HALLMARK FINANCIAL SERVICES INC
Form S-1/A
September 08, 2006

Table of Contents

As filed with the Securities and Exchange Commission on September 8, 2006

Registration No. 333-136414

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Amendment No. 1
to
Form S-1
REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933

HALLMARK FINANCIAL SERVICES, INC.
(Exact name of registrant as specified in its charter)

Nevada	**6331**	**87-0447375**
(State or other jurisdiction of incorporation or organization)	*(Primary Standard Industrial Classification Code Number)*	*(I.R.S. Employer Identification Number)*

777 Main Street
Suite 1000
Fort Worth, Texas 76102
(817) 348-1600
(Address, including zip code, and telephone number, including area code, of registrant s principal executive offices)

MARK J. MORRISON
President and Chief Executive Officer
HALLMARK FINANCIAL SERVICES, INC.
777 Main Street
Suite 1000
Fort Worth, Texas 76102
(817) 348-1600
(Name, address, including zip code, and telephone number, including area code, of agent for service)
Copies to:

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DALLAS, TEXAS 75201	**CHICAGO, ILLINOIS 60603**
(214) 954-6800	**(312) 853-7000**

Approximate date of commencement of proposed sale to the public: As soon as practicable after the effective date of this Registration Statement.

If any of the securities being registered on this Form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933, check the following box. o

If this Form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, please check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. o

If this Form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. o

If this Form is a post-effective amendment filed pursuant to Rule 462(d) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. o

The Registrant hereby amends this Registration Statement on such date or dates as may be necessary to delay its effective date until the Registrant shall file a further amendment which specifically states that this Registration Statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act of 1933, as amended, or until the Registration Statement shall become effective on such date as the Commission, acting pursuant to said Section 8(a), may determine.

Table of Contents

The information in this prospectus is not complete and may be changed. We may not sell these securities until the Securities and Exchange Commission declares our registration statement effective. This prospectus is not an offer to sell these securities and is not soliciting an offer to buy these securities in any state where the offer or sale is not permitted.

Subject to completion, dated September 8, 2006

6,750,000 Shares
Common Stock
$ per share

Hallmark Financial Services, Inc. is offering 3,375,000 shares and the selling stockholder is offering 3,375,000 shares. We will not receive any proceeds from the sale of our shares by the selling stockholder.

The last reported sale price of our common stock on September 6, 2006 was $10.35 per share.

Current trading symbol: American Stock Exchange HAF.

We have applied to have our stock listed on the Nasdaq Global Market under the symbol HALL.

This investment involves risk. See Risk Factors beginning on page 14.

	Per Share	Total
Public offering price	$	$
Underwriting discount	$	$
Proceeds, before expenses, to Hallmark Financial Services, Inc.	$	$
Proceeds, before expenses, to the selling stockholder	$	$

The underwriters have a 30-day option to purchase up to 1,012,500 additional shares of common stock from the selling stockholder to cover over-allotments, if any.

Neither the Securities and Exchange Commission nor any state insurance or securities commission has approved or disapproved of these securities or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

Piper Jaffray
William Blair & Company
Keefe, Bruyette & Woods
Raymond James

The date of this prospectus is , 2006.

TABLE OF CONTENTS

	Page
Special Note Regarding Forward-Looking Statements	ii
Prospectus Summary	1
Risk Factors	14
Use of Proceeds	24
Price Range of Our Common Stock	25
Dividend Policy	26
Capitalization	27
Selected Financial Data	28
Unaudited Pro Forma Financial Information	30
Management s Discussion and Analysis of Financial Condition and Results of Operations	32
Business	49
Management	75
Executive Compensation	80
Certain Relationships and Related Transactions	86
Principal and Selling Stockholder	88
Description of Capital Stock	90
Shares Eligible for Future Sale	93
Underwriting	94
Legal Matters	96
Experts	96
Where You Can Find More Information	96
Index to Financial Statements	F-1

Form of Underwriting Agreement
Restated Articles of Incorporation
Specimen Certificate for Common Stock
Opinion of McGuire, Craddock & Strother, P.C.
List of Subsidiaries
Consent of KPMG LLP
Consent of KPMG LLP

You should rely only on the information contained in this prospectus. We have not, and the underwriters and the selling stockholder have not, authorized any other person to provide you with different information. If anyone provides you with different or inconsistent information, you should not rely on it. We are not, the selling stockholder is not and the underwriters are not, making an offer to sell these securities in any jurisdiction where the offer or sale is not permitted. You should assume that the information appearing in this prospectus is accurate only as of the date on the front cover of this prospectus. Our business, financial condition, results of operations and prospects may have changed since that date.

