

HALLMARK FINANCIAL SERVICES INC  
Form 10-Q  
November 12, 2010

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

Quarterly report pursuant to Section 13 or 15(d) of the  
Securities Exchange Act of 1934

For the quarterly period ended September 30, 2010

Commission file number 001-11252

Hallmark Financial Services, Inc.

(Exact name of registrant as specified in its charter)

Nevada  
(State or other jurisdiction of  
Incorporation or organization)

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

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

76102  
(Zip Code)

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

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

Large accelerated filer  Accelerated filer   
Non-accelerated filer  Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

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Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: Common Stock, par value \$.18 per share – 20,124,169 shares outstanding as of November 10, 2010.

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PART I  
FINANCIAL INFORMATION

Item 1. Financial Statements

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

	September 30 2010 (unaudited)	December 31 2009
<b>ASSETS</b>		
Investments:		
Debt securities, available-for-sale, at fair value (cost; \$353,659 in 2010 and \$287,108 in 2009)	\$ 360,238	\$ 291,876
Equity securities, available-for-sale, at fair value (cost; \$34,366 in 2010 and \$27,251 in 2009)	44,025	35,801
Total investments	404,263	327,677
Cash and cash equivalents	81,984	112,270
Restricted cash and cash equivalents	5,991	5,458
Premiums receivable	52,288	46,635
Accounts receivable	2,958	3,377
Receivable for securities	7	-
Ceded unearned premiums	15,520	12,997
Reinsurance recoverable	19,684	10,008
Deferred policy acquisition costs	23,181	20,792
Goodwill	41,080	41,080
Intangible assets, net	26,124	28,873
Federal income tax recoverable	3,120	-
Prepaid expenses	1,733	923
Other assets	15,437	18,779
Total assets	\$ 693,370	\$ 628,869
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Liabilities:		
Note payable	\$ 2,800	\$ 2,800
Subordinated debt securities	56,702	56,702
Reserves for unpaid losses and loss adjustment expenses	223,828	184,662
Unearned premiums	138,218	125,089
Unearned revenue	140	191
Reinsurance balances payable	1,141	3,281
Accrued agent profit sharing	1,772	1,790
Accrued ceding commission payable	4,232	8,600
Pension liability	2,367	2,628
Deferred federal income taxes, net	1,366	942
Federal income tax payable	-	1,266
Payable for securities	11,609	19
Accounts payable and other accrued expenses	12,209	13,258
Total liabilities	456,384	401,228

## Commitments and contingencies (Note 17)

Redeemable non-controlling interest	1,288	1,124
Stockholders' equity:		
Common stock, \$0.18 par value (authorized 33,333,333 shares in 2010 and 2009; issued 20,872,831 in 2010 and 2009)	3,757	3,757
Additional paid-in capital	121,589	121,016
Retained earnings	105,396	98,482
Accumulated other comprehensive income	10,218	8,589
Treasury stock, at cost (748,662 shares in 2010 and 757,828 in 2009)	(5,262)	(5,327)
Total stockholders' equity	235,698	226,517
	\$ 693,370	\$ 628,869

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

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

	Three Months Ended		Nine Months Ended	
	September 30		September 30	
	2010	2009	2010	2009
Gross premiums written	\$ 82,199	\$ 74,013	\$ 247,238	\$ 220,545
Ceded premiums written	(10,152)	(11,222)	(29,263)	(16,714)
Net premiums written	72,047	62,791	217,975	203,831
Change in unearned premiums	(1,641)	1,447	(10,606)	(17,844)
Net premiums earned	70,406	64,238	207,369	185,987
Investment income, net of expenses	4,036	3,467	10,513	11,203
Net realized gains	311	597	5,757	1,116
Finance charges	1,833	1,525	5,247	4,324
Commission and fees	(392)	2,018	(1,204)	10,834
Other income	23	58	45	93
Total revenues	76,217	71,903	227,727	213,557
Losses and loss adjustment expenses	51,293	40,579	146,449	115,552
Operating expenses	21,602	23,428	65,956	71,056
Interest expense	1,151	1,147	3,447	3,456
Amortization of intangible assets	917	916	2,749	2,412
Total expenses	74,963	66,070	218,601	192,476
Income before tax	1,254	5,833	9,126	21,081
Income tax expense	205	1,585	2,142	5,766
Net income	1,049	4,248	6,984	15,315
Less: Net income attributable to non-controlling interest	33	34	70	36
Net income attributable to Hallmark Financial Services, Inc.	\$ 1,016	\$ 4,214	\$ 6,914	\$ 15,279
Net income per share attributable to Hallmark Financial Services, Inc. common stockholders:				
Basic	\$ 0.05	\$ 0.20	\$ 0.34	\$ 0.73
Diluted	\$ 0.05	\$ 0.20	\$ 0.34	\$ 0.73

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
<b>Common Stock</b>				
Balance, beginning of period	\$ 3,757	\$ 3,757	\$ 3,757	\$ 3,751
Issuance of common stock upon option exercises	-	-	-	6
Balance, end of period	3,757	3,757	3,757	3,757
<b>Additional Paid-In Capital</b>				
Balance, beginning of period	121,403	120,736	121,016	119,928
Accretion of redeemable noncontrolling interest	(77)	(87)	(239)	(259)
Equity based compensation	263	612	852	1,488
Exercise of stock options	-	-	(40)	104
Balance, end of period	121,589	121,261	121,589	121,261
<b>Retained Earnings</b>				
Balance, beginning of period	104,380	84,972	98,482	72,242
Adjustment to opening balance, net of tax (Note 2)	-	-	-	1,665
	104,380	84,972	98,482	73,907
Net income attributable to Hallmark Financial Services, Inc.	1,016	4,214	6,914	15,279
Balance, end of period	105,396	89,186	105,396	89,186
<b>Accumulated Other Comprehensive Income (Loss)</b>				
Balance, beginning of period	6,966	836	8,589	(16,432)
Adjustment to opening balance, net of tax (Note 2)	-	-	-	(1,665)
Adjusted balance, beginning of period	6,966	836	8,589	(18,097)
Additional minimum pension liability, net of tax	36	80	109	239
Net unrealized holding gains arising during period	3,527	7,881	7,277	27,197
Reclassification adjustment for gains included in net income	(311)	(636)	(5,757)	(1,178)
Balance, end of period	10,218	8,161	10,218	8,161
<b>Treasury Stock</b>				
Balance, beginning of period	(5,262)	(77)	(5,327)	(77)
Acquisition of treasury shares	-	(5,250)	-	(5,250)
Issuance of treasury stock upon option exercises	-	-	65	-
Balance, end of period	(5,262)	(5,327)	(5,262)	(5,327)
<b>Total Stockholders' Equity</b>	<b>\$ 235,698</b>	<b>\$ 217,038</b>	<b>\$ 235,698</b>	<b>\$ 217,038</b>
<b>Net income</b>	<b>\$ 1,049</b>	<b>\$ 4,248</b>	<b>\$ 6,984</b>	<b>\$ 15,315</b>

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Additional minimum pension liability, net of tax	36	80	109	239
Net unrealized holding gains arising during period	3,527	7,881	7,277	27,197
Reclassification adjustment for gains included in net income	(311)	(636)	(5,757)	(1,178)
Comprehensive income	4,301	11,573	8,613	41,573
Less: Comprehensive income attributable to non-controlling interest	33	34	70	36
Comprehensive income attributable to Hallmark Financial Services, Inc.	\$ 4,268	\$ 11,539	\$ 8,543	\$ 41,537

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



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

	Nine Months Ended September 30	
	2010	2009
<b>Cash flows from operating activities:</b>		
Net income	\$ 6,984	\$ 15,315
<b>Adjustments to reconcile net income to cash provided by operating activities:</b>		
Depreciation and amortization expense	3,527	2,979
Deferred federal income taxes	(1,034)	(1,117)
Realized gains on investments	(5,757)	(1,116)
Change in ceded unearned premiums	(2,523)	(5,036)
Change in premiums receivable	(5,653)	(4,787)
Change in accounts receivable	370	815
Change in deferred policy acquisition costs	(2,389)	(3,105)
Change in reserves for unpaid losses and loss adjustment expenses	39,166	15,252
Change in unearned premiums	13,129	23,462
Change in unearned revenue	(51)	(1,771)
Change in accrued agent profit sharing	(18)	(243)
Change in reinsurance recoverable	(9,676)	5,087
Change in reinsurance balances payable	(2,140)	2,680
Change in current federal income tax recoverable/payable	(4,386)	(384)
Change in accrued ceding commission payable	(4,368)	(5)
Change in all other liabilities	(1,310)	(8,094)
Change in all other assets	5,063	5,763
Net cash provided by operating activities	28,934	45,695
<b>Cash flows from investing activities:</b>		
Purchases of property and equipment	(1,155)	(907)
Net transfers (into)/from restricted cash and cash equivalents	(533)	3,470
Purchases of investment securities	(157,332)	(74,430)
Maturities, sales and redemptions of investment securities	99,919	65,283
Payment for acquisition of subsidiaries	-	(7,246)
Net cash used in investing activities	(59,101)	(13,830)
<b>Cash flows from financing activities:</b>		
Proceeds from exercise of employee stock options	25	110
Net repayments of notes payable	-	(1,417)
Distribution to non-controlling interest	(144)	(20)
Purchase of treasury shares	-	(5,250)
Net cash used in financing activities	(119)	(6,577)
Increase (Decrease) in cash and cash equivalents	(30,286)	25,288

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Cash and cash equivalents at beginning of period	112,270	59,134
Cash and cash equivalents at end of period	\$ 81,984	\$ 84,422

Supplemental cash flow information:

Interest paid	\$ 3,442	\$ 3,494
Taxes paid	\$ 7,564	\$ 7,267

Supplemental schedule of non-cash investing activities:

Change in receivable for securities related to investment disposals settled after the balance sheet date	\$ 42	\$ 850
Change in payable for securities related to investment purchases settled after the balance sheet date	\$ 11,590	\$ (2,918)

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

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

1. General

Hallmark Financial Services, Inc. (“Hallmark” and, together with subsidiaries, “we,” “us” or “our”) is an insurance holding company engaged in the sale of property/casualty insurance products to businesses and individuals. Our business involves marketing, distributing, underwriting and servicing our insurance products, as well as providing other insurance related services.

