockholder return, (20) debt reduction, (21) market share, (22) change in the fair market value of stock price, (23) operating income, (24) amount of oil and natural gas reserves, (25) oil and natural gas reserves additions, (26) cost of finding oil and natural gas reserves, (27) oil and natural gas reserve replacement ratios, (28) oil and natural gas production amounts, (29) oil and natural gas production sales amounts, (30) safety targets, (31) regulatory compliance, (32) any of the above goals as compared to the performance of a published or special index deemed applicable by the Committee, including, but not limited to, the Standard & Poor s 500 Stock Index or a group of comparable companies, and (33) other non-financial operating and management performance objectives.

To the extent consistent with Section 162(m) of the Code and the regulations promulgated thereunder, the Committee may determine that certain adjustments shall apply, in whole or in part, in such manner as specified by the Committee, to exclude or include the effect of specified events that occur during a Performance Period, including the following: (1) asset write-downs, (2) litigation, claims, judgments or settlements, (3) the effect of changes in tax law, accounting principles or other such laws or regulations affecting reporting results, (4) accruals for business combinations, reorganization and restructuring programs, including but not limited to reductions in force and early retirement incentives (5) any extraordinary, unusual, or nonrecurring items, including, but not limited to, such items described in management s discussion and analysis of financial condition and results of operations or the financial statements and/or notes thereto appearing in the Company s annual report for the applicable period, (6) goodwill impairment charges, (7) operating results for any business acquired during the calendar year, (8) third party expenses associated with any acquisitions, (9) any change in accounting principles or accounting charges, (10) any loss from discontinued operations, and (11) any other extraordinary events or occurrences identified by the Committee, to the extent set forth with reasonable particularity in connection with the establishment of performance goals.

(l) **Performance Period** means, in relation to any award, the calendar year or other fiscal period within a calendar year of less than 12 months for which a Participant s performance is being calculated, with each such period constituting a separate Performance Period.

(m) **Rice Energy** means Rice Energy Inc. (or any successor thereto).

(n) **Section 409A** shall mean Section 409A of the Code, the regulations and other binding guidance promulgated thereunder.

(o) **Separation from Service or Separates from Service** shall mean the Participant s death, retirement or other termination of employment or service with the employer (including all persons treated as a single employer under Sections 414(b) and 414(c)). For purposes hereof, the determination of controlled group members shall be made pursuant to the provisions of Sections 414(b) and 414(c); provided that the language **at least 50 percent** shall be used instead of **at least 80 percent** in each place that it appears in Section 1563(a)(1), (2) and (3) and Treas. Reg. Section 1.414(c)-2; provided, further, where legitimate business reasons exist (within the meaning of Treas. Reg.

Section 1.409A-1(h)(3)), the language **at least 20 percent** shall be used instead of **at least 80 percent** in each place it appears. Whether a Participant has experienced a Separation from Service will be determined based on all of the facts and circumstances in accordance with the guidance issued under Section 409A and, to the extent not inconsistent therewith, the terms of the Plan.

A-3

Table of Contents

(p) **Total and Permanent Disability** means: (1) if the Participant is insured under a long-term disability insurance policy or plan which is paid for by the Company, the Participant is totally disabled under the terms of that policy or plan; or (2) if no such policy or plan exists, the Participant shall be considered to be totally disabled as determined by the Committee.

3. ***Administration of the Plan***

(a) The management of the Plan shall be vested in the Committee; provided, however, that all acts and authority of the Committee pursuant to this Plan shall be subject to the provisions of the Committee s Charter, as amended from time to time, and such other authority as may be delegated to the Committee by the Board.

(b) Subject to the terms of the Plan, the Committee shall, among other things, have full authority and discretion to determine eligibility for participation in the Plan, make awards under the Plan, establish the terms and conditions of such awards (including the Performance Goal(s) and Performance Measure(s) to be utilized) and determine whether the Performance Goals applicable to any Performance Measures for any awards have been achieved. The Committee s determinations under the Plan need not be uniform among all Participants, or classes or categories of Participants, and may be applied to such Participants, or classes or categories of Participants, as the Committee, in its sole and absolute discretion, considers necessary, appropriate or desirable. The Committee is authorized to interpret the Plan, to adopt administrative rules, regulations, and guidelines for the Plan, and may correct any defect, supply any omission or reconcile any inconsistency or conflict in the Plan or in any award. All determinations by the Committee shall be final, conclusive and binding on the Company, the Participant and any and all interested parties.