Table of Contents

SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This prospectus contains certain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, which are intended to be covered by the safe harbors created thereby. Forward-looking statements include statements which are predictive in nature, which depend upon or refer to future events or conditions, or which include words such as expect, anticipate, intend, plan, believe, estimate or similar expres 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. Statements regarding the following subjects are forward-looking by their nature:

- our business and growth strategies;
- our performance goals;
- our projected financial condition and operating results;
- our understanding of our competition;
- industry and market trends;
- the impact of technology on our products, operations and business;
- use of the proceeds of this offering; and
- any other statements or assumptions that are not historical facts.

The forward-looking statements included in this prospectus are based on current expectations that involve numerous risks and uncertainties. Assumptions relating to these forward-looking statements 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 these 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 prospectus will prove to be accurate. In light of the significant uncertainties inherent in these forward-looking statements, 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.

Table of Contents

PROSPECTUS SUMMARY

The items in the following summary are described in more detail later in this prospectus. This summary provides an overview of selected information and does not contain all the information you should consider. Therefore, you should also read the more detailed information set out in this prospectus, including the sections entitled Special Note Regarding Forward-Looking Statements and Risk Factors, as well as the financial statements and related notes included in this prospectus. Unless the context requires otherwise, in this prospectus, the term Hallmark refers solely to Hallmark Financial Services, Inc. and the terms we, our, and us refer to Hallmark and its subsidiaries. Our four operating units described in this prospectus are referred to as our HGA Operating Unit, our TGA Operating Unit, our Phoenix Operating Unit and our Aerospace Operating Unit, while the subsidiaries comprising these operating units and our insurance company subsidiaries are referred to in the manner identified in the operational structure chart on page 8.

Who We Are

We are a diversified property/casualty insurance group that serves businesses and individuals in specialty and niche markets. We primarily offer commercial insurance, general aviation insurance and non-standard personal automobile insurance in selected market subcategories. We structure our products with the intent to retain low-severity and short-tailed risks. We focus on marketing, distributing, underwriting and servicing commercial and personal property/casualty insurance products that require specialized underwriting expertise or market knowledge. We believe this approach provides us the best opportunity to achieve favorable policy terms and pricing.

We market, distribute, underwrite and service our commercial and personal property/casualty insurance products through four operating units, each of which has a specific focus. Our HGA Operating Unit primarily handles standard commercial insurance, our TGA Operating Unit concentrates on excess and surplus lines commercial insurance, our Phoenix Operating Unit focuses on non-standard personal automobile insurance and our Aerospace Operating Unit specializes in general aviation insurance. The subsidiaries comprising our TGA Operating Unit and our Aerospace Operating Unit were acquired effective January 1, 2006. The insurance policies produced by our four operating units are written by our three insurance company subsidiaries as well as unaffiliated insurers.

Each operating unit has its own management team with significant experience in distributing products to its target markets and proven success in achieving underwriting profitability and providing efficient claims management. Each operating unit is responsible for marketing, distribution, underwriting and claims management while we provide capital management, reinsurance, actuarial, investment, financial reporting, technology and legal services and back office support at the parent level. We believe this approach optimizes our operating results by allowing us to effectively penetrate our selected specialty and niche markets while maintaining operational controls, managing risks, controlling overhead and efficiently allocating our capital across operating units.

We expect future growth to be derived from increased retention of the premiums we write, organic growth in premium produced by our existing operating units and selected, opportunistic acquisitions that meet our criteria. In 2005, we increased the capital of our insurance company subsidiaries, enabling them to retain significantly more of the business produced by our operating units. For the six months ended June 30, 2006, 63.6% of the total premium produced by our operating units was retained by our insurance company subsidiaries, while the remaining 36.4% was written for or ceded to unaffiliated insurers. We expect to continue to increase our retention of the total premium produced by our

Table of Contents

operating units. We believe increasing our overall retention will drive greater near-term profitability than focusing solely on growth in premium production and market share.

What We Do

We market commercial and personal property/casualty insurance products which are tailored to the risks and coverages required by the insured. We believe that most of our target markets are underserved by larger property/casualty insurers because of the specialized nature of the underwriting required. We are able to offer these products profitably as a result of the expertise of our experienced underwriters. We also believe our long-standing relationships with independent general agencies and retail agents and the service we provide differentiate us from larger property/casualty insurers.

