HALLMARK FINANCIAL SERVICES INC
Form 10-Q
August 06, 2012

**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 June 30, 2012

Commission file number 001-11252

**Hallmark Financial Services, Inc.**

(Exact name of registrant as specified in its charter)

| Nevada | 87-0447375 |
|---|---|
| (State or other jurisdiction of Incorporation or organization) | (I.R.S. Employer Identification No.) |

777 Main Street, Suite 1000, Fort Worth, Texas 76102
(Address of principal executive offices) (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 x 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 x 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 x
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 x

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 – 19,263,457 shares outstanding as of August 6, 2012.

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)

| | June 30 2012 (unaudited) | December 31 2011 (as adjusted) |
|---|---|---|
| ASSETS | | |
| Investments: | | |
| Debt securities, available-for-sale, at fair value (cost: $397,052 in 2012 and $380,578 in 2011) | $ 399,069 | $ 380,469 |
| Equity securities, available-for-sale, at fair value (cost: $30,119 in 2012 and $30,465 in 2011) | 40,715 | 44,159 |
| Total investments | 439,784 | 424,628 |
| Cash and cash equivalents | 76,230 | 74,471 |
| Restricted cash | 10,793 | 9,372 |
| Ceded unearned premiums | 21,692 | 19,470 |
| Premiums receivable | 68,882 | 53,513 |
| Accounts receivable | 3,495 | 3,946 |
| Receivable for securities | 2,334 | 2,617 |
| Reinsurance recoverable | 47,808 | 42,734 |
| Deferred policy acquisition costs | 25,481 | 22,554 |
| Goodwill | 44,695 | 44,695 |
| Intangible assets, net | 24,861 | 26,654 |
| Deferred federal income taxes, net | 1,940 | - |
| Federal income tax recoverable | 1,119 | 6,738 |
| Prepaid expenses | 1,651 | 1,458 |
| Other assets | 12,579 | 13,209 |
| Total assets | $ 783,344 | $ 746,059 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Liabilities: | | |
| Revolving credit facility payable | $ 1,550 | $ 4,050 |
| Subordinated debt securities | 56,702 | 56,702 |
| Reserves for unpaid losses and loss adjustment expenses | 314,109 | 296,945 |
| Unearned premiums | 163,371 | 146,104 |
| Unearned revenue | 63 | 55 |
| Reinsurance balances payable | 6,189 | 3,139 |
| Accrued agent profit sharing | 929 | 959 |
| Accrued ceding commission payable | 1,200 | 1,071 |
| Pension liability | 3,660 | 3,971 |

| | | |
|---|---|---|
| Payable for securities | 6,419 | 203 |
| Deferred federal income taxes, net | - | 135 |
| Accounts payable and other accrued expenses | 14,354 | 15,869 |
| Total liabilities | 568,546 | 529,203 |
| Commitments and Contingencies (Note 17) | | |
| Redeemable non-controlling interest | 1,274 | 1,284 |
| Stockholders' equity: | | |
| Common stock, $.18 par value, authorized 33,333,333 shares in 2012 and 2011; issued 20,872,831 in 2012 and 2011 | 3,757 | 3,757 |
| Additional paid-in capital | 122,669 | 122,487 |
| Retained earnings | 92,768 | 94,440 |
| Accumulated other comprehensive income | 5,888 | 6,446 |
| Treasury stock (1,609,374 shares in 2012 and 2011), at cost | (11,558) | (11,558) |
| Total stockholders' equity | 213,524 | 215,572 |
| | $ 783,344 | $ 746,059 |

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

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**Hallmark Financial Services, Inc. and Subsidiaries**

**Consolidated Statements of Operations**

(Unaudited)

($ in thousands, except per share amounts)

| | Three Months Ended June 30 | | Six Months Ended June 30 | |
|---|---|---|---|---|
| | 2012 | 2011 (as adjusted) | 2012 | 2011 (as adjusted) |
| Gross premiums written | $100,815 | $ 91,371 | $198,210 | $ 181,083 |
| Ceded premiums written | (15,678 ) | (12,415 ) | (28,111 ) | (25,893 ) |
| Net premiums written | 85,137 | 78,956 | 170,099 | 155,190 |
| Change in unearned premiums | (6,888 ) | (7,378 ) | (14,642 ) | (13,499 ) |
| Net premiums earned | 78,249 | 71,578 | 155,457 | 141,691 |
| Investment income, net of expenses | 3,932 | 3,778 | 7,778 | 7,785 |
| Net realized gains | 991 | 1,664 | 872 | 2,783 |
| Finance charges | 1,524 | 1,725 | 3,164 | 3,465 |
| Commission and fees | (184 ) | (243 ) | (4 ) | 172 |
| Other income | 59 | 11 | 290 | 25 |
| Total revenues | 84,571 | 78,513 | 167,557 | 155,921 |
| Losses and loss adjustment expenses | 61,229 | 61,920 | 116,020 | 125,705 |
| Other operating expenses | 25,419 | 23,887 | 51,351 | 47,040 |
| Interest expense | 1,178 | 1,153 | 2,327 | 2,311 |
| Amortization of intangible assets | 896 | 896 | 1,793 | 1,793 |
| Total expenses | 88,722 | 87,856 | 171,491 | 176,849 |
| Loss before tax | (4,151 ) | (9,343 ) | (3,934 ) | (20,928 ) |
| Income tax benefit | (2,351 ) | (9,264 ) | (2,328 ) | (9,650 ) |
| Net loss | (1,800 ) | (79 ) | (1,606 ) | (11,278 ) |
| Less: Net income attributable to non-controlling interest | 43 | 8 | 66 | 22 |
| Net loss attributable to Hallmark Financial Services, Inc. | $(1,843 ) | $ (87 ) | $(1,672 ) | $ (11,300 ) |
| Net loss per share attributable to Hallmark Financial Services, Inc. common stockholders: | | | | |
| Basic | $(0.10 ) | $ - | $(0.09 ) | $ (0.56 ) |
| Diluted | $(0.10 ) | $ - | $(0.09 ) | $ (0.56 ) |

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

**HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES**

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

(Unaudited)

($ in thousands)

| | Three Months Ended June 30 | | Six Months Ended June 30 | |
|---|---|---|---|---|
| | 2012 | 2011 (as adjusted) | 2012 | 2011 (as adjusted) |
| Net loss | $(1,800) | $(79) | $(1,606) | $(11,278) |
| Other comprehensive loss: | | | | |
| Change in net actuarial gain | 122 | 72 | 242 | 143 |
| Tax effect on change in net actuarial gain | (43) | (25) | (85) | (50) |
| Unrealized holding gains (losses) arising during the period | (2,006) | 1,032 | 17 | (120) |
| Tax effect on unrealized holding gains (losses) arising during the period | 702 | (361) | (6) | 42 |
| Reclassification adjustment for losses included in net income | (1,219) | (1,664) | (1,117) | (2,783) |
| Tax effect on reclassification adjustment for losses included in net income | 427 | 582 | 391 | 974 |
| Other comprehensive loss, net of tax | (2,017) | (364) | (558) | (1,794) |
| Comprehensive loss | $(3,817) | $(443) | $(2,164) | $(13,072) |
| Less: comprehensive income attributable to non-controlling interest | 43 | 8 | 66 | 22 |
| Comprehensive loss attributable to Hallmark Financial Services, Inc. | $(3,860) | $(451) | $(2,230) | $(13,094) |

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

**Hallmark Financial Services, Inc. and Subsidiaries**

**Consolidated Statements of Stockholders' Equity**

(Unaudited)

($ in thousands)

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2012 | 2011 (as adjusted) | 2012 | 2011 (as adjusted) |
| Common Stock | | | | |
| Balance, beginning of period | $3,757 | $3,757 | $3,757 | $3,757 |
| Balance, end of period | 3,757 | 3,757 | 3,757 | 3,757 |
| Additional Paid-In Capital | | | | |
| Balance, beginning of period | 122,644 | 122,074 | 122,487 | 121,815 |
| Accretion of redeemable noncontrolling interest | (90) | (3) | (71) | (6) |
| Equity based compensation | 115 | 227 | 253 | 489 |
| Exercise of stock options | - | (6) | - | (6) |
| Balance, end of period | 122,669 | 122,292 | 122,669 | 122,292 |
| Retained Earnings | | | | |
| Balance, beginning of period | 94,611 | 94,590 | 94,995 | 105,816 |
| Cumulative effect of adjustments resulting from adoption of change in accounting principle, net of tax | - | (472) | (555) | (485) |
| Net loss attributable to Hallmark Financial Services, Inc. | (1,843) | (87) | (1,672) | (11,300) |
| Balance, end of period | 92,768 | 94,031 | 92,768 | 94,031 |
| Accumulated Other Comprehensive Income | | | | |
| Balance, beginning of period | 7,905 | 8,207 | 6,446 | 9,637 |
| Additional minimum pension liability, net of tax | 79 | 47 | 157 | 93 |
| Net unrealized holding (losses) gains arising during period, net of tax | (1,304) | 671 | 11 | (78) |
| Reclassification adjustment for (gains) losses included in net income, net of tax | (792) | (1,082) | (726) | (1,809) |
| Balance, end of period | 5,888 | 7,843 | 5,888 | 7,843 |
| Treasury Stock | | | | |
| Balance, beginning of period | (11,558) | (5,262) | (11,558) | (5,262) |
| Acquistion of treasury shares | - | (4,911) | - | (4,911) |

| | | | | |
|---|---|---|---|---|
| Issuance of treasury stock upon option exercises | - | 105 | - | 105 |
| Balance, end of period | (11,558 ) | (10,068 ) | (11,558 ) | (10,068 ) |
| Total Stockholders' Equity | $213,524 | $217,855 | $213,524 | $217,855 |