We pursue our business activities through subsidiaries whose operations are organized into five business units, which are supported by our four insurance company subsidiaries. Our Standard Commercial business unit (formerly known as our AHIS Operating Unit) handles commercial insurance products and services in the standard market. Our E&S Commercial business unit (formerly known as our TGA Operating Unit) handles primarily commercial insurance products and services in the excess and surplus lines market. Our General Aviation business unit (formerly known as our Aerospace Operating Unit) handles general aviation insurance products and services. Our Excess & Umbrella business unit (formerly known as our Heath XS Operating Unit) offers low and middle market commercial umbrella and excess liability insurance on both an admitted and non-admitted basis focusing primarily on trucking, specialty automobile and non-fleet automobile coverage. Our Personal Lines business unit (formerly known as our Personal Lines Operating Unit) handles personal insurance products and services. Our insurance company subsidiaries supporting these business units are American Hallmark Insurance Company of Texas (“AHIC”), Hallmark Insurance Company (“HIC”), Hallmark Specialty Insurance Company (“HSIC”) and Hallmark County Mutual Insurance Company (“HCM”).

These five business units are segregated into three reportable industry segments for financial accounting purposes. The Standard Commercial Segment presently consists solely of the Standard Commercial business unit and the Personal Segment presently consists solely of the Personal Lines business unit. The Specialty Commercial Segment includes the E&S Commercial, General Aviation and Excess & Umbrella business units.

2. Basis of Presentation

Our unaudited consolidated financial statements included herein have been prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) and include our accounts and the accounts of our subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation. Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to rules and regulations of the Securities and Exchange Commission (“SEC”) for interim financial reporting. These unaudited consolidated financial statements should be read in conjunction with our audited consolidated financial statements for the year ended December 31, 2009 included in our Annual Report on Form 10-K filed with the SEC.

The interim financial data as of September 30, 2010 and 2009 is unaudited. However, in the opinion of management, the interim data includes all adjustments, consisting of normal recurring adjustments, necessary for a fair statement of the results for the interim periods. The results of operations for the period ended September 30, 2010 are not necessarily indicative of the operating results to be expected for the full year.

### Redeemable Non-Controlling Interest

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

### Reclassification

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

### Income Taxes

We file a consolidated federal income tax return. Deferred federal income taxes reflect the future tax consequences of differences between the tax bases of assets and liabilities and their financial reporting amounts at each year end. Deferred taxes are recognized using the liability method, whereby tax rates are applied to cumulative temporary differences based on when and how they are expected to affect the tax return. Deferred tax assets and liabilities are adjusted for tax rate changes in effect for the year in which these temporary differences are expected to be recovered or settled.

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

Our preparation of financial statements in conformity with GAAP requires us to make estimates and assumptions that affect our reported amounts of assets and liabilities and our disclosure of contingent assets and liabilities at the date of our consolidated financial statements, as well as our reported amounts of revenues and expenses during the reporting period. Refer to "Critical Accounting Estimates and Judgments" in our Annual Report on Form 10-K for the year ended December 31, 2009 for information on accounting policies that we consider critical in preparing our consolidated financial statements. Actual results could differ materially from those estimates.

### Fair Value of Financial Instruments

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

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

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

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

Notes Payable: The carrying value of our bank credit facility of \$2.8 million approximates the fair value based on the current interest rate.

Subordinated Debt Securities: Our trust preferred securities have a carried value of \$56.7 million and a fair value of \$54.8 million as of September 30, 2010. The fair value of our trust preferred securities is based on discounted cash flows using a current yield to maturity of 7.50% based on similar issues to discount future cash flows.

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

#### Variable Interest Entities

On June 21, 2005, we formed Hallmark Statutory Trust I (“Trust I”), an unconsolidated trust subsidiary, for the sole purpose of issuing \$30.0 million in trust preferred securities. Trust I used the proceeds from the sale of these securities and our initial capital contribution to purchase \$30.9 million of subordinated debt securities from Hallmark. The debt securities are the sole assets of Trust I, and the payments under the debt securities are the sole revenues of Trust I.

On August 23, 2007, we formed Hallmark Statutory Trust II (“Trust II”), an unconsolidated trust subsidiary, for the sole purpose of issuing \$25.0 million in trust preferred securities. Trust II used the proceeds from the sale of these securities and our initial capital contribution to purchase \$25.8 million of subordinated debt securities from Hallmark. The debt securities are the sole assets of Trust II, and the payments under the debt securities are the sole revenues of Trust II.

In 2009, the Financial Accounting Standards Board (“FASB”) issued revised accounting standards regarding consolidation of variable interest entities, which was effective for us on January 1, 2010. Accordingly, we reevaluated our investments in Trust I and II (collectively the “Trusts”) and determined that, while the Trusts continue to be variable interest entities, we are not the primary beneficiary. Therefore, the Trusts are not included in our consolidated financial statements.

#### Recently Issued Accounting Standards

In January 2010, the FASB updated Accounting Standards Codification (“ASC”) Topic 820, “Fair Value Measurements and Disclosures” (“ASC 820”) to require additional disclosures about fair value measurements regarding transfers between fair value categories as well as purchases, sales, issuances and settlements related to fair value measurements of financial instruments with non-observable inputs. This update was effective for interim and annual periods beginning after December 15, 2009 except for disclosures about purchases, sales, issuances and settlements of financial instruments with non-observable inputs, which are effective for years beginning after December 15, 2010. The adoption of ASC 820 did not have and is not expected to have a material impact on our financial position or results of operations but does require additional disclosures. (See Note 4, “Fair Value.”)



In June 2009, FASB issued Statement of Financial Accounting Standards No. 167, "Amendments to FASB Interpretation No. 46(R)" ("SFAS 167"), which was codified into ASC Topic 810, "Noncontrolling Interests" ("ASC 810"). ASC 810 addresses the effects of eliminating the qualifying special-purpose entity concept and responds to concerns about the application of certain key provisions of FASB Interpretation No. 46(R), "Consolidation of Variable Interest Entities," including concerns over the transparency of enterprises' involvement with variable interest entities. These provisions of ASC 810 were effective for calendar year end companies beginning on January 1, 2010 with earlier application prohibited. The adoption of ASC 810 did not have a material impact on our financial position or results of operations.

#### Accounting Pronouncements Not Yet Adopted

In October 2010, the FASB issued new guidance related to the accounting for costs associated with acquiring or renewing insurance contracts. The guidance identifies those costs relating to the successful acquisition of new or renewal insurance contracts which are to be capitalized. The guidance is effective for the Company for the year beginning January 1, 2012 and may be applied prospectively or retrospectively. The Company is in the process of assessing the effect that the implementation of the new guidance will have on its financial position and results of operations. The amount of acquisition costs the Company would defer under the new guidance may be less than the amount deferred under the Company's current accounting practice.

#### 3. Business Combinations

We account for business combinations using the purchase method of accounting pursuant to ASC 805. The cost of an acquired entity is allocated to the assets acquired (including identified intangible assets) and liabilities assumed based on their estimated fair values. The excess of the cost of an acquired entity over the net of the amounts assigned to assets acquired and liabilities assumed is an asset referred to as "goodwill." Indirect and general expenses related to business combinations are expensed as incurred for acquisitions in 2009 and after. Prior to 2009, indirect and general expenses were capitalized.

Effective August 29, 2008, we acquired 80% of the issued and outstanding membership interests in the subsidiaries now comprising our Excess & Umbrella business unit for consideration of \$15.0 million. In connection with the acquisition, we executed an operating agreement for each subsidiary. The operating agreements grant us the right to purchase the remaining 20% membership interests in the subsidiaries and grant to an affiliate of the seller the right to require us to purchase such remaining membership interests (the "Put/Call Option"). The Put/Call Option becomes exercisable by either us or the affiliate of the seller upon the earlier of August 29, 2012, the termination of the employment of the seller by the Excess & Umbrella business unit or a change of control of Hallmark. If the Put/Call Option is exercised, we will have the right or obligation to purchase the remaining 20% membership interests in the Excess & Umbrella business unit for an amount equal to nine times the average Pre-Tax Income (as defined in the operating agreements) for the previous 12 fiscal quarters. We estimate the ultimate redemption value of the Put/Call Option to be \$1.7 million at September 30, 2010.

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

#### 4. Fair Value

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

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

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

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

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

Where quoted prices are available on active exchanges for identical instruments, investment securities are classified within Level 1 of the valuation hierarchy. Level 1 investment securities include common and preferred stock.



Level 2 investment securities include corporate bonds, municipal bonds and U.S. Treasury securities for which quoted prices are not available on active exchanges for identical instruments. We use a third party pricing service to determine fair values for each Level 2 investment security in all asset classes. Since quoted prices in active markets for identical assets are not available, these prices are determined by the pricing service using observable market information such as quotes from less active markets and/or quoted prices of securities with similar characteristics, among other things. We have reviewed the processes used by the pricing service and have determined that they result in fair values consistent with the requirements of ASC 820 for Level 2 investment securities.