Our HGA Operating Unit primarily underwrites low-severity, short-tailed commercial property/casualty insurance products in the standard market. These products have historically produced stable loss results and include general liability, commercial automobile, commercial property and umbrella coverages. Our HGA Operating Unit markets its products through a network of approximately 165 independent agents primarily serving businesses in the non-urban areas of Texas, New Mexico, Oregon, Idaho, Montana and Washington as of June 30, 2006.

Our TGA Operating Unit primarily offers commercial property/casualty insurance products in the excess and surplus lines, or non-admitted, market. Excess and surplus lines insurance provides coverage for difficult to place risks that do not fit the underwriting criteria of insurers operating in the standard market. Our TGA Operating Unit focuses on small- to medium-sized commercial businesses that do not meet the underwriting requirements of standard insurers due to factors such as loss history, number of years in business, minimum premium size and types of business operation. Our TGA Operating Unit primarily writes general liability and commercial automobile policies, but also offers commercial property, dwelling fire, homeowners and non-standard personal automobile coverages. Our TGA Operating Unit markets its products through 36 independent general agencies with offices in Texas, Louisiana and Oklahoma, as well as approximately 825 independent retail agents in Texas, as of June 30, 2006.

Our Phoenix Operating Unit offers non-standard personal automobile policies which generally provide the minimum limits of liability coverage mandated by state law to drivers who find it difficult to obtain insurance from standard carriers due to various factors including age, driving record, claims history or limited financial resources. Our Phoenix Operating Unit markets this non-standard personal automobile insurance through approximately 920 independent retail agents in Texas, New Mexico, Arizona, Oklahoma and Idaho as of June 30, 2006.

Our Aerospace Operating Unit offers general aviation property/casualty insurance primarily for private and small commercial aircraft and airports. The aircraft liability and hull insurance products underwritten by our Aerospace Operating Unit target transitional or non-standard pilots who may have difficulty obtaining insurance from a standard carrier. Airport liability insurance is marketed to smaller, regional airports. Our Aerospace Operating Unit markets these general aviation insurance products through approximately 215 independent specialty brokers in 48 states as of June 30, 2006.

Our insurance company subsidiaries are American Hallmark Insurance Company of Texas (AHIC), Phoenix Indemnity Insurance Company (PIIC) and Gulf States Insurance Company (GSIC). Effective January 1, 2006, our insurance company subsidiaries entered into a pooling arrangement pursuant to which AHIC would retain 59.9% of the net premiums written, PIIC would retain 34.1% of the net premiums written and GSIC would retain 6.0% of the net premiums written. As of June 5, 2006,

A.M. Best Company, Inc. (A.M. Best), a nationally recognized insurance industry rating service and publisher, pooled its ratings of our three insurance company subsidiaries and assigned a financial strength rating of A- (Excellent) and an issuer credit rating of a- to each of our individual insurance company subsidiaries and to the pool formed by our insurance company subsidiaries.

The following table displays the gross premiums produced by our four operating units for affiliated and unaffiliated insurers for the years ended December 31, 2003 through 2005 and the six months ended June 30, 2005 and 2006, as well as the gross premiums written and net premiums written by our insurance subsidiaries for our four operating units for the same periods:

	Six Months Ended June 30,		Year Ended December 31,		
	2006	2005	2005	2004	2003
	(unaudited)		(in thousands)		
Gross Premiums Produced:					
HGA Operating Unit	$ 47,152	$ 42,547	$ 81,721	$ 75,808	$ 68,519
TGA Operating Unit[1]	58,429				
Phoenix Operating Unit	21,838	19,365	36,345	43,497	55,745
Aerospace Operating Unit[1]	15,861				
Total	$ 143,280	$ 61,912	$ 118,066	$ 119,305	$ 124,264
Gross Premiums Written:					
HGA Operating Unit[2]	$ 46,917	$	$ 52,952	$	$
TGA Operating Unit[1]	26,505				
Phoenix Operating Unit	21,838	19,473	36,515	33,389	43,338
Aerospace Operating Unit[1]	351				
Total	$ 95,611	$ 19,473	$ 89,467	$ 33,389	$ 43,338
Net Premiums Written:					
HGA Operating Unit[2]	$ 43,065	$	$ 51,249	$	$
TGA Operating Unit[1]	25,943				
Phoenix Operating Unit	21,838	19,473	37,003	33,067	36,569
Aerospace Operating Unit[1]	325				
Total	$ 91,171	$ 19,473	$ 88,252	$ 33,067	$ 36,569

(1) The subsidiaries comprising these operating units were acquired effective January 1, 2006 and, therefore, are not included in the six months ended June 30, 2005 or the years ended December 31, 2005, 2004 and 2003.