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)

| | Six Months Ended June 30 | |
|---|---|---|
| | 2012 | 2011 (as adjusted) |
| Cash flows from operating activities: | | |
| Net loss | $(1,606) | $(11,278) |
| Adjustments to reconcile net loss to cash provided by operating activities: | | |
| Depreciation and amortization expense | 2,360 | 2,463 |
| Deferred federal income taxes | (2,201) | (1,005) |
| Net realized gains | (872) | (2,783) |
| Shared-based payments expense | 253 | 489 |
| Change in ceded unearned premiums | (2,222) | 5,242 |
| Change in premiums receivable | (17,164) | (10,107) |
| Change in accounts receivable | 451 | 1,031 |
| Change in deferred policy acquisition costs | (2,927) | (2,289) |
| Change in unpaid losses and loss adjustment expenses | 17,164 | 27,217 |
| Change in unearned premiums | 16,864 | 7,240 |
| Change in unearned revenue | 8 | (23) |
| Change in accrued agent profit sharing | (30) | (24) |
| Change in reinsurance recoverable | (5,074) | (3,221) |
| Change in reinsurance payable | 3,050 | 2,371 |
| Change in current federal income tax recoverable | 5,619 | (9,045) |
| Change in accrued ceding commission payable | 129 | (1) |
| Change in all other liabilities | 372 | 1,009 |
| Change in all other assets | 3,048 | 3,712 |
| Net cash provided by operating activities | 17,222 | 10,998 |
| Cash flows from investing activities: | | |
| Purchases of property and equipment | (183) | (1,162) |
| Net transfers into restricted cash | (1,421) | (1,069) |
| Payment for acquisition of subsidiaries | - | (14,000) |
| Purchases of investment securities | (76,102) | (166,834) |
| Maturities, sales and redemptions of investment securities | 64,890 | 167,410 |
| Net cash used in investing activities | (12,816) | (15,655) |

| | | |
|---|---|---|
| Cash flows from financing activities: | | |
| Proceeds from exercise of employee stock options | - | 99 |
| Purchase of treasury shares | - | (4,911 ) |
| Activity under revolving credit facility | (2,500 ) | - |
| Distribution to non-controlling interest | (147 ) | (165 ) |
| Net cash used in financing activities | (2,647 ) | (4,977 ) |
| Increase (decrease) in cash and cash equivalents | 1,759 | (9,634 ) |
| Cash and cash equivalents at beginning of period | 74,471 | 60,519 |
| Cash and cash equivalents at end of period | $76,230 | $50,885 |
| Supplemental cash flow information: | | |
| Interest paid | $2,313 | $2,309 |
| Income taxes (recovered) paid | $(6,045 ) | $400 |
| Supplemental schedule of non-cash investing activities: | | |
| Change in receivable for securities related to investment disposals that settled after the balance sheet date | $(283 ) | $1,742 |
| Change in payable for securities related to investment purchases that settled after the balance sheet date | $6,216 | $5,864 |

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

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**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 six business units that are supported by our insurance company subsidiaries. Our Standard Commercial business unit handles commercial insurance products and services in the standard market. Our Workers Compensation business unit specializes in small and middle market workers compensation business. Our E&S Commercial business unit handles primarily commercial and medical professional liability insurance products and services in the excess and surplus lines market. Our General Aviation business unit handles general aviation insurance products and services. Our Excess & Umbrella business 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 handles personal insurance products and services. Our insurance company subsidiaries supporting these operating units are American Hallmark Insurance Company of Texas ("AHIC"), Hallmark Insurance Company ("HIC"), Hallmark Specialty Insurance Company ("HSIC"), Hallmark County Mutual Insurance Company ("HCM"), Hallmark National Insurance Company ("HNIC") and Texas Builders Insurance Company ("TBIC").

These six business units are segregated into three reportable industry segments for financial accounting purposes. The Standard Commercial Segment includes the Standard Commercial business unit and the Workers Compensation business unit. 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, 2011 included in our Annual Report on Form 10-K filed with the SEC.

The interim financial data as of June 30, 2012 and 2011 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 June 30, 2012 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.")

***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" under Item 7 of our Annual Report on Form 10-K for the year ended December 31, 2011 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.

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

Restricted Cash: The carrying amount for restricted cash reported in the balance sheet approximates the fair value.

Revolving Credit Facility Payable: The carrying value of our bank revolving credit facility of $1.6 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 $48.2 million as of June 30, 2012. The fair value of our trust preferred securities is based on discounted cash flows using a current yield to maturity of 8.0% based on similar issues to discount future cash flows and would be classified as Level 3 in the fair value hierarchy.

For reinsurance recoverable, federal income tax payable and receivable, other assets and other 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.

We evaluate on an ongoing basis our investments in Trust I and II (collectively the "Trusts") and we do not have a variable interest in the Trusts.  Therefore, the Trusts are not included in our consolidated financial statements.

We are also involved in the normal course of business with variable interest entities ("VIE's") primarily as a passive investor in mortgage-backed securities and certain collateralized corporate bank loans issued by third party VIE's. The maximum exposure to loss with respect to these investments is the investment carrying values included in the consolidated balance sheets.

***Adoption of New Accounting Pronouncements***

Effective January 1, 2012, the Company adopted new guidance issued by the Financial Accounting Standards Board ("FASB") 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 that should be capitalized. This guidance may be applied prospectively or retrospectively. The Company elected retrospective application of this guidance. The adoption of this guidance decreased deferred policy acquisition costs by $0.9 million, decreased deferred federal income taxes, net by $0.3 million and decreased stockholders' equity by $0.6 million as of December 31, 2011. Amortization of deferred policy acquisition costs included in other operating expenses and income tax benefit for the three months and six months ended June 30, 2011 were retrospectively restated to conform to the change in accounting guidance, the effect of which on previously reported net loss for the three months and six months ended June 30, 2011 was immaterial. In this Form 10-Q, interim financial information for the three and six-months ended June 30, 2011 and balances at December 31, 2011 have been adjusted in accordance with the adoption of this guidance.

In May 2011, the FASB issued amendments to achieve common fair value measurement and disclosure requirements in GAAP and International Financial Reporting Standards. New disclosures, with a particular focus on Level 3 measurement were required. All transfers between Level 1 and Level 2 were required to be disclosed. Information about when the current use of a non-financial asset measured at fair value differs from its highest and best use is to be disclosed. The amendments in this update are to be applied prospectively. The amendments are effective during interim and annual periods beginning after December 15, 2011. The adoption of this amendment did not have a material impact on our financial position or results of operations.

In June 2011, the FASB issued amendments to the presentation of comprehensive income. The amendments provide the option to present other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The components of other comprehensive income have not changed, nor has the guidance on when other comprehensive income items are reclassified to net income. All reclassification adjustments from other comprehensive income to net income are required to be presented on the face of the statement of comprehensive income. The adoption of this new guidance did not have a material impact on our financial position or results of operations but did require additional disclosures and impact financial statement presentation.

In September 2011, the FASB issued an accounting update to simplify how entities test goodwill for impairment. Under the update, an entity is not required to calculate the fair value of a reporting unit unless the entity determines that it is more likely than not that its fair value is less than its carrying amount. The update permits an entity to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the current two-step goodwill impairment test. The update is effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. The adoption of this update did not have a material impact on our financial position or results of operations.

**3. Business Combinations**

We account for business combinations using the purchase method of accounting pursuant to ASC Topic 805, “Business Combinations.” 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.

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 $1.6 million at June 30, 2012.

Effective December 31, 2010, we acquired all of the issued and outstanding capital stock of HNIC for initial consideration of $14.0 million paid in cash on January 3, 2011 to State Auto Financial Corporation, Inc. ("SAFCI"). In addition, an earnout of up to $2.0 million is payable to SAFCI quarterly in an amount equal to 2% of gross collected premiums on new or renewal personal lines insurance policies written by HNIC agents during the three years following closing. HNIC is an Ohio domiciled insurance company that writes non-standard personal automobile policies through independent agents in 21 states.

Effective July 1, 2011, we acquired all of the issued and outstanding capital stock of TBIC Holding Corporation ("TBIC Holding") for initial consideration of $1.6 million paid in cash on July 1, 2011. In addition, a holdback purchase price of up to $350 thousand may become payable following four full calendar quarters after closing and a contingent purchase price of up to $3.0 million may become payable following 16 full calendar quarters after closing, in each case based upon a formula contained in the acquisition agreement. As of June 30, 2012 we had accrued the maximum holdback purchase price of $350 thousand which is expected to be paid to the sellers during the third quarter of 2012. We recorded a bargain purchase gain of $165 thousand on the acquisition which was reported in other income. The gain resulted from the difference in the estimated purchase price and the fair value of the net assets acquired and liabilities assumed as of July 1, 2011.