In cases where there is limited activity or less transparency around inputs to the valuation, investment securities are classified within Level 3 of the valuation hierarchy. Level 3 investments are valued based on the best available data in order to approximate fair value. This data may be internally developed and consider risk premiums that a market participant would require. Investment securities classified within Level 3 include other less liquid investment securities.

The following table presents for each of the fair value hierarchy levels, our assets that are measured at fair value on a recurring basis at September 30, 2010 (in thousands):

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Unobservable Inputs (Level 3)	Total
U.S. Treasury securities and obligations of U.S. Government	\$ -	\$ 6,545	\$ -	\$ 6,545
Corporate debt securities	-	198,402	-	198,402
Municipal bonds	-	134,419	20,024	154,443
Asset backed	-	848	-	848
Total debt securities	-	340,214	20,024	360,238
Financial services	21,356	-	-	21,356
All other	22,669	-	-	22,669
Total equity securities	44,025	-	-	44,025
Total debt and equity securities	\$ 44,025	\$ 340,214	\$ 20,024	\$ 404,263

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

The following table summarizes the changes in fair value for all financial assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) during the nine months ended September 30, 2010 (in thousands):

Beginning balance as of January 1, 2010	\$ 25,272
Net purchases, issuances, sales and settlements	(5,125)
Total realized/unrealized gains included in net income	-
Net losses included in other comprehensive income	(123)
Transfers in and/or out of Level 3	-
Ending balance as of September 30, 2010	\$ 20,024

## 5. Investments

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

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

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

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

	Three Months Ended		Nine Months Ended	
	September 30		September 30	
	2010	2009	2010	2009
U.S. Treasury securities and obligations of U.S. Government	\$ -	\$ -	\$ -	\$ -
Corporate debt securities	281	239	3,650	1,269
Municipal bonds	-	-	(74)	(48)
Equity securities-financial services	-	58	1,767	115
Equity securities-all other	30	300	414	318
Net realized gain before other-than-temporary impairments	311	597	5,757	1,654
Other-than-temporary impairments	-	-	-	(538)
Net realized gain	\$ 311	\$ 597	\$ 5,757	\$ 1,116

We realized gross gains on investments of \$0.3 million and \$0.7 million during the three months ended September 30, 2010 and 2009, respectively, and \$5.9 and \$2.0 million for the nine months ended September 30, 2010 and 2009, respectively. We did not realize gross losses on investments for the three months ended September 30, 2010. We realized gross losses on investments of \$0.1 million during the three months ended September 30, 2009 and \$0.1 million and \$0.9 million for the nine months ended September 30, 2010 and 2009, respectively. We recorded proceeds from the sale of investment securities of \$26.3 million and \$25.3 million during the three months ended September 30, 2010 and 2009, respectively, and \$99.9 million and \$66.2 million for the nine months ended September 30, 2010 and 2009, respectively. Realized investment gains and losses are recognized in operations on the specific identification method.

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

As of September 30, 2010	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Treasury securities and obligations of U.S. Government	\$ 6,509	\$ 36	\$ -	\$ 6,545
Corporate debt securities	193,469	5,854	(921)	198,402
Municipal bonds	152,877	3,621	(2,055)	154,443
Asset backed	804	44	-	848
<b>Total debt securities</b>	<b>353,659</b>	<b>9,555</b>	<b>(2,976)</b>	<b>360,238</b>
Financial services	16,834	4,727	(205)	21,356
All other	17,532	5,465	(328)	22,669
<b>Total equity securities</b>	<b>34,366</b>	<b>10,192</b>	<b>(533)</b>	<b>44,025</b>
<b>Total debt and equity securities</b>	<b>\$ 388,025</b>	<b>\$ 19,747</b>	<b>\$ (3,509)</b>	<b>\$ 404,263</b>
<b>As of December 31, 2009</b>				
U.S. Treasury securities and obligations of U.S. Government	\$ 6,830	\$ 23	\$ (17)	\$ 6,836
Corporate debt securities	94,560	7,190	(2,201)	99,549
Municipal bonds	185,036	2,543	(2,786)	184,793
Asset backed	682	17	(1)	698
<b>Total debt securities</b>	<b>287,108</b>	<b>9,773</b>	<b>(5,005)</b>	<b>291,876</b>
Financial services	17,156	5,008	(232)	21,932
All other	10,095	3,790	(16)	13,869
<b>Total equity securities</b>	<b>27,251</b>	<b>8,798</b>	<b>(248)</b>	<b>35,801</b>
<b>Total debt and equity securities</b>	<b>\$ 314,359</b>	<b>\$ 18,571</b>	<b>\$ (5,253)</b>	<b>\$ 327,677</b>

The following schedules summarize the gross unrealized losses showing the length of time that investments have been continuously in an unrealized loss position as of September 30, 2010 and December 31, 2009 (in thousands):

	12 months or less		As of September 30, 2010 Longer than 12 months		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. Treasury securities and obligations of U.S. Government	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Corporate debt securities	28,953	(229)	4,774	(692)	33,727	(921)
Municipal bonds	7,356	(32)	48,391	(2,023)	55,747	(2,055)
Total debt securities	36,309	(261)	53,165	(2,715)	89,474	(2,976)
Financial services	1,259	(205)	-	-	1,259	(205)
All other	4,611	(328)	-	-	4,611	(328)
Total equity securities	5,870	(533)	-	-	5,870	(533)
Total debt and equity securities	\$ 42,179	\$ (794)	\$ 53,165	\$ (2,715)	\$ 95,344	\$ (3,509)

	12 months or less		As of December 31, 2009 Longer than 12 months		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. Treasury securities and obligations of U.S. Government	\$ 3,202	\$ (17)	\$ -	\$ -	\$ 3,202	\$ (17)
Corporate debt securities	18,924	(166)	9,642	(2,035)	28,566	(2,201)
Municipal bonds	28,940	(1,524)	42,183	(1,262)	71,123	(2,786)
Asset backed	51	(1)	-	-	51	(1)
Total debt securities	51,117	(1,708)	51,825	(3,297)	102,942	(5,005)
Financial services	1,417	(232)	-	-	1,417	(232)
All other	658	(16)	-	-	658	(16)
Equity securities	2,075	(248)	-	-	2,075	(248)
Total debt and equity securities	\$ 53,192	\$ (1,956)	\$ 51,825	\$ (3,297)	\$ 105,017	\$ (5,253)

At September 30, 2010, the gross unrealized losses more than twelve months old were attributable to 35 bond positions. At December 31, 2009, the gross unrealized losses more than twelve months old were attributable to 60 bond positions. We consider these losses as a temporary decline in value as they are predominately on bonds that we do not intend to sell and do not believe we will be required to sell prior to recovery of our amortized cost basis. We see no other indications that the decline in values of these securities is other-than-temporary.

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

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

The amortized cost and estimated fair value of debt securities at September 30, 2010 by contractual maturity are as follows. Expected maturities may differ from contractual maturities because certain borrowers may have the right to call or prepay obligations with or without penalties.

	Amortized Cost (in thousands)	Fair Value
Due in one year or less	\$ 27,776	\$ 28,312
Due after one year through five years	184,429	190,046
Due after five years through ten years	96,305	97,434
Due after ten years	44,345	43,598
Asset backed	804	848
	\$ 353,659	\$ 360,238

Activity related to the credit component recognized in earnings for the nine months ended September 30, 2010, on debt securities held by us for which a portion of other-than-temporary impairment was previously recognized in other comprehensive income is as follows (in thousands):

Balance, January 1, 2010	\$ 1,168
Reductions for securities sold or matured during the period	(1,168)
Balance, September 30, 2010	\$ -

## 6. Pledged Investments

We have certain of our securities pledged for the benefit of various state insurance departments and reinsurers. These securities are included with our available-for-sale debt securities because we have the ability to trade these securities. We retain the interest earned on these securities. These securities had a carrying value of \$26.8 million at September 30, 2010 and a carrying value of \$29.7 million at December 31, 2009.

## 7. Share-Based Payment Arrangements

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

As of September 30, 2010, there were incentive stock options to purchase 1,286,666 shares of our common stock outstanding and non-qualified stock options to purchase 320,000 shares of our common stock outstanding and there were 392,501 shares reserved for future issuance under the 2005 LTIP. As of September 30, 2010, there were incentive stock options to purchase 2,500 shares outstanding under the 1994 Employee Plan and non-qualified stock options to purchase 20,834 shares outstanding under the 1994 Director Plan. The exercise price of all such outstanding stock options is equal to the fair market value of our common stock on the date of grant.

Options granted under the 1994 Employee Plan prior to October 31, 2003, vest 40% six months from the date of grant and an additional 20% on each of the first three anniversary dates of the grant and terminate ten years from the date of grant. Incentive stock options granted under the 2005 LTIP prior to 2009 and the 1994 Employee Plan after October 31, 2003, vest 10%, 20%, 30% and 40% on the first, second, third and fourth anniversary dates of the grant, respectively, and terminate five to ten years from the date of grant. Incentive stock options granted in 2009 under the 2005 LTIP vest in equal annual increments on each of the first seven anniversary dates and terminate ten years from the date of grant. There was one grant of 25,000 incentive stock options in 2010 under the 2005 LTIP that vest in equal annual increments on each of the first three anniversary dates and terminates ten years from the date of grant. Non-qualified stock options granted under the 2005 LTIP generally vest 100% six months after the date of grant and terminate ten years from the date of grant. There was one grant of 200,000 non-qualified stock options in 2009 under the 2005 LTIP that vest in equal annual increments on each of the first seven anniversary dates and terminate ten years from the date of grant. All non-qualified stock options granted under the 1994 Director Plan vested 40% six months from the date of grant and an additional 10% on each of the first six anniversary dates of the grant and terminate ten years from the date of grant.