(2) We commenced retaining the business produced by our HGA Operating Unit during the third quarter of 2005.

Our Competitive Strengths

We believe that we enjoy the following competitive strengths:

Specialized Market Knowledge and Underwriting Expertise. All of our operating units possess extensive knowledge of the specialty and niche markets in which they operate, which we believe allows them to effectively structure and market their property/casualty insurance products. Our Phoenix Operating Unit has a thorough understanding of the unique characteristics of the non-standard personal automobile market. Our HGA Operating Unit has significant underwriting experience in its target markets for standard commercial property/casualty insurance products. In addition, our TGA Operating Unit and Aerospace Operating Unit have developed specialized underwriting expertise which enhances their ability to profitably underwrite non-standard property/casualty insurance coverages.

Tailored Market Strategies. Each of our operating units has developed its own customized strategy for penetrating the specialty or niche markets in which it operates. These strategies include distinctive product structuring, marketing, distribution, underwriting and servicing approaches by each operating unit. As a result, we are able to structure our property/casualty insurance products to serve the unique risk and coverage needs of our insureds. We believe that these market-specific strategies enable us to provide policies tailored to the target customer which are appropriately priced and fit our risk profile.

Superior Agent and Customer Service. We believe that performing the underwriting, billing, customer service and claims management functions at the operating unit level allows us to provide superior service to both our independent agents and insured customers. The easy-to-use interfaces and responsiveness of our operating units enhance their relationships with the independent agents who sell our policies. We also believe that our consistency in offering our insurance products through hard and soft markets helps to build and maintain the loyalty of our independent agents. Our customized products, flexible payment plans and prompt claims processing are similarly beneficial to our insureds.

Market Diversification. We believe that operating in various specialty and niche segments of the property/casualty insurance market diversifies both our revenues and our risks. We also believe our operating units generally operate on different market cycles, producing more earnings stability than if we focused entirely on one product. As a result of the pooling arrangement among our insurance company subsidiaries, we are able to allocate our capital among these various specialty and niche markets in response to market conditions and expansion opportunities. We believe that this market diversification reduces our risk profile and enhances our profitability.

Experienced Management Team. Hallmark s senior management has an average of over 20 years of insurance industry experience. In addition, our operating units have strong management teams, with an average of nearly 25 years of insurance industry experience for the heads of our operating units and an average of more than 15 years of underwriting experience for our underwriters. Our management has significant experience in all aspects of property/casualty insurance, including underwriting, claims management, actuarial analysis, reinsurance and regulatory compliance. In addition, Hallmark s senior management has a strong track record of acquiring businesses that expand our product offerings and improve our profitability profile.

Our Strategy

We are striving to become a leading diversified property/casualty insurance group offering products in specialty and niche markets through the following strategies:

Focusing on Underwriting Discipline and Operational Efficiency. We seek to consistently generate an underwriting profit on the business we write in hard and soft markets. Our operating units have a strong track record of underwriting discipline and operational efficiency which we seek to continue. We believe that in soft markets our competitors often offer policies at a low or negative underwriting profit in order to maintain or increase their premium volume and market share. In contrast, we seek to write business based on its profitability rather than focusing solely on premium production. To that end, we provide financial incentives to many of our underwriters and independent agents based on underwriting profitability.

Table of Contents

Increasing the Retention of Business Written by Our Operating Units. Our operating units have a strong track record of writing profitable business in their target markets. Historically, the majority of those premiums were retained by unaffiliated insurers. During 2005, we increased the capital of our insurance company subsidiaries which has enabled us to retain significantly more of the premiums our operating units produce. We expect to continue to increase the portion of our premium production retained by our insurance company subsidiaries. We believe that the underwriting profit earned from this newly retained business will drive our profitability growth in the near-term.

Achieving Organic Growth in Our Existing Business Lines. We believe that we can achieve organic growth in our existing business lines by consistently providing our insurance products through market cycles, expanding geographically, expanding our agency relationships and further penetrating our existing customer base. We believe that our extensive market knowledge and strong agency relationships position us to compete effectively in our various specialty and niche markets. We also believe there is a significant opportunity to expand some of our existing business lines into new geographical areas and through new agency relationships while maintaining our underwriting discipline and operational efficiency. In addition, we believe there is an opportunity for some of our operating units to further penetrate their existing customer bases with additional products offered by our other operating units.