**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, collateralized corporate bank loans, municipal bonds, and U.S. Treasury securities for which quoted prices are not available on active exchanges for identical instruments. We use third party pricing services 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 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 services and have determined that they result in fair values consistent with the requirements of ASC 820 for Level 2 investment securities. In addition, using the prices received for the securities from the third party pricing services, we compare a sample of the prices against additional sources. We have not adjusted any prices received from the third party pricing services.

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 June 30, 2012 (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 | $ - | $ 15,127 | $ - | $ 15,127 |
| Corporate bonds | - | 102,022 | - | 102,022 |
| Collateralized corporate bank loans | - | 107,810 | 1,053 | 108,863 |
| Municipal bonds | - | 150,689 | 18,766 | 169,455 |
| Mortgage-backed | - | 3,602 | - | 3,602 |
| Total debt securities | - | 379,250 | 19,819 | 399,069 |
| | | | | |
| Financial services | 14,294 | - | - | 14,294 |
| All other | 26,421 | - | - | 26,421 |
| Total equity securities | 40,715 | - | - | 40,715 |
| | | | | |
| Total debt and equity securities | $ 40,715 | $ 379,250 | $ 19,819 | $ 439,784 |

Due to significant unobservable inputs into the valuation model for certain municipal bonds and a collateralized corporate bank loan in illiquid markets, we classified these investments as level 3 in the fair value hierarchy. We used an income approach in order to derive an estimated fair value of the municipal bonds classified as Level 3, which included inputs such as expected holding period, benchmark swap rate, benchmark discount rate and a discount rate premium for illiquidity. The fair value of the collateralized corporate bank loan classified as level 3 is based on discounted cash flows using current yield to maturity of 9.4%, which is based on the relevant spread over LIBOR for this particular loan to discount future cash flows.

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 six months ended June 30, 2012 (in thousands):

| | |
|---|---|
| Beginning balance as of January 1, 2012 | $ 20,608 |
| | |
| Settlements | (236) |
| Total realized/unrealized gains included in net income | (553) |
| Net losses included in other comprehensive income | - |
| Transfers into Level 3 | - |
| Transfers out of Level 3 | - |
| | |
| Ending balance as of June 30, 2012 | $ 19,819 |

**5. Investments**

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

| As of June 30, 2012 | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|
| U.S. Treasury securities and obligations of U.S. Government | $ 15,119 | $ 13 | $ (5 ) | $ 15,127 |
| Corporate bonds | 100,613 | 2,602 | (1,193 ) | 102,022 |
| Collateralized corporate bank loans | 109,853 | 320 | (1,310 ) | 108,863 |
| Municipal bonds | 167,940 | 4,280 | (2,765 ) | 169,455 |
| Mortgage-backed | 3,527 | 86 | (11 ) | 3,602 |
| Total debt securities | 397,052 | 7,301 | (5,284 ) | 399,069 |
| Financial services | 10,999 | 3,298 | (3 ) | 14,294 |
| All other | 19,120 | 7,509 | (208 ) | 26,421 |
| Total equity securities | 30,119 | 10,807 | (211 ) | 40,715 |
| Total debt and equity securities | $ 427,171 | $ 18,108 | $ (5,495 ) | $ 439,784 |
| As of December 31, 2011 | | | | |
| U.S. Treasury securities and obligations of U.S. Government | $ 11,152 | $ 24 | $ - | $ 11,176 |
| Corporate bonds | 93,272 | 2,305 | (1,655 ) | 93,922 |
| Collateralized corporate bank loans | 94,638 | 175 | (1,920 ) | 92,893 |
| Municipal bonds | 177,432 | 3,458 | (2,549 ) | 178,341 |
| Mortgage-backed | 4,084 | 80 | (27 ) | 4,137 |
| Total debt securities | 380,578 | 6,042 | (6,151 ) | 380,469 |
| Financial services | 11,618 | 4,463 | (260 ) | 15,821 |
| All other | 18,847 | 9,554 | (63 ) | 28,338 |
| Total equity securities | 30,465 | 14,017 | (323 ) | 44,159 |
| Total debt and equity securities | $ 411,043 | $ 20,059 | $ (6,474 ) | $ 424,628 |

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

| | Three Months Ended June 30 | | Six Months Ended June 30 | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| U.S. Treasury securities and obligations of U.S. Government | $ - | $ - | $ - | $ 14 |
| Corporate bonds | (36 ) | 271 | (150 ) | 271 |
| Collateralized corporate bank loans | 135 | 206 | 136 | 640 |
| Municipal bonds | (163 ) | 66 | (243 ) | (1 ) |
| Mortgage-backed | - | - | - | - |
| Equity securities-financial services | (22 ) | 51 | 70 | 789 |
| Equity securities-all other | 1,305 | 1,070 | 1,305 | 1,070 |
| Gain on investments | 1,219 | 1,664 | 1,118 | 2,783 |
| Other-than-temporary impairments | (228 ) | - | (246 ) | - |
| Net realized gains | $ 991 | $ 1,664 | $ 872 | $ 2,783 |

We realized gross gains on investments of $1.4 million and $1.7 million during the three months ended June 30, 2012 and 2011, respectively and $1.5 million and $2.9 million for the six months ended June 30, 2012 and 2011, respectively. We realized gross losses on investments of $0.2 million and $43 thousand for the three months ended June 30, 2012 and 2011. We realized gross losses on investments of $0.4 million and $0.1 million for the six months ended June 30, 2012 and 2011. We recorded proceeds from the sale of investment securities of $6.0 million and $10.2 million during the three months ended June 30, 2012 and 2011, respectively, and $6.2 million and $42.9 million for the six months ended June 30, 2012 and 2011, respectively. Realized investment gains and losses are recognized in operations on the specific identification method.

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 June 30, 2012 and December 31, 2011 (in thousands):

| | As of June 30, 2012 | | | | | |
|---|---|---|---|---|---|---|
| | 12 months or less | | 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 | $10,073 | $ (5 ) | $ - | $ - | $10,073 | $ (5 ) |
| Corporate bonds | 27,175 | (459 ) | 4,473 | (734 ) | 31,648 | (1,193 ) |
| Collateralized corporate bank loans | 55,213 | (914 ) | 14,815 | (396 ) | 70,028 | (1,310 ) |
| Municipal bonds | 21,745 | (245 ) | 36,689 | (2,520 ) | 58,434 | (2,765 ) |
| Mortgage-backed | 688 | (10 ) | 106 | (1 ) | 794 | (11 ) |
| Total debt securities | 114,894 | (1,633 ) | 56,083 | (3,651 ) | 170,977 | (5,284 ) |
| Financial services | 90 | (3 ) | - | - | 90 | (3 ) |
| All other | 1,128 | (208 ) | - | - | 1,128 | (208 ) |
| Total equity securities | 1,218 | (211 ) | - | - | 1,218 | (211 ) |
| Total debt and equity securities | $116,112 | $ (1,844 ) | $ 56,083 | $ (3,651 ) | $172,195 | $ (5,495 ) |

| | As of December 31, 2011 | | | | | |
|---|---|---|---|---|---|---|
| | 12 months or less | | 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 bonds | 21,752 | (869 ) | 2,366 | (786 ) | 24,118 | (1,655 ) |
| Collateralized corporate bank loans | 69,717 | (1,917 ) | 19 | (3 ) | 69,736 | (1,920 ) |
| Municipal bonds | 26,780 | (196 ) | 39,741 | (2,353 ) | 66,521 | (2,549 ) |
| Municipal bonds | 740 | (27 ) | - | - | 740 | (27 ) |
| Total debt securities | 118,989 | (3,009 ) | 42,126 | (3,142 ) | 161,115 | (6,151 ) |
| Financial services | 1,789 | (260 ) | - | - | 1,789 | (260 ) |
| All other | 2,959 | (63 ) | - | - | 2,959 | (63 ) |
| Total equity securities | 4,748 | (323 ) | - | - | 4,748 | (323 ) |
| Total debt and equity securities | $123,737 | $ (3,332 ) | $ 42,126 | $ (3,142 ) | $165,863 | $ (6,474 ) |

At June 30, 2012, the gross unrealized losses more than twelve months old were attributable to 59 debt security positions. At December 31, 2011, the gross unrealized losses more than twelve months old were attributable to 25 debt security 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.

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.

The amortized cost and estimated fair value of debt securities at June 30, 2012 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 | Fair Value |
|---|---|---|
| | (in thousands) | |
| Due in one year or less | $48,230 | $48,590 |
| Due after one year through five years | 181,967 | 184,767 |
| Due after five years through ten years | 111,172 | 110,914 |
| Due after ten years | 52,156 | 51,196 |
| Mortgage-backed | 3,527 | 3,602 |
| | $397,052 | $399,069 |

**6. Pledged Investments**

We have pledged certain of our securities 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 $26.5 million and $27.5 million at June 30, 2012 and December 31, 2011, respectively.