(c) Subject to the provisions of the Plan, the Committee will have the authority and discretion to determine the extent to which awards under the Plan will be structured to conform to the requirements applicable to performance-based compensation as described in Section 162(m) of the Code, and to take such action, establish such procedures, and impose such restrictions at the time such awards are granted as the Committee determines to be necessary or appropriate to conform to such requirements. Notwithstanding any provision of the Plan to the contrary, if an award under this Plan is intended to qualify as performance-based compensation under Section 162(m) of the Code and the regulations issued thereunder and a provision of this Plan would prevent such award from so qualifying, such provision shall be administered, interpreted and construed to carry out such intention (or disregarded to the extent such provision cannot be so administered, interpreted or construed).

(d) The benefits provided under the Plan are intended to be excepted from coverage under Section 409A and the regulations promulgated thereunder and shall be construed accordingly. Notwithstanding any provision of the Plan to the contrary, if any benefit provided under this Plan is subject to the provisions of Section 409A and the regulations issued thereunder (and not excepted therefrom), the provisions of the Plan shall be administered, interpreted and construed in a manner necessary to comply with Section 409A and the regulations issued thereunder (or disregarded to the extent such provision cannot be so administered, interpreted, or construed.)

4. ***Participation in the Plan***

Officers and key employees of the Company shall be eligible to participate in the Plan. No employee shall have the right to participate in the Plan, and participation in the Plan in any one Performance Period does not entitle an individual to participate in future Performance Periods.

5. ***Incentive Compensation Awards***

(a) The Committee may, in its discretion, from time to time make awards to persons eligible for participation in the Plan pursuant to which the Participant will earn cash compensation. The amount of a

Participant s award may be based on a percentage of such Participant s salary or such other methods as may be established by the Committee. Each award shall be communicated to the Participant, and shall specify, among other things, the terms and conditions of the award and the Performance Goals to be achieved. The maximum amount that may be awarded and paid under the Plan to a Participant for any calendar year shall not exceed USD $3,000,000.

(b) With respect to awards that are intended to be performance-based compensation under Section 162(m) of the Code, each award shall be conditioned upon the Company s achievement of one or more Performance Goal(s) with respect to the Performance Measure(s) established by the Committee. No later than ninety (90) days after the beginning of the applicable Performance Period, the Committee shall establish in writing the Performance Goals, Performance Measures and the method(s) for computing the amount of compensation which will be payable under the Plan to each Participant if the Performance Goals established by the Committee are attained; provided however, that for a Performance Period of less than one year, the Committee shall take any such actions prior to the lapse of 25% of the Performance Period. In addition to establishing minimum Performance Goals below which no compensation shall be payable pursuant to an award, the Committee, in its discretion, may create a performance schedule under which an amount less than or more than the target award may be paid so long as the Performance Goals have been achieved.

(c) The Committee, in its sole discretion, may also establish such additional restrictions or conditions that must be satisfied as a condition precedent to the payment of all or a portion of any awards. Such additional restrictions or conditions need not be performance-based and may include, among other things, the receipt by a Participant of a specified annual performance rating, the continued employment by the Participant and/or the achievement of specified performance goals by the Company, business unit or Participant. Furthermore and notwithstanding any provision of this Plan to the contrary, the Committee, in its sole discretion, may reduce the amount of any award to a Participant if it concludes that such reduction is necessary or appropriate based upon: (i) an evaluation of such Participant s performance; (ii) comparisons with compensation received by other similarly situated individuals working within the Company s industry; (iii) the Company s financial results and conditions; or (iv) such other factors or conditions that the Committee deems relevant. Notwithstanding any provision of this Plan to the contrary, the Committee shall not use its discretionary authority to increase any award that is intended to be performance-based compensation under Section 162(m) of the Code.

6. ***Payment of Individual Incentive Awards***

(a) After the end of the Performance Period, the Committee shall certify in writing the extent to which the applicable Performance Goals and any other material terms have been achieved. Subject to the provisions of the Plan, earned Awards shall be paid in the first calendar year immediately following the end of the Performance Period on or before March 15th of such calendar year (**Payment Date**). For purposes of this provision, and for so long as the Code permits, the minutes of the Committee meeting in which the certification is made may be treated as written certification.