A summary of the status of our stock options as of and changes during the nine months ended September 30, 2010 is presented below:

	Number of Shares	Average Exercise Price	Contractual Term (Years)	Intrinsic Value \$ (000)
Outstanding at January 1, 2010	1,614,166	\$ 9.62		
Granted	25,000	\$ 9.12		
Exercised	(9,166)	\$ 2.69		
Forfeited or expired	-	\$ -		
Outstanding at September 30, 2010	1,630,000	\$ 9.65	7.3	\$ 1,515
Exercisable at September 30, 2010	779,427	\$ 10.34	6.6	\$ 538

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Intrinsic value of options exercised	\$ -	\$ -	\$ 47	\$ 107
Cost of share-based payments (non-cash)	\$ 263	\$ 612	\$ 852	\$ 1,488
Income tax benefit of share-based payments recognized in income	\$ 8	\$ 118	\$ 23	\$ 231

As of September 30, 2010 there was \$2.2 million of total unrecognized compensation cost related to non-vested share-based compensation arrangements granted under our plans, of which \$0.3 million is expected to be recognized during the remainder of 2010, \$0.8 million is expected to be recognized in 2011, \$0.4 million is expected to be recognized in 2012, \$0.2 million is expected to be recognized each year from 2013 through 2015 and \$0.1 million is expected to be recognized in 2016.

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



The following table details the weighted average grant date fair value and related assumptions for the periods indicated. No options were granted in the third quarter of 2010 or 2009.

	Nine Months Ended September 30,	
	2010	2009
Grant date fair value per share	\$ 3.62	\$ 2.84
Expected term (in years)	6.0	6.2
Expected volatility	35.0%	40.0%
Risk free interest rate	3.2%	2.5%

## 8. Segment Information

The following is business segment information for the three and nine months ended September 30, 2010 and 2009 (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
<b>Revenues:</b>				
Standard Commercial Segment	\$ 17,211	\$ 19,569	\$ 52,510	\$ 57,783
Specialty Commercial Segment	32,892	32,346	97,503	97,601
Personal Segment	25,418	18,735	71,386	54,971
Corporate	696	1,253	6,328	3,202
Consolidated	\$ 76,217	\$ 71,903	\$ 227,727	\$ 213,557
<b>Pre-tax income (loss), net of non-controlling interest:</b>				
Standard Commercial Segment	\$ (234)	\$ 2,164	\$ (3,043)	\$ 5,987
Specialty Commercial Segment	2,515	3,588	9,829	14,280
Personal Segment	743	2,225	4,525	7,738
Corporate	(1,803)	(2,178)	(2,255)	(6,960)
Consolidated	\$ 1,221	\$ 5,799	\$ 9,056	\$ 21,045

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

	September 30, 2010	December 31, 2009
<b>Assets</b>		
Standard Commercial Segment	\$ 130,916	\$ 136,745
Specialty Commercial Segment	316,040	280,970
Personal Segment	165,692	109,844
Corporate	80,722	101,310
	<b>\$ 693,370</b>	<b>\$ 628,869</b>

## 9. Reinsurance

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Ceded earned premiums	\$ 9,483	\$ 7,137	\$ 26,740	\$ 12,331
Reinsurance recoveries	\$ 6,247	\$ 4,166	\$ 16,825	\$ 7,388

We currently reinsure the following exposures on business generated by our Standard Commercial, E&S Commercial, Excess & Umbrella, Personal Lines and General Aviation business units:

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

- o We retain the first \$3.0 million of property catastrophe losses; and
- o Our reinsurers reimburse us 100% for any loss in excess of our \$3.0 million retention up to \$30.0 million for each catastrophic occurrence, subject to an aggregate limit of \$54.0 million.
- Commercial property. Our commercial property reinsurance is excess-of-loss coverage intended to reduce the financial impact a single-event or catastrophic loss may have on our results. The terms of our commercial property reinsurance are:
  - o We retain the first \$1.0 million of loss for each commercial property risk;
  - o Our reinsurers reimburse us for the next \$5.0 million for each commercial property risk, and \$10.0 million for all commercial property risk involved in any one occurrence, in all cases subject to an aggregate limit of \$30.0 million for all commercial property losses occurring during the treaty period; and
  - o Individual risk facultative reinsurance is purchased on any commercial property with limits above \$6.0 million.
- Commercial casualty. Our commercial casualty reinsurance is excess-of-loss coverage intended to reduce the financial impact a single-event loss may have on our results. The terms of our commercial casualty reinsurance are:
  - o We retain the first \$1.0 million of any commercial liability risk; and
  - o Our reinsurers reimburse us for the next \$5.0 million for each commercial liability risk.
- Aviation. We purchase reinsurance specific to the aviation risks underwritten by our General Aviation business unit. This reinsurance provides aircraft hull and liability coverage and airport liability coverage on a per occurrence basis on the following terms:
  - o We retain the first \$1.0 million of each aircraft hull or liability loss or airport liability loss;
  - o Our reinsurers reimburse us for the next \$5.5 million of each combined aircraft hull and liability loss and for the next \$4.0 million of each airport liability loss.
- Excess & Umbrella. Currently, we purchase proportional reinsurance where we retain 21% of each risk and cede the remaining 79% to reinsurers. In states where we are not yet licensed to offer a non-admitted product, we utilize a fronting arrangement pursuant to which we assume all of the risk and then retrocede a portion of that risk under the same proportional reinsurance treaty. Through June 30, 2009, our Excess & Umbrella business unit wrote policies pursuant to a general agency agreement with an unaffiliated carrier and we assumed 35% of the risk from that carrier.
- Hallmark County Mutual. HCM is used to front certain lines of business in our Specialty Commercial and Personal Segments in Texas where we previously produced policies for third party county mutual insurance companies and reinsured 100% for a fronting fee. In addition, HCM is used to front business produced by unaffiliated third parties. HCM does not retain any business.

## 10. Note Payable

On January 27, 2006, we borrowed \$15.0 million under our revolving credit facility to fund the cash required to close the acquisition of the subsidiaries comprising our E&S Commercial business unit. As of September 30, 2010, the balance on the revolving note was \$2.8 million, which currently bears interest at 2.79% per annum. (See Note 12, "Credit Facilities.")

## 11. Subordinated Debt Securities

On June 21, 2005, we entered into a trust preferred securities transaction pursuant to which we issued \$30.9 million aggregate principal amount of subordinated debt securities due in 2035. To effect the transaction, we formed Trust I as a Delaware statutory trust. Trust I issued \$30.0 million of preferred securities to investors and \$0.9 million of common securities to us. Trust I used the proceeds from these issuances to purchase the subordinated debt securities. Our Trust I subordinated debt securities bear an initial interest rate of 7.725% until June 15, 2015, at which time interest will adjust quarterly to the three-month LIBOR rate plus 3.25 percentage points. Trust I pays dividends on its preferred securities at the same rate. Under the terms of our Trust I subordinated debt securities, we pay interest only each quarter and the principal of the note at maturity. The subordinated debt securities are uncollaterized and do not require maintenance of minimum financial covenants. As of September 30, 2010, the balance of our Trust I subordinated debt was \$30.9 million.

On August 23, 2007, we entered into a trust preferred securities transaction pursuant to which we issued \$25.8 million aggregate principal amount of subordinated debt securities due in 2037. To effect the transaction, we formed Trust II as a Delaware statutory trust. Trust II issued \$25.0 million of preferred securities to investors and \$0.8 million of common securities to us. Trust II used the proceeds from these issuances to purchase the subordinated debt securities. Our Trust II subordinated debt securities bear an initial interest rate of 8.28% until September 15, 2017, at which time interest will adjust quarterly to the three-month LIBOR rate plus 2.90 percentage points. Trust II pays dividends on its preferred securities at the same rate. Under the terms of our Trust II subordinated debt securities, we pay interest only each quarter and the principal of the note at maturity. The subordinated debt securities are uncollaterized and do not require maintenance of minimum financial covenants. As of September 30, 2010, the balance of our Trust II subordinated debt was \$25.8 million.

## 12. Credit Facilities

Our First Restated Credit Agreement with The Frost National Bank dated January 27, 2006 was most recently amended effective May 27, 2010 to extend the term of the facility until May 27, 2012, provide for the repayment of all amounts outstanding at termination on or before April 30, 2015, reduce the revolving commitment to \$5.0 million from \$25.0 million and eliminate the credit sub-facility for premium finance operations. This amendment further revised various affirmative and negative covenants and changed the interest rate, at our election, to either the prime rate or LIBOR plus 2.5%. We pay an annual average fee of 0.25% of the average daily unused balance of the credit facility. We pay letter of credit fees at the rate of 1.00% per annum. Our obligations under the revolving credit facility are secured by a security interest in the capital stock of all of our subsidiaries, guarantees of all of our subsidiaries and the pledge of all of our non-insurance company assets. The revolving credit facility contains covenants that, among other things, require us to maintain certain financial and operating ratios and restrict certain distributions, transactions and organizational changes. As of September 30, 2010, we were in compliance with or had obtained waivers of all of our covenants. As of September 30, 2010, we had \$2.8 million outstanding under this facility.