**7. Reserves for Unpaid Losses and Loss Adjustment Expenses**

Unpaid losses and loss adjustment expenses (“LAE”) represent the estimated ultimate net cost of all reported and unreported losses incurred through each balance sheet date. The reserves for unpaid losses and LAE are estimated using individual case-basis valuations and statistical analyses. These reserves are revised periodically and are subject to the effects of trends in loss severity and frequency. Due to the inherent uncertainty in estimating unpaid losses and LAE, the actual ultimate amounts may differ from the recorded amounts. The estimates are periodically reviewed and adjusted as experience develops or new information becomes known. Such adjustments are included in current operations.

We recorded $1.6 million of unfavorable prior years’ loss development during the three months ended June 30, 2012. We recorded $1.4 million of favorable prior years’ loss development during the six months ended June 30, 2012. For the year to date, our General Aviation business unit experienced $2.7 million of favorable prior years’ loss development related to our liability and aircraft lines of business. Our Standard Commercial business unit experienced $1.9 million of favorable prior years’ loss development primarily related to commercial property and auto liability partially offset by the late development of a general liability claim. Our Workers Compensation business unit experienced $0.9 million of favorable prior years’ loss development. These favorable developments were partially offset by unfavorable prior year loss development in our Personal Lines business unit and our E&S Commercial business unit for the six months ended June 30, 2012. Our Personal Lines business unit experienced $2.3 million of unfavorable prior years’ loss development of which $1.6 million is the result of unfavorable development in auto liability claims spread throughout various states. The remaining unfavorable prior years’ loss development for our

Personal Lines business unit was the result of $0.7 million of unfavorable prior years' loss development in our low value dwelling/homeowners line of business. For the year to date, our E&S Commercial business unit had $1.8 million of unfavorable prior years' loss development related primarily to commercial auto liability and physical damage.

We recorded $0.7 million and $15.8 million of unfavorable prior years’ loss development during the three and six months ended June 30, 2011, respectively. For the first half of fiscal 2011, our Personal Lines business unit experienced $14.3 million of unfavorable prior years’ loss development of which $9.5 million was attributable to Florida developing much worse than expected due primarily to rapid growth in the claim volume from Florida and the complexity related to Florida personal injury protection coverage claims. The remaining unfavorable prior years’ loss development for our Personal Lines business unit was primarily due to development of auto liability claims spread throughout our other states. For the first half of fiscal 2011, our E&S Commercial business unit had $3.1 million of unfavorable prior years’ loss development related primarily to commercial auto liability and physical damage, while our Standard Commercial business unit experienced $0.5 million of unfavorable prior years’ loss development driven by a late developing umbrella claim and large loss developments in a commercial property claim and a commercial auto liability claim. These unfavorable developments were partially offset by $2.1 million of favorable prior years’ loss development in our General Aviation business unit related to our liability lines of business.

**8. 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. As of June 30, 2012, there were incentive stock options to purchase 1,100,832 shares of our common stock outstanding and non-qualified stock options to purchase 319,157 shares of our common stock outstanding and there were 564,178 shares reserved for future issuance under the 2005 LTIP. 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.

Incentive stock options granted under the 2005 LTIP prior to 2009 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 and one grant of 5,000 incentive stock options in 2011 vest in equal annual increments on each of the first seven anniversary dates and terminate ten years from the date of grant. One grant of 25,000 incentive stock options in 2010 and one grant of 10,000 incentive stock options in 2011 vest in equal annual increments on each of the first three anniversary dates and terminate 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. One grant of 200,000 non-qualified stock options in 2009 vests in equal annual increments on each of the first seven anniversary dates and terminates ten years from the date of grant.

A summary of the status of our stock options as of and changes during the six months ended June 30, 2012 is presented below:

| | Number of Shares | Weighted Average Exercise Price | Average Remaining Contractual Term (Years) | Aggregate Intrinsic Value ($000) |
|---|---|---|---|---|
| Outstanding at January 1, 2012 | 1,419,989 | $ 9.66 | | |
| Granted | - | | | |
| Exercised | - | | | |
| Forfeited or expired | - | | | |
| Outstanding at June 30, 2012 | 1,419,989 | $ 9.66 | 5.7 | $ 679 |
| Exercisable at June 30, 2012 | 1,126,418 | $ 10.42 | 5.4 | $ 353 |

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 June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| Intrinsic value of options exercised | $ - | $ 4 | $ - | $ 4 |
| Cost of share-based payments (non-cash) | $ 115 | $ 227 | $ 253 | $ 489 |
| Income tax benefit of share-based payments recognized in income | $ 12 | $ 7 | $ 23 | $ 15 |

As of June 30, 2012, there was $0.8 million of total unrecognized compensation cost related to non-vested share-based compensation arrangements granted under our plans, of which $0.1 million is expected to be recognized during the remainder of 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 Hallmark'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 we do not have sufficient historical exercise data to provide a basis for estimating the expected term. There were no options granted during the first half of 2012. There were no options granted during the first quarter of 2011. There were two options granted during the second quarter of 2011 with a weighted average grant date fair value per share of $3.50, a weighted average expected term of 6.3 years, a weighted average expected volatility of 38.0% and a weighted average risk free interest rate of 2.6%.

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**9. Segment Information**

The following is business segment information for the three and six months ended June 30, 2012 and 2011 (in thousands):

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | June 30, | | June 30, | |
| | 2012 | 2011 | 2012 | 2011 |
| Revenues: | | | | |
| Standard Commercial Segment | $17,924 | $16,241 | $36,030 | $33,668 |
| Specialty Commercial Segment | 43,046 | 34,476 | 83,439 | 67,619 |
| Personal Segment | 22,905 | 25,869 | 47,336 | 50,919 |
| Corporate | 696 | 1,927 | 752 | 3,715 |
| Consolidated | $84,571 | $78,513 | $167,557 | $155,921 |
| | | | | |
| Pre-tax income (loss), net of non-controlling interest: | | | | |
| Standard Commercial Segment | $(710) | $(4,767) | $(2,072) | $(5,150) |
| Specialty Commercial Segment | 2,929 | 812 | 8,906 | 4,263 |
| Personal Segment | (4,211) | (4,620) | (5,402) | (17,804) |
| Corporate | (2,202) | (776) | (5,432) | (2,259) |
| Consolidated | $(4,194) | $(9,351) | $(4,000) | $(20,950) |

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

| | June 30, 2012 | December 31, 2011 |
|---|---|---|
| Assets | | |
| Standard Commercial Segment | $148,750 | $ 144,673 |
| Specialty Commercial Segment | 384,744 | 348,699 |
| Personal Segment | 228,262 | 232,381 |
| Corporate | 21,588 | 20,306 |
| | $783,344 | $ 746,059 |

**10. 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. In order to mitigate credit risk to reinsurance companies, most of our reinsurance recoverable balance as of June 30, 2012 was with reinsurers that had an A.M. Best rating of “A–” or better.

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| Ceded earned premiums | $ 13,504 | $ 15,313 | $ 25,890 | $ 32,151 |
| Reinsurance recoveries | $ 9,073 | $ 6,933 | $ 14,050 | $ 19,483 |

We currently reinsure the following exposures on business generated by our 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:

  - We retain the first $6.0 million of property catastrophe losses; and

  - Our reinsurers reimburse us 100% for any loss in excess of our $6.0 million retention up to $34.0 million for each catastrophic occurrence, subject to an aggregate limit of $68.0 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:

  - We retain the first $1.0 million of loss for each commercial property risk;

  - 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

  - Individual risk facultative reinsurance is purchased on any commercial property with limits above $6.0 million.

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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:

- We retain the first $1.0 million of any commercial liability risk; and

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- 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; and

  - 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.

- Workers Compensation. We purchase excess of loss reinsurance specific to the workers compensation risks underwritten by our Workers Compensation business unit. The terms of our workers compensation reinsurance are:

  - o We retain the first $1.0 million of each workers compensation loss; and

  - o Our reinsurers reimburse us 100% for the next $14.0 million for each workers compensation loss, subject to a maximum limit of $10.0 million for any one person and an aggregate limit of $28.0 million for all workers compensation losses.

- Standard Commercial. We purchase proportional reinsurance where we cede 100% of the risks to reinsurers on the equipment breakdown coverage on our commercial multi-peril property and business owners risks and on the employment practices liability coverage on certain commercial multi-peril, general liability and business owners risks.

- Excess & Umbrella. We purchase proportional reinsurance where we retain 20% of each risk and cede the remaining 80% 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.

- E&S Commercial. Effective June 1, 2012 we purchase proportional reinsurance on our medical professional liability risks where we retain 50% of each risk and cede the remaining 50% to reinsurers. Prior to June 1, 2012 we retained 40% of each risk and ceded the remaining 60% 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. In addition, we purchase facultative reinsurance on our commercial umbrella and excess liability risks where we retain 10% of the first $1.0 million of risk and cede the remaining 90% to reinsurers. We cede 100% of our commercial umbrella and excess liability risks in excess of $1.0 million.

- 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.