(b) Unless otherwise determined by the Committee or as otherwise provided in a Company plan applicable to Participant or any agreement between the Participant and the Company, Participants who have a Separation from Service prior to the end of the Performance Period of an award for any reason other than as provided below, shall Forfeit any and all rights to payment under such award(s) then outstanding under the terms of the Plan and shall not be entitled to any cash payment for the applicable period. If a Participant Separates from Service prior to the end of the Performance Period of an award (i) by reason of death or Total and Permanent Disability, the Participant s award shall be prorated to reflect the period of service during the Performance Period prior to his/her death or Total and Permanent Disability; (ii) on account of an involuntary Separation from Service by the Company other than for Cause (A) within the 90-day period immediately preceding a Change in Control, or (B) on or within the one (1) year period

following a Change in Control, the award will be deemed earned at a target award level; or (iii) on account of an involuntary Separation from Service by the Company other than for Cause (and other than an involuntary Separation from Service by the Company in connection with a Change in Control as described in clause (ii)) which occurs on or after July 1st of an annual Performance Period, the Participant s award shall be prorated to reflect the period of service during the Performance Period prior to his/her Separation from Service.

Except as otherwise provided herein, any payments under the Plan shall be paid either to the Participant or, as appropriate, the Participant s estate, subject to the Committee s certification that the applicable Performance Goals and other material terms have been met. For purposes of this subsection 6(b), the prorated portion of an award shall be based on the ratio of the number of complete months the Participant is employed or serves during the Performance Period to the total number of months in the Performance Period. Any payment to which a Participant becomes entitled to receive pursuant to the Change in Control provisions of this subsection 6(b) will be paid to the Participant contemporaneous with the consummation of the Change in Control or, if later, on or before the sixtieth (60th) day following the Participant s Separation from Service (but, in each case, within the short-term deferral exception as specified in Treas. Reg. § 1.409A-1(b)(4)).

(c) The Committee shall determine whether, to what extent, and under what additional circumstances amounts payable with respect to an award under the Plan shall be deferred either automatically, at the election of the Participant, or by the Committee.

7. ***Clawback/Recoupment***

To the extent required by (a) applicable law, including, without limitation, the requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, any Securities and Exchange Commission rule or any applicable securities exchange listing standard and/or (ii) any policy that may be adopted by the Board or Committee, any awards granted under this Plan and amounts paid or payable pursuant to or with respect to such awards shall be subject to clawback to the extent necessary to comply with such laws and/or policy, which clawback may include Forfeiture, repurchase and/or recoupment of awards and amounts paid or payable pursuant to or with respect to such awards. ,

8. ***Amendment or Termination of the Plan***

While the Company intends that the Plan shall continue in force from year to year, the Committee reserves the right to amend, modify or terminate the Plan, at any time; provided, however, that no such modification, amendment or termination shall, without the consent of the Participant, materially adversely affect the rights of such Participant to any payment that has been determined by the Committee to be due and owing to the Participant under the Plan but not yet paid. Any and all actions permitted under this Section 8 may be authorized and performed by the Committee in its sole and absolute discretion.

Notwithstanding the foregoing or any provision of the Plan to the contrary, the Committee may at any time (without the consent of the Participant) modify, amend or terminate any or all of the provisions of this Plan to the extent necessary to conform the provisions of the Plan with Section 409A or Section 162(m) of the Code, the regulations promulgated thereunder or an exception thereto regardless of whether such modification, amendment, or termination of the Plan shall adversely affect the rights of a Participant under the Plan. Notwithstanding any provision of the Plan to the contrary, in no event shall the Committee or Board (or any member thereof), or the Company (or its employees, officers, directors or affiliates) have any liability to any Participant (or any other person) due to the failure of the Plan to satisfy the requirements of Section 409A or any other applicable law.

9. ***Rights Not Transferable***

A Participant s rights under the Plan may not be assigned, pledged, or otherwise transferred except, in the event of a Participant s death, to the Participant s designated beneficiary, or in the absence of such a designation, by will or by the

laws of descent and distribution.