## 13. Deferred Policy Acquisition Costs

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Deferred	\$ (10,725)	\$ (7,454)	\$ (38,422)	\$ (38,539)
Amortized	10,280	8,257	36,033	35,434
Net	\$ (445)	\$ 803	\$ (2,389)	\$ (3,105)

## 14. Earnings per Share

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Weighted average shares - basic	20,124	20,652	20,122	20,790
Effect of dilutive securities	62	14	56	32
Weighted average shares - assuming dilution	20,186	20,666	20,178	20,822

For the three months and nine months ended September 30, 2010 and 2009, 899,166 shares of common stock potentially issuable upon the exercise of employee stock options were excluded from the weighted average number of shares outstanding on a diluted basis because the effect of such options would be anti-dilutive.

## 15. Net Periodic Pension Cost

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Interest cost	\$ 163	\$ 160	\$ 488	\$ 482
Amortization of net loss	56	122	168	366
Expected return on plan assets	(136)	(121)	(409)	(363)
Net periodic pension cost	\$ 83	\$ 161	\$ 247	\$ 485

We contributed \$246 thousand and \$340 thousand to our frozen defined benefit cash balance plan (“Cash Balance Plan”) during the three months and nine months ended September 30, 2010, respectively. We did not make any contributions to the Cash Balance Plan during the three months and nine months ended September 30, 2009. Refer to Note 13 to the consolidated financial statements in our Annual Report on Form 10-K for the year ended December 31, 2009 for more discussion of our retirement plans.

## 16. Income Taxes

Our effective income tax rate for the nine months ended September 30, 2010 was 23.5%, which varied from the statutory income tax rate utilized primarily due to an increase in the proportion of tax exempt income relative to total pre-tax income and the recognition of a tax benefit related to the disposal of certain securities. Our effective income tax rate for the nine months ended September 30, 2009 was 27.4%, which varied from the statutory income tax rate utilized primarily because of our investments in tax exempt securities and a reduction in the valuation allowance.

## 17. Commitments and Contingencies

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

On August 9, 2010 we announced the execution of an agreement for our wholly-owned subsidiary, HIC, to acquire State Auto National Insurance Company (“SAN”) from State Auto Financial Corporation. SAN is an Ohio domiciled insurance company which writes non-standard personal automobile policies through independent agents in 21 states. Closing of the acquisition is subject to regulatory approval and other customary closing conditions.

The purchase price for the acquisition will be \$14.0 million cash at closing plus an earn-out of up to \$2.0 million. We expect to fund the acquisition out of working capital. The cash portion of the purchase price is subject to post-closing adjustment to the extent the statutory capital and surplus of SAN is greater or less than \$10.0 million. The earn-out is payable quarterly in an amount equal to 2% of gross collected premiums on new or renewal personal lines insurance policies written by SAN agents during the three years following closing. In connection with the closing, SAN will enter into reinsurance agreements with an affiliate of the seller pursuant to which the affiliate will handle all claims and assume all liabilities arising under policies issued by SAN prior to the closing and during a transition period of up to six months following the closing.



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

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

Introduction

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

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

- **Standard Commercial Segment.** Our Standard Commercial Segment includes the standard lines commercial property/casualty insurance products and services handled by our Standard Commercial business unit (formerly known as our AHIS Operating Unit).
- **Specialty Commercial Segment.** Our Specialty Commercial Segment includes the excess and surplus lines commercial property/casualty insurance products and services handled by our E&S Commercial business unit (formerly known as our TGA Operating Unit), the general aviation insurance products and services handled by our General Aviation business unit (formerly known as our Aerospace Operating Unit), and the low and middle market commercial umbrella and excess liability insurance products handled by our Excess & Umbrella business unit (formerly known as our Heath XS Operating Unit).
- **Personal Segment.** Our Personal Segment includes the non-standard personal automobile insurance and complementary personal insurance products and services handled by our Personal Lines business unit (formerly known as our Personal Lines Operating Unit).

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

- **American Hallmark Insurance Company of Texas ("AHIC")** presently retains all of the risks on the commercial property/casualty policies marketed within the Standard Commercial Segment, retains a portion of risks on the personal policies marketed within the Personal Segment and assumes a portion of the risks on the commercial and aviation property/casualty policies marketed within the Specialty Commercial Segment.



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

AHIC, HSIC, and HIC have entered into a pooling arrangement pursuant to which AHIC retains 46% of the total net premiums written by all of our business units, HIC retains 34% of our total net premiums written and HSIC retains 20% of our total net premiums written. This pooling arrangement has no impact on our consolidated financial statements reported in accordance with U.S. generally accepted accounting principles (“GAAP”).

#### Results of Operations

Management Overview. During the three and nine months ended September 30, 2010, our total revenues were \$76.2 million and \$227.7 million, representing a 6% and 7% increase, respectively, from the \$71.9 million and \$213.6 million in total revenues for the same periods of 2009. The increase in revenue for the three months ended September 30, 2010 was primarily attributable to increased production in our Personal Segment due to geographic expansion. The increase in revenue for the nine months ended September 30, 2010 was primarily attributable to increased production in our Personal Segment due to geographic expansion, increased retention of business in our E&S Commercial business unit, increased earned premium in our Excess & Umbrella business unit and gains realized on our investment portfolio. These increases in revenue were partially offset by reduced earned premium in our Standard Commercial Segment due to the deterioration of the general economic environment in our major markets.

We reported net income attributable to Hallmark of \$1.0 million and \$6.9 million for the three and nine months ended September 30, 2010, respectively, which was \$3.2 million and \$8.4 million lower than the \$4.2 million and \$15.3 million net income attributable to Hallmark reported for the same periods of 2009. On a diluted basis per share, net income was \$0.05 and \$0.34 per share for the three and nine months ended September 30, 2010, respectively, as compared to net income of \$0.20 and \$0.73 per share for the same periods in 2009. The decrease in net income for the three and nine months ending September 30, 2010 was primarily due to increased loss and loss adjustment expenses (“LAE”) due to higher current accident year loss estimates, as well as unfavorable prior year loss development of \$0.5 million and \$7.0 million recognized during the three and nine months ended September 30, 2010, respectively, as compared to \$1.7 million and \$3.5 million unfavorable development recognized for the three and nine months ended September 30, 2009. Partially offsetting the increased loss and LAE was the increase in revenue for the three and nine months ending September 30, 2010, as well as lower operating expenses due to lower production related expenses in our Standard Commercial, E&S Commercial and General Aviation business units and lower general and administrative costs in our Standard Commercial Segment as a result of ongoing cost reduction initiatives. The Company’s effective income tax rate for the nine months ending September 30, 2010 was 23.5% as compared to the 27.4% effective income tax rate for the same period during 2009. The decrease in the effective tax rate was primarily due to an increase in the proportion of tax exempt income relative to total pre-tax income and the recognition of a tax benefit related to the disposal of certain securities.



## Third Quarter 2010 as Compared to Third Quarter 2009

The following is additional business segment information for the three months ended September 30, 2010 and 2009 (in thousands):

Hallmark Financial Services, Inc.  
Consolidated Segment Data

	Three Months Ended September 30, 2010				
	Standard Commercial Segment	Specialty Commercial Segment	Personal Segment	Corporate	Consolidated
Produced premium (1)	\$ 15,586	\$ 39,653	\$ 25,188	\$ -	\$ 80,427
Gross premiums written	15,586	41,425	25,188	-	82,199
Ceded premiums written	(1,147)	(8,915)	(90)	-	(10,152)
Net premiums written	14,439	32,510	25,098	-	72,047
Change in unearned premiums	1,626	(1,368)	(1,899)	-	(1,641)
Net premiums earned	16,065	31,142	23,199	-	70,406
Total revenues	17,211	32,892	25,418	696	76,217
Losses and loss adjustment expenses	12,183	20,788	18,322	-	51,293
Pre-tax income (loss), net of non-controlling interest	(234)	2,515	743	(1,803)	1,221
Net loss ratio (2)	75.8%	66.8%	79.0%		72.9%
Net expense ratio (2)	32.2%	30.1%	21.0%		29.4%
Net combined ratio (2)	108.0%	96.9%	100.0%		102.3%

	Three Months Ended September 30, 2009				
	Standard Commercial Segment	Specialty Commercial Segment	Personal Segment	Corporate	Consolidated
Produced premium (1)	\$ 17,309	\$ 36,064	\$ 17,424	\$ -	\$ 70,797
Gross premiums written	17,309	39,280	17,424	-	74,013
Ceded premiums written	(1,144)	(10,078)	-	-	(11,222)
Net premiums written	16,165	29,202	17,424	-	62,791
Change in unearned premiums	1,627	92	(272)	-	1,447
Net premiums earned	17,792	29,294	17,152	-	64,238
Total revenues	19,569	32,346	18,735	1,253	71,903

Losses and loss adjustment expenses	11,425	17,641	11,513	-	40,579
Pre-tax income (loss), net of non-controlling interest	2,164	3,588	2,225	(2,178)	5,799
Net loss ratio (2)	64.2%	60.2%	67.1%		63.2%
Net expense ratio (2)	32.8%	29.8%	22.4%		31.0%
Net combined ratio (2)	97.0%	90.0%	89.5%		94.2%

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

(2) The net loss ratio is calculated as incurred losses and LAE divided by net premiums earned, each determined in accordance with GAAP. The net expense ratio is now calculated for our business units that retain 100% of produced premium as total operating expenses for the unit offset by agency fee income divided by net premiums earned, each determined in accordance with GAAP. For the business units that do not retain 100% of the produced premium, the net expense ratio is calculated as underwriting expenses of the insurance company subsidiaries for the unit offset by agency fee income, divided by net premiums earned, each determined in accordance with GAAP. Net combined ratio is calculated as the sum of the net loss ratio and the net expense ratio.