- Hallmark National Insurance Company. Simultaneous with the December 31, 2010 closing of our acquisition of HNIC, HNIC entered into reinsurance contracts with an affiliate of the seller pursuant to which such affiliate of the seller handles all claims and assumes all liabilities arising under policies issued by HNIC prior to closing or during a transition period of up to six months following the closing.

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**11. Revolving Credit Facility Payable**

Our First Restated Credit Agreement with The Frost National Bank dated January 27, 2006, as amended to date, provides a revolving credit facility of $15.0 million. We pay interest on the outstanding balance at our election at a rate of the prime rate or LIBOR plus 2.5%. We pay an annual 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. We are in compliance with or have obtained waivers of all of our covenants. As of June 30, 2012, the balance on the revolving note was $1.6 million. The revolving note currently bears interest at 2.97% per annum.

**12. 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 June 30, 2012, 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 June 30, 2012, the balance of our Trust II subordinated debt was $25.8 million.

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13. Deferred Policy Acquisition Costs

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| Deferred | $(7,584) | $(12,817) | $(33,270) | $(28,056) |
| Amortized | 6,646 | 11,812 | 30,343 | 25,767 |
| Net | $(938) | $(1,005) | $(2,927) | $(2,289) |

**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 June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| Weighted average shares - basic | 19,263 | 20,033 | 19,263 | 20,078 |
| Effect of dilutive securities | - | - | - | - |
| Weighted average shares - assuming dilution | 19,263 | 20,033 | 19,263 | 20,078 |

For the three months and six months ended June 30, 2012, 809,999 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. For the three months and six months ended June 30, 2011, 939,166 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 June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| Interest cost | $ 141 | $ 153 | $ 282 | $ 305 |
| Amortization of net loss | 121 | 71 | 241 | 143 |
| Expected return on plan assets | (146 ) | (147 ) | (292 ) | (295 ) |
| Net periodic pension cost | $ 116 | $ 77 | $ 231 | $ 153 |

We contributed $175 thousand and $301 thousand to our frozen defined benefit cash balance plan during the three months and six months ended June 30, 2012, respectively. We contributed $126 thousand and $220 thousand to our frozen defined benefit cash balance plan during the three months and six months ended June 30, 2011, respectively. Refer to Note 14 to the consolidated financial statements in our Annual Report on Form 10-K for the year ended December 31, 2011 for more discussion of our retirement plans.

**16. Income Taxes**

Our effective income tax rate for the six months ended June 30, 2012 was 59.2%, which varied from the statutory income tax rate primarily as a result of our tax exempt income increasing the tax benefit from our pre-tax loss. Our effective income tax rate for the six months ended June 30, 2011 was 46.1%, which varied from the statutory income tax rate utilized primarily due to the increase in the tax exempt income relative to lower pre-tax income and the recognition of a tax benefit related to the disposal of certain securities.

**17. Commitments and Contingencies**

In December 2010, our E&S Commercial business unit was informed by the Texas Comptroller of Public Accounts that a surplus lines tax audit covering the period January 1, 2007 through December 31, 2009 was complete. A subsidiary within our E&S Commercial business unit (“TGA”) frequently acts as a managing general underwriter (“MGU”) authorized to underwrite policies on behalf of Republic Vanguard Insurance Company and HSIC, both Texas eligible surplus lines insurance carriers. In its role as the MGU, TGA underwrites policies on behalf of these carriers while other agencies located in Texas, generally referred to as “producing agents,” deliver the policies to the insureds and collect all premiums due from the insureds. During the period under audit, the producing agents also collected the

surplus lines premium taxes due on the policies from the insureds, held them in trust, and timely remitted those taxes to the Comptroller. We believe this system for collecting and paying the required surplus lines premium taxes complies in all respects with the Texas Insurance Code and other regulations, which clearly require that the same party who delivers the policies and collects the premiums will also collect premium taxes, hold premium taxes in trust, and pay premium taxes to the Comptroller. It also complies with long standing industry practice. The Comptroller asserts that TGA is liable for the surplus lines premium taxes related to policy transactions and premiums collected from surplus lines insureds during the audit period and that TGA owes $4.5 million in premium taxes, as well as $0.9 million in penalties and interest for the audit period.

We disagree with the Comptroller and intend to vigorously fight their assertion that TGA is liable for the surplus lines premium taxes. During the past several months we have been engaged in conversations with the Comptroller's counsel and are waiting on the Comptroller's position paper. At this stage, we cannot predict the course of any proceedings, the timing of any rulings or other significant events relating to such surplus lines tax audit. Given these limitations and the inherent difficulty of projecting the outcome of regulatory disputes, we are presently unable to reasonably estimate the possible loss or legal costs that are likely to arise out of the surplus lines tax audit or any future proceedings relating to this matter. Also, based on current information, we believe that a favorable outcome of this dispute is at least reasonably possible. Therefore we have not accrued any amount as of June 30, 2012 related to this matter.

We are engaged in other 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.

**18. Changes in Accumulated Other Comprehensive Income Balances**

The changes in accumulated other comprehensive income balances as of June 30, 2012 and 2011 were as follows (in thousands):

| | Minimum Pension Liability | Unrealized Gains (Loss) | Accumulated Other Comprehensive Income (Loss) |
|---|---|---|---|
| Balance at December 31, 2010 | $ (2,024) | $ 11,661 | $ 9,637 |
| Other comprehensive income (loss): | | | |
| Change in net actuarial loss | 143 | - | 143 |
| Tax effect on change in net actuarial loss | (50) | - | (50) |
| Net unrealized holding losses arising during the period | - | (120) | (120) |
| Tax effect on unrealized losses arising during the period | - | 42 | 42 |
| Reclassification adjustment for gains (losses) included in net income | - | (2,783) | (2,783) |
| Tax effect on reclassification adjustment for gains (losses) included in net income | - | 974 | 974 |
| Other comprehensive income (loss), net of tax | 93 | (1,887) | (1,794) |
| Balance at June 30, 2011 | $ (1,931) | $ 9,774 | $ 7,843 |
| Balance at December 31, 2011 | $ (2,978) | $ 9,424 | $ 6,446 |
| Other comprehensive income (loss): | | | |
| Change in net actuarial loss | 242 | - | 242 |
| Tax effect on change in net actuarial loss | (85) | - | (85) |
| Net unrealized holding gains arising during the period | - | 17 | 17 |
| Tax effect on unrealized gains arising during the period | - | (6) | (6) |
| Reclassification adjustment for gains (losses) included in net income | - | (1,117) | (1,117) |
| Tax effect on reclassification adjustment for gains (losses) included in net income | - | 391 | 391 |
| Other comprehensive income (loss), net of tax | 157 | (715) | (558) |
| Balance at June 30, 2012 | $ (2,821) | $ 8,709 | $ 5,888 |

**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 six business units, which are supported by our 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 and the workers compensation insurance products handled by our Workers Compensation business unit.

- ***Specialty Commercial Segment.*** Our Specialty Commercial Segment includes the excess and surplus lines commercial property/casualty, medical professional liability and satellite launch insurance products and services handled by our E&S Commercial business unit, the general aviation insurance products and services handled by our General Aviation business unit, and the commercial excess liability and umbrella insurance products handled by our Excess & Umbrella business unit.

- ***Personal Segment.*** Our Personal Segment includes the non-standard personal automobile insurance, low value dwelling/homeowners, renters, motorcycle and business auto insurance products and services handled by our Personal Lines business 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 a portion of the risks on the commercial property/casualty and workers compensation policies marketed within the Standard Commercial Segment, retains a portion of the risks on personal policies marketed within the Personal Segment and retains a portion of the risks on the commercial, medical professional liability, aviation and satellite launch 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 and medical professional liability 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 the commercial and aviation property/casualty products marketed within the Specialty Commercial Segment.

- ***Hallmark National Insurance Company ("HNIC")*** was acquired on December 31, 2010. Simultaneous with the closing of the acquisition, HNIC entered into reinsurance contracts with an affiliate of the seller, pursuant to which such affiliate of the seller will handle all claims and assume all liabilities arising under policies issued by HNIC prior to the closing or during a transition period of up to six months following the closing. Commencing January 1, 2011, HNIC retains a portion of the risks on the personal policies marketed within the Personal Segment.

- ***Hallmark County Mutual Insurance Company ("HCM")*** control and management is maintained through our wholly owned subsidiary 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. HCM does not retain any business.

- ***Texas Builders Insurance Company ("TBIC")*** was acquired on July 1, 2011 and retains a portion of the risks on the workers compensation policies marketed within our Standard Commercial Segment.

AHIC, HIC, HSIC and HNIC have entered into a pooling arrangement pursuant to which AHIC retains 33% of the total net premiums written by any of them, HIC retains 28% of our total net premiums written by any of them, HSIC retains 28% of our total net premiums written by any of them and HNIC retains 11% of our total premiums written by any of them. Neither HCM nor TBIC is a party to the intercompany pooling arrangement. 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 six months ended June 30, 2012, our total revenues were $84.6 million and $167.6 million, representing an 8% and 7% increase, respectively, from the $78.5 million and $155.9 million in total revenues for the same period of 2011.  This increase in revenue was primarily attributable to increased earned premium largely from increased production by our E&S Commercial business unit and the acquisition of our Workers Compensation business unit during the third quarter of 2011. These increases in revenue were partially offset by lower net realized gains and lower finance charges and earned premium in our Personal Lines business unit due mostly to the impact of rate increases, the reduction of premium written in Florida and exiting certain other underperforming states and programs.