10. ***Funding/Payment***
The Plan is not funded and all awards payable hereunder shall be paid from the general assets of the Company. No provision contained in this Plan and no action taken pursuant to the provisions of this Plan shall create

A-6

a trust of any kind or require the Company to maintain or set aside any specific funds to pay benefits hereunder. To the extent a Participant acquires a right to receive payments from the Company under the Plan, such right shall be no greater than the right of any unsecured general creditor of the Company. If any earned award is not paid by the Payment Date due to administrative impracticality, such earned award will be paid, without earnings, as soon as administratively practicable thereafter.

11. *Withholdings*

The Company shall have the right to withhold from any awards payable under the Plan or other wages payable to a Participant such amounts sufficient to satisfy federal, state and local tax withholding obligations arising from or in connection with the Participant s participation in the Plan and such other deductions as may be authorized by the Participant or as required by applicable law.

12. *No Employment or Service Rights*

Nothing contained in the Plan shall confer upon any Participant any right with respect to continued employment or service with the Company (or any of its affiliates) nor shall the Plan interfere in any way with the right of the Company (or any of its affiliates) to at any time reassign the Participant to a different job, change the compensation of the Participant or terminate the Participant s employment or service for any reason.

13. *Other Compensation Plans*

Nothing contained in this Plan shall prevent the Corporation from adopting other or additional compensation arrangements for employees of the Corporation, including arrangements that are not intended to comply with Section 162(m) of the Code.

14. *Governing Law*

The Plan shall be governed by and construed in accordance with the laws of the State of Delaware, without giving effect to its conflict of law provisions.

15. *Effective Date*

The Plan shall become effective on June 3, 2015, subject to approval of the Plan by Rice Energy s stockholders on or around such date.

Table of Contents

VOTE BY INTERNERNET - www.proxyvote.com or scan the QR Barcode above

Use the Internet to transmit your voting instructions and for electronic delivery of information up until 11:59 p.m. Eastern Time on June 2, 2015. Have your proxy card in hand when you access the web site and follow the instructions to obtain your records and to create an electronic voting instruction form.

ELECTRONIC DELIVERY OF FUTURE PROXY MATERIALS

If you would like to reduce the costs incurred by Rice Energy Inc. in mailing proxy materials, you can consent to receiving all future proxy statements, proxy cards and annual reports electronically via e-mail or the Internet. To sign up for electronic delivery, please follow the instructions above to vote using the Internet and, when prompted, indicate that you agree to receive or access proxy materials electronically in future years.

VOTE BY PHONE - 1-800-690-6903

Use any touch-tone telephone to transmit your voting instructions up until 11:59 p.m. Eastern Time on June 2, 2015. Have your proxy card in hand when you call and then follow the instructions.

VOTE BY MAIL

Mark, sign and date your proxy card and return it in the postage-paid envelope we have provided or return it to Rice Energy Inc., c/o Broadridge, 51 Mercedes Way, Edgewood, NY 11717.

TO VOTE, MARK BLOCKS BELOW IN BLUE OR BLACK INK AS FOLLOWS:

M90021-P59797 KEEP THIS PORTION FOR YOUR RECORDS

DETACH AND RETURN THIS PORTION ONLY

THIS PROXY CARD IS VALID ONLY WHEN SIGNED AND DATED.

RICE ENERGY INC. **The Board of Directors recommends a vote FOR the following:**	**For All**	**Withhold All**	**For All Except**	To withhold authority to vote for any individual nominee(s), mark For All Except and write the number(s) of the nominee(s) on the line below.
1. The election of two (2) Class I directors nominated by our Board of Directors to serve until the Company s 2018 annual meeting of stockholders;	¨	¨	¨	

Nominees:
01) Daniel J. Rice IV
02) James W. Christmas

The Board of Directors recommends a vote FOR the following proposals:	**For**	**Against**	**Abstain**
2. Approval of the Annual Incentive Bonus Plan;	¨	¨	¨
3. Advisory approval of the Company's executive compensation;	¨	¨	¨

The Board of Directors recommends a vote for every "1 year" on the following proposal:	**1 Year**	**2 Years**	**3 Years**	**Abstain**
4. Advisory approval on the frequency of future advisory votes on the Company's executive compensation;	¨	¨	¨	¨

The Board of Directors recommends a vote FOR the following proposal:	**For**	**Against**	**Abstain**
5. Ratification of Ernst & Young LLP as Rice Energy's independent registered public accounting firm for the fiscal year ending December 31, 2015.	¨	¨	¨

NOTE: Such other business as may properly come before the meeting or any adjournment or postponement thereof.