### Standard Commercial Segment

Gross premiums written for the Standard Commercial Segment were \$15.6 million for the three months ended September 30, 2010, which was \$1.7 million, or 10%, less than the \$17.3 million reported for the same period in 2009. Net premiums written were \$14.4 million for the three months ended September 30, 2010 as compared to \$16.2 million reported for the same period in 2009. The decrease in premium volume was predominately due to the deterioration of the general economic environment, particularly in the construction industry, reducing the available insured exposures.

Total revenue for the Standard Commercial Segment of \$17.2 million for the three months ended September 30, 2010 was \$2.4 million less than the \$19.6 million reported during the same period in 2009. This 12% decrease in total revenue was mostly due to decreased net premiums earned of \$1.7 million and reduced profit sharing commissions of \$0.7 million related to unfavorable loss development on prior treaty years.

Our Standard Commercial Segment reported a pre-tax loss of \$0.2 million for the three months ended September 30, 2010 as compared to pre-tax income of \$2.2 million for the same period of 2009. Higher loss and LAE of \$0.8 million, primarily as a result of weather related losses and unfavorable prior year development, and decreased revenue were the primary drivers of the pre-tax loss for the three months ended September 30, 2010. Partially offsetting the decline in pre-tax results were lower operating expenses of \$0.7 million driven by lower general and administrative costs and lower production related expenses.

The Standard Commercial Segment reported a net loss ratio of 75.8% for the three months ended September 30, 2010 as compared to 64.2% for 2009. The gross loss ratio before reinsurance for the three months ended September 30, 2010 was 80.1% as compared to the 66.2% reported for the same period of 2009. The higher gross and net loss ratio for the three months ended September 30, 2010 was driven by development of weather related losses. The loss and LAE during the three months ended September 30, 2010 for the Standard Commercial Segment included unfavorable loss reserve development of \$0.8 million as compared to unfavorable development of \$0.4 million for the same period in 2009.

### Specialty Commercial Segment

The \$32.9 million of total revenue for the Specialty Commercial Segment during the three months ended September 30, 2010 was \$0.6 million higher than the \$32.3 million reported for the same period in 2009. This increase in revenue was primarily comprised of higher earned premiums of \$1.8 million as a result of the increased earned premium in our E&S Commercial business unit as well as increased net investment income of \$0.5 million. These increases in revenues were partially offset by lower commission and fee income of \$1.7 million primarily related to the shift from a third party agency structure to an insurance underwriting structure.

Pre-tax income for the Specialty Commercial Segment of \$2.5 million for the third quarter of 2010 was \$1.1 million lower than the \$3.6 million reported for the same period in 2009. The decrease in pre-tax income was primarily due to higher loss and LAE expenses of \$3.1 million primarily as a result of higher current accident year loss estimates. This increase in loss and LAE was partially offset by lower operating expenses of \$1.7 million. The decrease in operating expense was the combined result of (i) lower production related expenses of \$1.9 million due primarily to lower fronting fees in our E&S Commercial business unit as we began direct writing this business during 2009 and to increased quota share ceding commissions in our Excess & Umbrella business unit due to increased ceded premiums, (ii) lower salary and related expenses of \$0.1 million, partially offset by (iii) increased other operating expenses of \$0.3 million, primarily increased professional fees. In addition increased amortization of intangible assets of \$0.2 million related to our acquisition of CYR on June 5, 2009 further contributed to the decrease in pre-tax income.



The Specialty Commercial Segment reported a net loss ratio of 66.8% for the three months ended September 30, 2010 as compared to 60.2% for the same period during 2009. The gross loss ratio before reinsurance was 64.6% for the three months ended September 30, 2010 as compared to 59.6% for the same period during 2009. The higher gross and net loss ratio was impacted by increased volatility in large general liability, commercial automobile and aircraft hull losses in the current accident year. During the three months ended September 30, 2010 the Specialty Commercial Segment reported \$0.8 million of favorable prior year loss development as compared to \$1.2 million of unfavorable prior loss development for the same period during 2009.

#### Personal Segment

Net premiums written for our Personal Segment increased \$7.7 million during the third quarter of 2010 to \$25.1 million as compared to \$17.4 million for the third quarter of 2009. The increase in premium was due mostly to continued geographic expansion.

Total revenue for the Personal Segment increased 36% to \$25.4 million for the third quarter of 2010 from \$18.7 million for the third quarter of 2009. Higher earned premium of \$6.0 million was the primary reason for the increase in revenue for the period. Increased finance charges and net investment income of \$0.4 million and \$0.3 million, respectively, further contributed to the increase in revenue during the third quarter of 2010.

Pre-tax income for the Personal Segment was \$0.7 million for the three months ended September 30, 2010 as compared to \$2.2 million for the same period of 2009. Increased revenue was offset by increased losses and LAE of \$6.8 million and increased operating expenses of \$1.3 million due primarily to increased production related expenses and salary and related expenses due to continued geographic expansion.

The Personal Segment reported a net loss ratio of 79.0% for the three months ended September 30, 2010 as compared to 67.1% for the third quarter of 2009. The increase in the net loss ratio was due primarily to continued geographic expansion as the resulting growth has created a larger portion of new and maturing business as compared to our mature legacy business. Our current accident year loss ratio reflects the near term loss ratio penalty associated with this change in mix of seasoned versus less seasoned business. During the three months ended September 30, 2010, the Personal Segment reported \$0.5 million of unfavorable prior loss development as compared to \$0.1 million unfavorable prior year development reported for the same period in 2009.

#### Corporate

Total revenue for Corporate decreased by \$0.6 million for the three months ended September 30, 2010 as compared to the same period the prior year. This decrease in total revenue was due primarily to gains of \$0.3 million recognized on our investment portfolio for the three months ended September 30, 2010 as compared to gains of \$0.6 million recognized during the same period in 2009. Further contributing to this decrease in revenue was lower net investment income of \$0.3 million for the three months ended September 30, 2010 as compared to the same period of the prior year.

Corporate pre-tax loss was \$1.8 million for the three months ended September 30, 2010 as compared to a \$2.2 million pre-tax loss for the same period the prior year. The decrease in pre-tax loss was the result of a \$0.7 million reduction in operating expenses during the third quarter of 2010 as compared to the same period during 2009. The operating expense reduction for the quarter came primarily from lower professional fees of \$0.4 million, lower expense related to stock options granted to employees and directors of \$0.3 million, lower salary and related expenses of \$0.2 million and lower travel expenses of \$0.1 million. These decreases in operating expenses were partially offset by a \$0.4 million recovery of advances for a cancelled start-up program during the third quarter of 2009. In addition further contributing to the lower expenses during the third quarter of 2010 as compared to the same period during 2009 was decreased amortization of intangible assets of \$0.2 million. Decreased revenue discussed above partially offset the decreased operating expenses.



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Nine Months Ended September 30, 2010 as Compared to Nine Months Ended September 30, 2009

The following is additional business segment information for the nine months ended September 30, 2010 and 2009 (in thousands):

Hallmark Financial Services, Inc.  
Consolidated Segment Data

	Nine Months Ended September 30, 2010				
	Standard Commercial Segment	Specialty Commercial Segment	Personal Segment	Corporate	Consolidated
Produced premium (1)	\$ 52,487	\$ 115,286	\$ 74,932	\$ -	\$ 242,705
Gross premiums written	52,475	119,831	74,932	-	247,238
Ceded premiums written	(3,092)	(26,062)	(109)	-	(29,263)
Net premiums written	49,383	93,769	74,823	-	217,975
Change in unearned premiums	200	(1,288)	(9,518)	-	(10,606)
Net premiums earned	49,583	92,481	65,305	-	207,369
Total revenues	52,510	97,503	71,386	6,328	227,727
Losses and loss adjustment expenses	39,451	58,415	48,583	-	146,449
Pre-tax income (loss), net of non-controlling interest	(3,043)	9,829	4,525	(2,255)	9,056
Net loss ratio (2)	79.6%	63.2%	74.4%		70.6%
Net expense ratio (2)	31.9%	29.2%	21.7%		29.5%
Net combined ratio (2)	111.5%	92.4%	96.1%		100.1%

	Nine Months Ended September 30, 2009				
	Standard Commercial Segment	Specialty Commercial Segment	Personal Segment	Corporate	Consolidated
Produced premium (1)	\$ 56,881	\$ 110,598	\$ 54,968	\$ -	\$ 222,447
Gross premiums written	56,881	108,696	54,968	-	220,545
Ceded premiums written	(3,331)	(13,383)	-	-	(16,714)
Net premiums written	53,550	95,313	54,968	-	203,831
Change in unearned premiums	419	(13,692)	(4,571)	-	(17,844)
Net premiums earned	53,969	81,621	50,397	-	185,987
Total revenues	57,783	97,601	54,971	3,202	213,557

Losses and loss adjustment expenses	33,890	48,422	33,240	-	115,552
Pre-tax income (loss), net of non-controlling interest	5,987	14,280	7,738	(6,960)	21,045
Net loss ratio (2)	62.8%	59.3%	66.0%		62.1%
Net expense ratio (2)	32.4%	30.0%	21.4%		30.8%
Net combined ratio (2)	95.2%	89.3%	87.4%		92.9%

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

(2) The net loss ratio is calculated as incurred losses and LAE divided by net premiums earned, each determined in accordance with GAAP. The net expense ratio is calculated for our business units that retain 100% of produced premium as total operating expenses for the unit offset by agency fee income divided by net premiums earned, each determined in accordance with GAAP. For the business units that do not retain 100% of the produced premium, the net expense ratio is calculated as underwriting expenses of the insurance company subsidiaries for the unit offset by agency fee income, divided by net premiums earned, each determined in accordance with GAAP. Net combined ratio is calculated as the sum of the net loss ratio and the net expense ratio.