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The increase in revenue for the three months and six months ended June 30, 2012 was complemented by slightly decreased loss and loss adjustment expenses ("LAE") due primarily to lower current accident year loss trends. During the three months ended June 30, 2012 we recorded $1.6 million unfavorable prior year loss development. During the six months ended June 30, 2012 we recorded $1.4 million of favorable prior year loss development. During the three and six months ended June 30, 2011 we recorded $0.7 million and $15.8 million, respectively, of unfavorable prior year loss development. Of the $15.8 million unfavorable development recognized for the six months ended June 30, 2011, $9.5 million was a result of adverse prior year loss reserve development in our Personal Lines Segment in Florida. In addition, the results for the six months ended June 30, 2012 and 2011 included $10.4 million and $9.4 million, respectively, in net losses from weather related claims.

We reported a $1.8 million net loss attributable to Hallmark for the three months ended June 30, 2012 as compared to $87 thousand net loss attributable to Hallmark for the same period during 2011. We reported a net loss attributable to Hallmark of $1.7 million for the six months ended June 30, 2012, which was $9.6 million lower than the $11.3 million net loss reported for the six months ended June 30, 2011. On a diluted basis per share, we reported a net loss of $0.10 per share for the three months ended June 30, 2012, as compared to net loss of $0.00 per share for the same period in 2011. On a diluted basis per share, net loss per share was $0.09 for the six months ended June 30, 2012 as compared to net loss per share of $0.56 for the same period during 2011. We reported an income tax benefit of $2.3 million, or an effective income tax rate of 59.2%, for the six months ended June 30, 2012, as compared to income tax benefit of $9.7 million, or an effective rate of 46.1%, for the same period during 2011.

**Second Quarter 2012 as Compared to Second Quarter 2011**

The following is additional business segment information for the three months ended June 30, 2012 and 2011 (in thousands):

**Hallmark Financial Services, Inc**

**Consolidated Segment Data**

| | Three Months Ended June 30, 2012 | | | | |
|---|---|---|---|---|---|
| | Standard Commercial Segment | Specialty Commercial Segment | Personal Segment | Corporate | Consolidated |
| Gross premiums written | $20,739 | $ 61,456 | $18,620 | - | $ 100,815 |
| Ceded premiums written | (1,730 ) | (13,749 ) | (199 ) | - | (15,678 ) |
| Net premiums written | 19,009 | 47,707 | 18,421 | - | 85,137 |
| Change in unearned premiums | (2,369 ) | (7,017 ) | 2,498 | - | (6,888 ) |
| Net premiums earned | 16,640 | 40,690 | 20,919 | - | 78,249 |
| Total revenues | 17,924 | 43,046 | 22,905 | 696 | 84,571 |
| Losses and loss adjustment expenses | 13,013 | 28,286 | 19,930 | - | 61,229 |
| Pre-tax income (loss), net of non-controlling interest | (710 ) | 2,929 | (4,211 ) | (2,202 ) | (4,194 ) |
| Net loss ratio (1) | 78.2 % | 69.5 % | 95.3 % | | 78.2 % |
| Net expense ratio (1) | 34.2 % | 28.4 % | 28.8 % | | 30.5 % |
| Net combined ratio (1) | 112.4 % | 97.9 % | 124.1 % | | 108.7 % |

| | Three Months Ended June 30, 2011 | | | | |
|---|---|---|---|---|---|
| | Standard Commercial Segment | Specialty Commercial Segment | Personal Segment | Corporate | Consolidated |
| Gross premiums written | $18,549 | $ 48,533 | $24,289 | - | $ 91,371 |
| Ceded premiums written | (1,392 ) | (10,877 ) | (146 ) | - | (12,415 ) |
| Net premiums written | 17,157 | 37,656 | 24,143 | - | 78,956 |
| Change in unearned premiums | (1,796 ) | (5,171 ) | (411 ) | - | (7,378 ) |
| Net premiums earned | 15,361 | 32,485 | 23,732 | - | 71,578 |

| | | | | | |
|---|---|---|---|---|---|
| Total revenues | 16,241 | 34,476 | 25,869 | 1,927 | 78,513 |
| Losses and loss adjustment expenses | 15,789 | 23,549 | 22,582 | - | 61,920 |
| Pre-tax income (loss), net of non-controlling interest | (4,767 ) | 812 | (4,620 ) | (776 ) | (9,351 ) |
| Net loss ratio (1) | 102.8 % | 72.5 % | 95.2 % | | 86.5 % |
| Net expense ratio (1) | 34.0 % | 30.6 % | 27.7 % | | 31.9 % |
| Net combined ratio (1) | 136.8 % | 103.1 % | 122.9 % | | 118.4 % |

(1) 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 $20.7 million for the three months ended June 30, 2012, which was $2.2 million, or 12%, more than the $18.5 million reported for the same period in 2011. Net premiums written were $19.0 million for the three months ended June 30, 2012 as compared to $17.2 million reported for the same period in 2011. The increase in premium volume was primarily due to the acquisition of our Workers Compensation business unit during the third quarter of 2011.

Total revenue for the Standard Commercial Segment of $17.9 million for the three months ended June 30, 2012 was $1.7 million more than the $16.2 million reported during the same period in 2011. This 10% increase in total revenue was mostly due to increased net premiums earned of $1.3 million due primarily to the acquisition of our Workers Compensation business unit during the third quarter of 2011, higher net investment income of $0.3 million, and a $0.1 million lower adverse profit share commission revenue adjustment as compared to the second quarter of 2011.

Our Standard Commercial Segment reported a pre-tax loss of $0.7 million for the three months ended June 30, 2012 as compared to a pre-tax loss of $4.8 million for the same period of 2011. This decrease in pre-tax loss was primarily the result of lower loss and LAE of $2.8 million and the increased revenue discussed above, partially offset by higher operating expenses of $0.4 million due primarily to the acquisition of our Workers Compensation business unit during the third quarter of 2011.

The Standard Commercial Segment reported a net loss ratio of 78.2% for the three months ended June 30, 2012 as compared to 102.8% for the same period of 2011. The gross loss ratio before reinsurance for the three months ended June 30, 2012 was 86.4% as compared to the 90.3% reported for the same period of 2011. The decrease in the net loss ratio was impacted by lower current accident year loss trends excluding catastrophe losses during the second quarter of 2012 as compared to the same period in 2011. The gross and net loss results for the three months ended June 30, 2012 and 2011 include $4.8 million and $3.7 million, respectively, of weather related losses. During the three months ended June 30, 2012, the Standard Commercial Segment reported unfavorable loss reserve development of $0.2 million as compared to $0.8 million favorable loss development during the same period of 2011.

***Specialty Commercial Segment***

The $43.0 million of total revenue for the three months ended June 30, 2012 was $8.5 million higher than the $34.5 million reported by the Specialty Commercial Segment for the same period in 2011. This increase in revenue was primarily due to higher net premiums earned of $8.2 million largely from increased production in our E&S Commercial business unit, Excess & Umbrella business unit and a new space risk program entered into during the first quarter of 2011. Further contributing to this increased revenue was higher net investment income of $0.4 million.

Pre-tax income for the Specialty Commercial Segment of $2.9 million for the second quarter of 2012 was $2.1 million higher than the $0.8 million reported for the same period in 2011. The increase in pre-tax income was primarily due to the increased revenue discussed above partially offset by higher loss and LAE expenses of $4.7 million and higher operating expenses of $1.8 million. Our E&S Commercial business unit reported a $6.2 million increase in loss and LAE due primarily to increased premium production as well as higher current accident year loss trends. Our General Aviation business unit reported a $1.9 million decrease in loss and LAE due primarily to weather related losses during the three months ended June 30, 2011, as well as increased favorable prior year loss development of $2.7 million during the three months ended June 30, 2012 as compared to $2.1 million favorable development recognized during the second quarter of 2011, partially offset by higher current accident year loss trends. The increase in operating expenses for the three months ended June 30, 2012 were primarily the result of increased production related expenses of $1.5 million and increased salary and related expenses of $0.3 million.

The Specialty Commercial Segment reported a net loss ratio of 69.5% for the three months ended June 30, 2012 as compared to 72.5% for the same period during 2011. The gross loss ratio before reinsurance was 66.1% for the three months ended June 30, 2012 as compared to 68.8% for the same period in 2011. Our E&S Commercial business unit reported $2.6 million and $2.1 million of unfavorable prior years' loss development, respectively, for the three months ended June 30, 2012 and 2011. Our General Aviation business unit reported $2.7 million and $2.1 million of favorable prior years' loss development, respectively, for the three months ended June 30, 2012 and 2011.