For address changes, please check this box and write them on the back where indicated. ¨

Please indicate if you plan to attend this meeting.	¨	¨
	Yes	**No**

Please sign exactly as your name(s) appear(s) hereon. When signing as attorney, executor, administrator, or

other fiduciary, please give full title as such. Joint owners should each sign personally. All holders must sign. If a corporation, company or partnership, please sign in full corporate, company or partnership name by authorized officer.

Signature [PLEASE SIGN WITHIN BOX]	Date	Signature (Joint Owners)	Date

Table of Contents

2015 Annual Meeting of Stockholders

Wednesday, June 3, 2015

10:00 AM EDT

Hilton Garden Inn

1000 Corporate Drive

Canonsburg, PA 15317

Driving Directions:

From Pittsburgh International Airport -

Take Airport Parkway - Merge onto I-376 East for 10.3 miles. Merge onto I-79 South via Exit 64A Washington. Travel for approximately 13 miles. Take exit 48(Southpointe/Hendersonville). Turn right off the exit, then right onto Corporate Drive. The Hilton Garden Inn is on the right.

From I-79 southbound -

Take exit 48(Southpointe/Hendersonville). Turn right off the exit. Then right onto Corporate Drive. The Hilton Garden Inn is on the right.

From I-79 northbound -

Take exit 48(Southpointe/Hendersonville). Turn left off the exit. At Corporate Drive turn right. The Hilton Garden Inn is on the right.

From I-70 east/west -

Follow signs for I-79 north. Then take exit 48(Southpointe/Hendersonville). Turn left off the exit. At Corporate Drive turn right.

Important Notice Regarding the Availability of Proxy Materials for the 2015 Annual Meeting:

The Notice and Proxy Statement and Form 10-K are available at www.proxyvote.com.

M90022-P59797

RICE ENERGY INC.

Annual Meeting of Stockholders

June 3, 2015, 10:00 AM

This proxy is solicited by the Board of Directors of Rice Energy Inc.

The stockholder(s) hereby appoint(s) Daniel J. Rice IV and William E. Jordan, or either of them, as proxies, each with the power to appoint his substitute, and hereby authorizes them to represent and to vote, as designated on the reverse side of this ballot, or as otherwise properly presented, all of the shares of common stock of RICE ENERGY INC. that the stockholder(s) is/are entitled to vote at the Annual Meeting of Stockholders to be held at 10:00 AM, EDT, on June 3, 2015, at The Hilton Garden Inn, 1000 Corporate Drive, Canonsburg, PA 15317, and any adjournment or postponement thereof.

THIS PROXY WILL BE VOTED BY THE PROXIES AS DIRECTED, OR IF NO DIRECTION IS INDICATED, WILL BE VOTED (i) "FOR" ELECTION OF ALL CLASS I DIRECTOR NOMINEES (PROPOSAL 1); (ii) "FOR" APPROVAL OF THE ANNUAL INCENTIVE BONUS PLAN (PROPOSAL 2); (iii) "FOR" ADVISORY APPROVAL OF THE COMPANY'S EXECUTIVE COMPENSATION (PROPOSAL 3); (iv) "FOR" AN ANNUAL FREQUENCY OF FUTURE ADVISORY VOTES ON THE COMPANY'S EXECUTIVE COMPENSATION (PROPOSAL 4); and (v) "FOR" RATIFICATION OF ERNST & YOUNG LLP AS THE INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM (PROPOSAL 5), AND IN ACCORDANCE WITH THE PROXIES BEST JUDGMENT UPON SUCH OTHER BUSINESS AS MAY PROPERLY COME BEFORE THE ANNUAL MEETING OR ANY ADJOURNMENT OR POSTPONEMENT THEREOF.

Address Changes: ____
____

(If you noted any Address Changes above, please mark corresponding box on the reverse side.)

Continued and to be signed on reverse side