### Standard Commercial Segment

Gross premiums written for the Standard Commercial Segment were \$52.5 million for the nine months ended September 30, 2010, which was \$4.4 million, or 8%, less than the \$56.9 million reported for the same period in 2009. Net premiums written were \$49.4 million for the nine months ended September 30, 2010 as compared to \$53.6 million reported for the same period in 2009. The decrease in premium volume was predominately due to the deterioration of the general economic environment, particularly in the construction industry, reducing the available insured exposures.

Total revenue for the Standard Commercial Segment of \$52.5 million for the nine months ended September 30, 2010 was \$5.3 million less than the \$57.8 million reported during the same period in 2009. This 9% decrease in total revenue was primarily due to lower net premiums earned of \$4.4 million, decreased profit sharing commission of \$0.5 million related to unfavorable loss development on prior treaty years and lower net investment income of \$0.4 million.

Our Standard Commercial Segment reported a pre-tax loss of \$3.0 million for the nine months ended September 30, 2010 as compared to pre-tax income of \$6.0 million for the same period of 2009. Higher loss and LAE of \$5.6 million, primarily as a result of weather related losses and unfavorable prior year development, and decreased revenue contributed to this pre-tax loss reported for the nine months ended September 30, 2010. Partially offsetting the decline in results were lower operating expenses of \$1.8 million driven by lower general and administrative costs and lower production related expenses.

The Standard Commercial Segment reported a net loss ratio of 79.6% for the nine months ended September 30, 2010 as compared to 62.8% for 2009. The gross loss ratio before reinsurance for the nine months ended September 30, 2010 was 83.2% as compared to the 62.7% reported for the same period of 2009. The higher gross and net loss ratio for the nine months ended September 30, 2010 was impacted by an increased number of large property losses, including weather related losses. Further contributing to the higher gross and net loss ratio during the nine months ended September 30, 2010 was unfavorable loss reserve development of \$4.1 million, as compared to favorable development of \$0.2 million for the same period during 2009.

### Specialty Commercial Segment

The \$97.5 million of total revenue for the Specialty Commercial Segment during the nine months ended September 30, 2010 was \$0.1 million lower than the \$97.6 million reported for the same period in 2009. This decrease in revenue was primarily comprised of lower commission and fee income of \$11.6 million primarily related to the shift from a third party agency structure to an insurance underwriting structure. Decreased finance charges of \$0.2 million further contributed to this decrease in revenue. This decrease in revenue was partially offset by increased net premiums earned of \$10.9 million as a result of the increased retention of business in our E&S Commercial business unit and increased earned premium in our Excess & Umbrella business unit and increased net investment income of \$0.9 million.

Pre-tax income for the Specialty Commercial Segment of \$9.8 million for the first nine months of 2010 was \$4.5 million lower than the \$14.3 million reported for the same period in 2009. The decrease in pre-tax income was primarily due to decreased revenue and higher loss and LAE expenses of \$10.0 million. The decrease in pre-tax income was partially offset by lower operating expenses of \$6.1 million. The decrease in operating expense was the combined result of (i) lower production related expenses of \$6.2 million due primarily to lower commission expense and fronting fees in our E&S Commercial business unit as we began direct writing and retaining 100% of this business during 2009, and to increased quota share ceding commissions in our Excess & Umbrella business unit due to increased ceded premiums, (ii) lower salary and related expenses of \$0.3 million, partially offset by (iii) increased other operating expenses of \$0.4 million, primarily due to increased professional fees. In addition increased amortization of intangible assets of \$0.5 million related to our acquisition of CYR on June 5, 2009 further contributed to the decrease in pre-tax income.

The Specialty Commercial Segment reported a net loss ratio of 63.2% for the nine months ended September 30, 2010 as compared to 59.3% for the same period during 2009. The higher net loss ratio was impacted by (i) late emerging general liability claims and (ii) increased volatility in large general liability claims, aircraft hull losses and commercial automobile claims (partially weather related) in the current accident year. The Specialty Commercial Segment reported \$1.7 million of unfavorable prior year development for the nine months ended September 30, 2010 as compared to \$3.9 million of unfavorable development for the same period during 2009.

#### Personal Segment

Net premiums written for our Personal Segment increased \$19.8 million during the first nine months of 2010 to \$74.8 million as compared to \$55.0 million for the first nine months of 2009. The increase in premium was due mostly to continued geographic expansion.

Total revenue for the Personal Segment increased 30% to \$71.4 million for the first nine months of 2010 from \$55.0 million for the first nine months of 2009. Higher earned premium of \$14.9 million was the primary reason for the increase in revenue for the period. Increased finance charges of \$1.2 million and net investment income of \$0.3 million further contributed to the increase in revenue during the first nine months of 2010.

Pre-tax income for the Personal Segment was \$4.5 million for the nine months ended September 30, 2010 as compared to \$7.7 million for the same period of 2009. Increased revenue was offset by increased losses and LAE of \$15.3 million and increased operating expenses of \$4.2 million due mostly to increased production and salary expense related to continued geographic expansion.

The Personal Segment reported a net loss ratio of 74.4% for the nine months ended September 30, 2010 as compared to 66.0% for the same period of 2009. The increase in the net loss ratio was due primarily to continued geographic expansion as the resulting growth has created a larger portion of new and maturing business as compared to our mature legacy business. Our current accident year loss ratio reflects the near term loss ratio penalty associated with this change in mix of seasoned versus less seasoned business. During the nine months ended September 30, 2010, the Personal Segment reported \$1.2 million of unfavorable prior loss development driven in large part by legal expense related to a 2001 bad faith claim as compared to \$0.2 million favorable prior year development reported for the same period in 2009.

#### Corporate

Total revenue for Corporate increased by \$3.1 million for the nine months ended September 30, 2010 as compared to the same period the prior year. This increase in total revenue was due primarily to gains of \$5.8 million recognized on our investment portfolio for the nine months ended September 30, 2010 as compared to \$1.1 million of gains

recognized during the same period in 2009. This increase in revenue was offset by lower net investment income of \$1.5 million for the nine months ended September 30, 2010 as compared to the same period of the prior year.

Corporate pre-tax loss was \$2.3 million for the nine months ended September 30, 2010 as compared to a \$7.0 million pre-tax loss for the same period the prior year. The decrease in pre-tax loss was the result of increased revenue, as well as a \$1.4 million reduction in operating expenses. The reduction in operating expenses during the nine months ended September 30, 2010 as compared to the same period in the prior year came primarily from lower expense related to stock options granted to employees and directors of \$0.6 million, lower professional fees of \$0.5 million and lower salary and related expenses of \$0.3 million. In addition further contributing to the lower expenses was decreased amortization of intangible assets of \$0.2 million.

## Financial Condition and Liquidity

### Sources and Uses of Funds

Our sources of funds are from insurance-related operations, financing activities and investing activities. Major sources of funds from operations include premiums collected (net of policy cancellations and premiums ceded), commissions, and processing and service fees. As a holding company, Hallmark is dependent on dividend payments and management fees from its subsidiaries to meet operating expenses and debt obligations. As of September 30, 2010, Hallmark had \$12.9 million in unrestricted cash and invested assets at the holding company. Unrestricted cash and invested assets of our non-insurance subsidiaries were \$4.0 million as of September 30, 2010. As of that date, our insurance subsidiaries held \$65.1 million of cash and cash equivalents as well as \$360.2 million in debt securities with an average modified duration of 2.7 years. Accordingly, we do not anticipate selling long-term debt instruments to meet any liquidity needs.

AHIC, domiciled in Texas, is limited in the payment of dividends in any 12-month period, without the prior written consent of the Texas Department of Insurance, to the greater of statutory net income for the prior calendar year or 10% of statutory surplus as of the prior year end. Dividends may only be paid from unassigned surplus funds. HIC, domiciled in Arizona, is limited in the payment of dividends to the lesser of 10% of prior year surplus or prior year's net investment income, without prior written approval from the Arizona Department of Insurance. HSIC, domiciled in Oklahoma, is limited in the payment of dividends to the greater of 10% of prior year surplus or prior year's statutory net income, not including realized capital gains, without prior written approval from the Oklahoma Insurance Department. During 2010, our insurance company subsidiaries' ordinary dividend capacity is \$19.4 million, of which \$15.9 million is available to Hallmark. As a county mutual, dividends from HCM are payable to policyholders. None of our insurance company subsidiaries paid a dividend to Hallmark during the first nine months of 2010 or the 2009 fiscal year.

### Comparison of September 30, 2010 to December 31, 2009

On a consolidated basis, our cash and investments (excluding restricted cash) at September 30, 2010 were \$486.2 million compared to \$439.9 million at December 31, 2009. An increase in the fair market value of our investment portfolio for the period and cash from operating activities were the primary reasons for this increase.

Comparison of Nine Months Ended September 30, 2010 and September 30, 2009

Net cash provided by our consolidated operating activities was \$28.9 million for the first nine months of 2010 compared to \$45.7 million for the first nine months of 2009. The decrease in operating cash flow was primarily due to higher paid losses and lower collected ceding commissions, partially offset by more collected premiums.

Net cash used in investing activities during the first nine months of 2010 was \$59.1 million as compared to \$13.8 million for the same period in 2009. Contributing to the increase in cash used in investing activities were an increase of \$82.9 million in purchases of debt and equity securities, partially offset by a \$34.6 million increase in maturities, sales and redemptions of investment securities during 2010.

Cash used in financing activities during the first nine months of 2010 was \$0.1 million as compared to \$6.6 million for the same period of 2009. The cash used during the first nine months of 2009 was primarily for the payment of a note payable by our premium finance operation and for the repurchase of the Company's common stock.