***Personal Segment***

Net premiums written for our Personal Segment decreased $5.7 million during the second quarter of 2012 to $18.4 million compared to $24.1 million for the second quarter of 2011. The decrease in premium was due mostly to the impact of rate increases, the reduction of premium written in Florida and exiting certain other underperforming states and programs. Total revenue for the Personal Segment decreased 11% to $22.9 million for the second quarter of 2012 from $25.9 million for the second quarter of 2011. Lower earned premium of $2.8 million and lower finance charges of $0.2 million were the primary reason for the decrease in revenue for the period.

Pre-tax loss for the Personal Segment was $4.2 million for the three months ended June 30, 2012 as compared to pre-tax loss of $4.6 million for the same period of 2011. The decreased pre-tax loss was driven by decreased losses and LAE of $2.7 million and lower operating expenses of $0.7 million due mostly to decreased production related expense, partially offset by the lower revenue discussed above.

The Personal Segment reported a net loss ratio of 95.3% for the three months ended June 30, 2012 as compared to 95.2% for the second quarter of 2011. The loss ratio for the three months ended June 30, 2012 includes favorable current accident year loss trends in our non-standard auto line of business offset by increased weather and fire related losses in our low value dwelling/homeowners line of business. The loss and LAE during the three months ended June 30, 2012 and 2011 included $1.5 million of adverse prior year development. The Personal Segment reported a net expense ratio of 28.8% for the three months ended June 30, 2012 as compared to 27.7% for the second quarter of 2011. The increase in the expense ratio was due predominately to growth in headcount.

***Corporate***

Total revenue for Corporate decreased by $1.2 million for the three months ended June 30, 2012 as compared to the same period the prior year. This decrease in total revenue was due to lower net investment income of $0.5 million and lower net realized gains of $0.7 million for the three months ended June 30, 2012 as compared to the same period of the prior year.

Corporate pre-tax loss was $2.2 million for the three months ended June 30, 2012 as compared to $0.8 million pre-tax loss for the same period the prior year. The increase in pre-tax loss was the result of the decreased revenue discussed above and higher operating expenses of $0.2 million due primarily to an adjustment to the expected earn-out payable in conjunction with the acquisition of HNIC during the second quarter of 2011.

**Six Months Ended June 30, 2012 as Compared to Six Months Ended June 30, 2011**

The following is additional business segment information for the six months ended June 30, 2012 and 2011 (in thousands):

**Hallmark Financial Services, Inc.**

**Consolidated Segment Data**

| | Six Months Ended June 30, 2012 | | | | |
|---|---|---|---|---|---|
| | Standard Commercial Segment | Specialty Commercial Segment | Personal Segment | Corporate | Consolidated |
| Gross premiums written | $39,586 | $ 116,341 | $42,283 | - | $ 198,210 |
| Ceded premiums written | (3,187 ) | (24,563 ) | (361 ) | - | (28,111 ) |
| Net premiums written | 36,399 | 91,778 | 41,922 | - | 170,099 |
| Change in unearned premiums | (2,930 ) | (13,053 ) | 1,341 | - | (14,642 ) |
| Net premiums earned | 33,469 | 78,725 | 43,263 | - | 155,457 |
| Total revenues | 36,030 | 83,439 | 47,336 | 752 | 167,557 |
| Losses and loss adjustment expenses | 26,777 | 51,295 | 37,948 | - | 116,020 |
| Pre-tax income (loss), net of non-controlling interest | (2,072 ) | 8,906 | (5,402 ) | (5,432 ) | (4,000 ) |
| Net loss ratio (1) | 80.0 % | 65.2 % | 87.7 % | | 74.6 % |
| Net expense ratio (1) | 34.0 % | 28.7 % | 28.1 % | | 30.5 % |
| Net combined ratio (1) | 114.0 % | 93.9 % | 115.8 % | | 105.1 % |

| | Six Months Ended June 30, 2011 | | | | |
|---|---|---|---|---|---|
| | Standard Commercial Segment | Specialty Commercial Segment | Personal Segment | Corporate | Consolidated |
| Gross premiums written | $36,004 | $ 88,615 | $56,464 | - | $ 181,083 |
| Ceded premiums written | (2,564 ) | (18,597 ) | (4,732 ) | - | (25,893 ) |
| Net premiums written | 33,440 | 70,018 | 51,732 | - | 155,190 |
| Change in unearned premiums | (2,187 ) | (6,318 ) | (4,994 ) | - | (13,499 ) |
| Net premiums earned | 31,253 | 63,700 | 46,738 | - | 141,691 |

| | | | | | |
|---|---|---|---|---|---|
| Total revenues | 33,668 | 67,619 | 50,919 | 3,715 | 155,921 |
| Losses and loss adjustment expenses | 28,414 | 43,350 | 53,941 | - | 125,705 |
| Pre-tax income (loss), net of non-controlling interest | (5,150 ) | 4,263 | (17,804) | (2,259 ) | (20,950 ) |
| Net loss ratio (1) | 90.9 % | 68.1 % | 115.4 % | | 88.7 % |
| Net expense ratio (1) | 32.7 % | 30.4 % | 25.8 % | | 31.2 % |
| Net combined ratio (1) | 123.6 % | 98.5 % | 141.2 % | | 119.9 % |

(1) 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 $39.6 million for the six months ended June 30, 2012, which was $3.6 million, or 10%, more than the $36.0 million reported for the same period in 2011. Net premiums written were $36.4 million for the six months ended June 30, 2012 as compared to $33.4 million reported for the same period in 2011. The increase in premium volume was primarily due to the acquisition of our Workers Compensation business unit during the third quarter of 2011.

Total revenue for the Standard Commercial Segment of $36.0 million for the six months ended June 30, 2012 was $2.3 million more than the $33.7 million reported during the same period in 2011. This 7% increase in total revenue was mostly due to increased net premiums earned of $2.2 million due primarily to the acquisition of our Workers Compensation business unit during the third quarter of 2011, higher net investment income of $0.5 million, partially offset by an adverse profit share commission revenue adjustment of $0.1 million during the second quarter of 2012 related to unfavorable development on the treaty year beginning July 1, 2003 as compared to a $0.2 million favorable profit share commission adjustment during the same period the prior year.

Our Standard Commercial Segment reported a pre-tax loss of $2.1 million for the six months ended June 30, 2012 as compared to pre-tax loss of $5.2 million for the same period of 2011. Lower loss and LAE expenses of $1.6 million and increased revenue contributed to this decrease in pre-tax loss for the six months ended June 30, 2012. Partially offsetting the decline in pre-tax loss were higher operating expenses of $0.9 million primarily due to the acquisition of our Workers Compensation business unit during the third quarter of 2011.

The Standard Commercial Segment reported a net loss ratio of 80.0% for the six months ended June 30, 2012 as compared to 90.9% for the same period in 2011. The gross loss ratio before reinsurance for the six months ended June 30, 2012 was 79.3% as compared to the 92.3% reported for the same period of 2011. The lower gross and net loss ratios for the six months ended June 30, 2012 were aided by lower current accident year loss trends excluding catastrophe losses. The gross and net loss results for the six months ended June 30, 2012 and 2011 include $8.8 million and $6.7 million, respectively, of weather related losses. During the six months ended June 30, 2012 the Standard Commercial Segment reported favorable loss reserve development of $2.8 million, as compared to unfavorable development of $0.5 million for the same period during 2011.

***Specialty Commercial Segment***

The $83.4 million of total revenue for the Specialty Commercial Segment during the six months ended June 30, 2012 was $15.8 million higher than the $67.6 million reported for the same period in 2011. This increase in revenue was due to higher net premiums earned of $15.0 million due predominately to increased production in our E&S

Commercial business unit, Excess & Umbrella business unit and a new space risk program entered into during the first quarter of 2011. Further contributing to this increased revenue was higher net investment income of $0.7 million.

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Pre-tax income for the Specialty Commercial Segment of $8.9 million for the first six months of 2012 was $4.6 million higher than the $4.3 million reported for the same period in 2011. The increase in pre-tax income was primarily due to the increased revenue discussed above partially offset by higher loss and LAE expenses of $7.9 million and higher operating expenses of $3.3 million. Our E&S Commercial business unit reported a $9.6 million increase in loss and LAE due primarily to increased premium volume as well as higher current accident year loss trends. Our General Aviation business unit reported a $2.2 million decrease in loss and LAE due primarily to weather related losses during the six months ended June 30, 2011, as well as favorable prior year loss development of $2.7 million during the six months ended June 30, 2012 as compared to $2.1 million favorable development recognized during the same period the prior year, partially offset by higher current accident year loss trends. The increased operating expenses for the first six months of 2012 were primarily the result of increased production related expenses of $2.8 million and higher salary and related expense of $0.5 million.

The Specialty Commercial Segment reported a net loss ratio of 65.2% for the six months ended June 30, 2012 as compared to 68.1% for the same period during 2011. The lower net loss ratio was impacted by lower weather related claims for the six months ended June 30, 2012, partially offset by higher current accident year loss trends predominately in our commercial auto and general aviation lines of business. The Specialty Commercial Segment reported $0.9 million of favorable prior year development for the six months ended June 30, 2012 as compared to $1.0 million of unfavorable development for the same period during 2011.

***Personal Segment***

Net premiums written for our Personal Segment decreased $9.8 million during the first six months of 2012 to $41.9 million compared to $51.7 million for the first six months of 2011. The decrease in premium was due mostly to the impact of rate increases, the reduction of premium written in Florida and exiting certain other underperforming states and programs. Total revenue for the Personal Segment decreased 7% to $47.3 million for the first six months of 2012 from $50.9 million for the first six months of 2011. Lower earned premium of $3.5 million and lower finance charges of $0.2 million were the primary reason for the decrease in revenue for the period. The decrease in revenue was partially offset by increased net investment income of $0.1 million during the first six months of 2012.

Pre-tax loss for the Personal Segment was $5.4 million for the six months ended June 30, 2012 as compared to pre-tax loss of $17.8 million for the same period of 2011. The lower pre-tax loss was the result of lower losses and LAE of $16.0 million partially offset by lower revenue discussed above.

The Personal Segment reported a net loss ratio of 87.7% for the six months ended June 30, 2012 as compared to 115.4% for the same period of 2011. The decrease in the net loss ratio was primarily due to normalizing claims experience during the first six months of 2012 as compared to extremely adverse claims development during the same period in 2011 due to rapid growth in the Florida claim volume and the complexity related to Florida personal injury protection claims. The net loss ratio for our Florida related business was 314.0% for the six months ended June 30,

2011, which equates to approximately 39.6% of the net loss ratio reported as of June 30, 2011. The loss ratio for the six months ended June 30, 2012 included improving current accident year loss trends in our non-standard auto line of business partially offset by increased weather and fire related losses in our low value dwelling/homeowners line of business. The loss and LAE during the six months ended June 30, 2012 included $2.3 million of adverse prior year development as compared to $14.3 million of adverse prior year development for the same period during 2011. The Personal Segment reported a net expense ratio of 28.1% for the six months ended June 30, 2012 as compared to 25.8% for the same period of 2011. The increase in the expense ratio was due predominately to growth in headcount.

***Corporate***

Total revenue for Corporate decreased by $3.0 million for the six months ended June 30, 2012 as compared to the same period the prior year. This decrease in total revenue was due primarily to gains of $0.9 million recognized on our investment portfolio for the six months ended June 30, 2012 as compared to $2.8 million of gains recognized during the same period in 2011. Further contributing to this decrease in revenue was lower net investment income of $1.3 million for the six months ended June 30, 2012 as compared to the same period of the prior year.

Corporate pre-tax loss was $5.4 million for the six months ended June 30, 2012 as compared to a $2.3 million pre-tax loss for the same period the prior year. The increase in pre-tax loss was the result of the decreased revenue discussed above and higher operating expenses of $0.2 million due to a reduced adjustment to the expected earn-out payable in conjunction with the acquisition of HNIC during the six months ended June 30, 2012 as compared to the same period the prior year.

**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 June 30, 2012, Hallmark had $4.2 million in unrestricted cash and invested assets at the holding company. Unrestricted cash and invested assets of our non-insurance subsidiaries were $5.6 million as of June 30, 2012. As of that date, our insurance subsidiaries held $66.4 million of cash and cash equivalents as well as $399.1 million in debt securities with an average modified duration of 2.9 years. Accordingly, we do not anticipate selling long-term debt instruments to meet any liquidity needs.

AHIC and TBIC, domiciled in Texas, are limited in the payment of dividends to their stockholders 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 policyholders’ 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 policyholders’ 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 policyholders’ surplus or prior year’s statutory net income, not including realized capital gains, without prior written approval from the Oklahoma Insurance Department. HNIC, domiciled in Ohio, is limited in the

payment of dividends to the greater of 10% of statutory policyholders' surplus as of the prior December 31 or statutory net income as of the prior December 31 without prior written approval from the Ohio Insurance Department. During 2012, the aggregate ordinary dividend capacity of these subsidiaries is $20.3 million, of which $15.0 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 six months of 2012 or the 2011 fiscal year.

***Comparison of June 30, 2012 to December 31, 2011***

On a consolidated basis, our cash and investments (excluding restricted cash) at June 30, 2012 were $516.0 million compared to $499.1 million at December 31, 2011. The acquisition of debt securities for which $6.2 million settled subsequent to quarter end and a $6.5 million federal income tax refund during the second quarter of 2012 were the primary reasons for this increase, as well as other cash flow from operations.

***Comparison of Six Months Ended June 30, 2012 and June 30, 2011***

Net cash provided by our consolidated operating activities was $17.2 million for the first six months of 2012 compared to net cash provided by operating activities of $11.0 million for the first six months of 2011. The increase in operating cash flow was primarily due to a $6.5 million federal income tax refund during the second quarter of 2012.

Net cash used in investing activities during the first six months of 2012 and 2011 was $12.8 million and $15.7 million, respectively. The decrease in cash used in investing activities during the first six months of 2012 was due to a decrease in purchases of debt and equity securities of $90.7 million, a $14.0 million payment for the acquisition of HNIC during the first quarter 2011, and a decrease in purchases of property and equipment of $1.0 million, partially offset by a decrease in maturities, sales and redemptions of investment securities of $102.5 million and a $0.3 million increase in transfers to restricted cash.

Cash used in financing activities during the first three months of 2012 was $2.6 million as a result of a $2.5 million repayment on our revolving credit facility and a distribution to non-controlling interest for our Excess & Umbrella business unit. Cash used in financing activities during the first six months of 2011 was $5.0 million primarily related to the repurchase of the Company's common stock during the second quarter of 2011.

***Credit Facilities***

Our First Restated Credit Agreement with The Frost National Bank dated January 27, 2006, as amended to date, provides a revolving credit facility of $15.0 million. We pay interest on the outstanding balance at our election at a rate of the prime rate or LIBOR plus 2.5%. We pay an annual 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. We are in compliance with or have obtained waivers of all of our covenants. As of June 30, 2012, the balance on the revolving note was $1.6 million. The revolving note currently bears interest at 2.97% per annum.

***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 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 uncollaterized and do not require maintenance of minimum financial covenants. As of June 30, 2012, 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 uncollaterized and do not require maintenance of minimum financial covenants. As of June 30, 2012, the balance of our Trust II subordinated debt was $25.8 million.

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

There have been no material changes to the market risks discussed in Item 7A to Part II of our Form 10-K for the fiscal year ended December 31, 2011.

**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.**

In December 2010, our E&S Commercial business unit was informed by the Texas Comptroller of Public Accounts that a surplus lines tax audit covering the period January 1, 2007 through December 31, 2009 was complete. A subsidiary within our E&S Commercial business unit (“TGA”) frequently acts as a managing general underwriter (“MGU”) authorized to underwrite policies on behalf of Republic Vanguard Insurance Company and HSIC, both Texas eligible surplus lines insurance carriers. In its role as the MGU, TGA underwrites policies on behalf of these carriers while other agencies located in Texas, generally referred to as “producing agents,” deliver the policies to the insureds and collect all premiums due from the insureds. During the period under audit, the producing agents also collected the surplus lines premium taxes due on the policies from the insureds, held them in trust, and timely remitted those taxes to the Comptroller. We believe this system for collecting and paying the required surplus lines premium taxes complies in all respects with the Texas Insurance Code and other regulations, which clearly require that the same party who delivers the policies and collects the premiums will also collect premium taxes, hold premium taxes in trust, and pay premium taxes to the Comptroller. It also complies with long standing industry practice. The Comptroller asserts that TGA is liable for the surplus lines premium taxes related to policy transactions and premiums collected from surplus lines insureds during the audit period and that TGA owes $4.5 million in premium taxes, as well as $0.9 million in penalties and interest for the audit period.

We disagree with the Comptroller and intend to vigorously fight their assertion that TGA is liable for the surplus lines premium taxes. During the past several months we have been engaged in conversations with the Comptroller's counsel and are waiting on the Comptroller's position paper. At this stage, we cannot predict the course of any proceedings, the timing of any rulings or other significant events relating to such surplus lines tax audit. Given these limitations and the inherent difficulty of projecting the outcome of regulatory disputes, we are presently unable to reasonably estimate the possible loss or legal costs that are likely to arise out of the surplus lines tax audit or any future proceedings relating to this matter. Also, based on current information, we believe that a favorable outcome of this dispute is at least reasonably possible. Therefore we have not accrued any amount as of June 30, 2012 related to this matter.

We are engaged in other 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.**

There have been no material changes to the risk factors discussed in Item 1A to Part 1 of our Form 10-K for the fiscal year ended December 31, 2011.

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

None.

**Item 3. Defaults Upon Senior Securities.**

None.

**Item 4. Mine Safety Disclosures.**

None.

**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). |
| 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). |
| 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. |
| 101 + | Interactive Data files |
| + | XBRL Interactive Data files with detailed tagging will be filed by amendment to this Quarterly Report on Form 10-Q within 30 days of the filing date of this Quarterly Report on Form 10-Q, as permitted by Rule 405(a)(2) of Regulation S-T. |

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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)

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|---|---|
| Date: August 6, 2012 | /s/ Mark J. Morrison<br>Mark J. Morrison, Chief Executive Officer and President |
| Date: August 6, 2012 | /s/ Jeffrey R. Passmore<br>Jeffrey R. Passmore, Chief Accounting Officer and Senior Vice President |