Credit Facilities

Our First Restated Credit Agreement with The Frost National Bank was most recently amended effective May 27, 2010 to extend the term of the facility until May 27, 2012, provide for the repayment of all amounts outstanding at termination on or before April 30, 2015, reduce the revolving commitment to \$5.0 million from \$25.0 million and eliminate the credit sub-facility for premium finance operations. This amendment further revised various affirmative and negative covenants and changed the interest rate, at our election, to either the prime rate or LIBOR plus 2.5%. We pay an annual average fee of 0.25% of the average daily unused balance of the credit facility. We pay letter of credit fees at the rate of 1.00% per annum. Our obligations under the revolving credit facility are secured by a security interest in the capital stock of all of our subsidiaries, guarantees of all of our subsidiaries and the pledge of all of our non-insurance company assets. The revolving credit facility contains covenants that, among other things, require us to maintain certain financial and operating ratios and restrict certain distributions, transactions and organizational changes. As of September 30, 2010, we were in compliance with or had obtained waivers of all of our covenants. As of September 30, 2010, we had \$2.8 million outstanding under this facility.

Trust Preferred Securities

On June 21, 2005, we entered into a trust preferred securities transaction pursuant to which we issued \$30.9 million aggregate principal amount of subordinated debt securities due in 2035. To effect the transaction, we formed a Delaware statutory trust, Hallmark Statutory Trust I ("Trust I"). Trust I issued \$30.0 million of preferred securities to investors and \$0.9 million of common securities to us. Trust I used the proceeds from these issuances to purchase the subordinated debt securities. Our Trust I subordinated debt securities bear an initial interest rate of 7.725% until June 15, 2015, at which time interest will adjust quarterly to the three-month LIBOR rate plus 3.25 percentage points. Trust I pays dividends on its preferred securities at the same rate. Under the terms of our Trust I subordinated debt securities, we pay interest only each quarter and the principal of the note at maturity. The subordinated debt securities are uncollateralized and do not require maintenance of minimum financial covenants. As of September 30, 2010, the balance of our Trust I subordinated debt was \$30.9 million.

On August 23, 2007, we entered into a trust preferred securities transaction pursuant to which we issued \$25.8 million aggregate principal amount of subordinated debt securities due in 2037. To effect the transaction, we formed a Delaware statutory trust, Hallmark Statutory Trust II (“Trust II”). Trust II issued \$25.0 million of preferred securities to investors and \$0.8 million of common securities to us. Trust II used the proceeds from these issuances to purchase the subordinated debt securities. Our Trust II subordinated debt securities bear an initial interest rate of 8.28% until September 15, 2017, at which time interest will adjust quarterly to the three-month LIBOR rate plus 2.90 percentage points. Trust II pays dividends on its preferred securities at the same rate. Under the terms of our Trust II subordinated debt securities, we pay interest only each quarter and the principal of the note at maturity. The subordinated debt securities are uncollateralized and do not require maintenance of minimum financial covenants. As of September 30, 2010, the balance of our Trust II subordinated debt was \$25.8 million.

### Item 3. Quantitative and Qualitative Disclosures About Market Risk.

This Item is omitted as permitted for a “smaller reporting company” (as defined by the SEC).

### Item 4. Controls and Procedures.

The principal executive officer and principal financial officer of Hallmark have evaluated our disclosure controls and procedures and have concluded that, as of the end of the period covered by this report, such disclosure controls and procedures were effective in ensuring that information required to be disclosed by us in the reports that we file or submit under the Securities Exchange Act of 1934 is timely recorded, processed, summarized and reported. The principal executive officer and principal financial officer also concluded that such disclosure controls and procedures were effective in ensuring that information required to be disclosed by us in the reports that we file or submit under such Act is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure. During the most recent fiscal quarter, there have been no changes in our internal controls over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

### Risks Associated with Forward-Looking Statements Included in this Form 10-Q

This Form 10-Q contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, which are intended to be covered by the safe harbors created thereby. These statements include the plans and objectives of management for future operations, including plans and objectives relating to future growth of our business activities and availability of funds. The forward-looking statements included herein are based on current expectations that involve numerous risks and uncertainties. Assumptions relating to the foregoing involve judgments with respect to, among other things, future economic, competitive and market conditions, regulatory framework, weather-related events and future business decisions, all of which are difficult or impossible to predict accurately and many of which are beyond our control. Although we believe that the assumptions underlying the forward-looking statements are reasonable, any of the assumptions could be inaccurate and, therefore, there can be no assurance that the forward-looking statements included in this Form 10-Q will prove to be accurate. In light of the significant uncertainties inherent in the forward-looking statements included herein, the inclusion of such information should not be regarded as a representation by us or any other person that our objectives and plans will be achieved.



PART II  
OTHER INFORMATION

Item 1. Legal Proceedings.

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

Item 1A. Risk Factors.

This Item is omitted as permitted for a “smaller reporting company” (as defined by the SEC).

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

None.

Item 3. Defaults Upon Senior Securities.

None.

Item 4. (Removed and Reserved.)

Item 5. Other Information.

None.

Item 6. Exhibits.

The following exhibits are filed herewith or incorporated herein by reference:

Exhibit Number	Description
3(a)	Restated Articles of Incorporation of the registrant, as amended (incorporated by reference to Exhibit 3.1 to the registrant’s Registration Statement on Form S-1 [Registration No. 333-136414] filed September 8, 2006).
3(b)	Amended and Restated By-Laws of the registrant (incorporated by reference to Exhibit 3.1 to the registrant’s Current Report on Form 8-K filed October 1, 2007).
4(a)	Specimen certificate for Common Stock, \$0.18 par value per share, of the registrant (incorporated by reference to Exhibit 4.1 to Amendment No. 1 to the registrant’s Registration Statement on Form S-1 [Registration No. 333-136414] filed September 8, 2006).

Exhibit Number	Description
4(b)	Indenture dated as of June 21, 2005, between Hallmark Financial Services, Inc. and JPMorgan Chase Bank, National Association (incorporated by reference to Exhibit 4.1 to the registrant's Current Report on Form 8-K filed June 27, 2005).
4(c)	Amended and Restated Declaration of Trust of Hallmark Statutory Trust I dated as of June 21, 2005, among Hallmark Financial Services, Inc., as sponsor, Chase Bank USA, National Association, as Delaware trustee, and JPMorgan Chase Bank, National Association, as institutional trustee, and Mark Schwarz and Mark Morrison, as administrators (incorporated by reference to Exhibit 4.2 to the registrant's Current Report on Form 8-K filed June 27, 2005).
4(d)	Form of Junior Subordinated Debt Security Due 2035 (incorporated by reference to Exhibit 4.1 to the registrant's Current Report on Form 8-K filed June 27, 2005).
4(e)	Form of Capital Security Certificate (incorporated by reference to Exhibit 4.2 to the registrant's Current Report on Form 8-K filed June 27, 2005).
4(f)	First Restated Credit Agreement dated January 27, 2006, between Hallmark Financial Services, Inc. and The Frost National Bank (incorporated by reference to Exhibit 4.1 to the registrant's Current Report on Form 8-K filed February 2, 2006).
4(g)	Form of Registration Rights Agreement dated January 27, 2006, between Hallmark Financial Services, Inc. and Newcastle Special Opportunity Fund I, L.P. and Newcastle Special Opportunity Fund II, L.P. (incorporated by reference to Exhibit 4.1 to the registrant's Current Report on Form 8-K filed February 2, 2006).
4(h)	Indenture dated as of August 23, 2007, between Hallmark Financial Services, Inc. and The Bank of New York Trust Company, National Association (incorporated by reference to Exhibit 4.1 to the registrant's Current Report on Form 8-K filed August 24, 2007).
4(i)	Amended and Restated Declaration of Trust of Hallmark Statutory Trust II dated as of August 23, 2007, among Hallmark Financial Services, Inc., as sponsor, The Bank of New York (Delaware), as Delaware trustee, and The Bank of New York Trust Company, National Association, as institutional trustee, and Mark Schwarz and Mark Morrison, as administrators (incorporated by reference to Exhibit 4.2 to the registrant's Current Report on Form 8-K filed August 24, 2007).
4(j)	Form of Junior Subordinated Debt Security Due 2037 (incorporated by reference to Exhibit 4.1 to the registrant's Current Report on Form 8-K filed August 24, 2007).
4(k)	Form of Capital Security Certificate (incorporated by reference to Exhibit 4.2 to the registrant's Current Report on Form 8-K filed August 24, 2007).
4(l)	Seventh Amendment to First Restated Credit Agreement dated May 27, 2010, between Hallmark Financial Services, Inc. and The Frost National Bank (incorporated by reference to Exhibit 10.1 to the registrant's Current Report on Form 8-K filed June 17, 2010).
31(a)	Certification of principal executive officer required by Rule 13a-14(a) or Rule 15d-14(a).

31(b) Certification of principal financial officer required by Rule 13a-14(a) or Rule 15d-14(a).

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Exhibit Number	Description
32(a)	Certification of principal executive officer Pursuant to 18 U.S.C. 1350.
32(b)	Certification of principal financial officer Pursuant to 18 U.S.C. 1350.

SIGNATURES

In accordance with the requirements of the Exchange Act, the registrant has caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

HALLMARK FINANCIAL SERVICES, INC.  
(Registrant)

Date: November 10, 2010

/s/ Mark J. Morrison  
Mark J. Morrison, Chief Executive Officer and President  
(Principal Executive Officer)

Date: November 10, 2010

/s/ Jeffrey R. Passmore  
Jeffrey R. Passmore, Chief Accounting Officer and  
Senior Vice President  
(Principal Financial Officer)