Pursuing Selected, Opportunistic Acquisitions. We seek to opportunistically acquire insurance organizations that operate in specialty or niche property/casualty insurance markets that are complementary to our existing operations. We seek to acquire companies with experienced management teams, stable loss results and strong track records of underwriting profitability and operational efficiency. Where appropriate, we intend to ultimately retain profitable business produced by the acquired companies that would otherwise be retained by unaffiliated insurers. Our management has significant experience in evaluating potential acquisition targets, structuring transactions to ensure continued success and integrating acquired companies into our operational structure.

Our Challenges

As part of your evaluation of our business, you should take into account the challenges we face in implementing our strategies, including the following:

Structuring and Pricing Our Products in Response to Industry Cycles. Properly structuring and pricing our property/casualty insurance products is critical to continuing premium production while maintaining underwriting profitability. If our products are overpriced, our premium production will decline. Conversely, if our products are underpriced, our underwriting results will suffer. The structure and price of our products must be continually evaluated due to the cyclical nature of the property/casualty insurance industry, which has historically been characterized by soft markets followed by hard markets. If we misprice our products in response to changing market conditions, our results of operations will be adversely affected.

Estimating Our Loss Reserves. We maintain loss reserves to cover our estimated ultimate liability for unpaid losses and loss adjustment expenses for reported and unreported claims incurred as of the end of each accounting period. These reserves represent management s estimates of what the ultimate settlement and administration of claims will cost and are not

reviewed by an independent actuary. Setting reserves is inherently uncertain and there can be no assurance that current or future reserves will prove adequate. If our loss reserves are inadequate, it will have an unfavorable impact on our results.

Maintaining Our Favorable Financial Strength Ratings. In June 2006, A.M. Best assigned a financial strength rating of A- (Excellent) to our individual and pooled insurance company subsidiaries. To maintain these ratings, our insurance company subsidiaries must maintain their capitalization and operating performance at a level consistent with projections provided to A.M. Best, as well as satisfy various other rating requirements. If A.M. Best downgrades our ratings, it is likely that we will not be able to compete as effectively and our ability to sell insurance policies could decline. As a result, our financial results would be adversely affected.

Attracting, Developing and Retaining Experienced Personnel. To sustain our growth as a diverse property/casualty insurance group operating in specialty and niche markets, we must continue to attract, develop and retain management, marketing, distribution, underwriting, customer service and claims personnel with expertise in the products we offer. We do not have employment agreements with most of our executive officers, including our Chief Executive Officer. The loss of key personnel, or our inability to recruit, develop and retain additional qualified personnel, could materially and adversely affect our business, growth and profitability.

For further discussion of these and other challenges, see Risk Factors.

The TGA and Aerospace Transactions

As part of our strategy to pursue selective, opportunistic acquisitions, we acquired the subsidiaries comprising the TGA Operating Unit and the Aerospace Operating Unit in separate transactions effective January 1, 2006. Our TGA Operating Unit is involved in the marketing, distribution, underwriting and servicing of property/casualty insurance products, primarily excess and surplus lines commercial automobile and general liability risks. Our Aerospace Operating Unit is involved in the marketing, distribution, underwriting and servicing of general aviation property/casualty insurance products with a particular emphasis on private and small commercial aircraft. We expect these acquisitions to significantly expand the scope of our insurance marketing and distribution operations and provide opportunities for increased underwriting. Both of these operating units fit our acquisition profile by having seasoned management teams, operating in specialized segments of the property/casualty insurance market and possessing strong track records of underwriting profitability.

Company History

Hallmark was formed in 1987 and initially operated a small chain of retail outlets specializing in the sale and financing of optical products and services. These activities were discontinued as of December 31, 1990. Our insurance operations began in 1990 when Hallmark acquired, through several transactions, a managing general agency, a small group of retail insurance agencies, a premium finance company and AHIC. Until 2002, our insurance operations consisted of marketing, distributing, underwriting, financing and servicing non-standard personal automobile insurance in Texas, as well as claims adjusting and other related services.

During 2000 and 2001, Newcastle Partners, L.P. (Newcastle Partners) accumulated approximately 48% of our outstanding common stock. Mark E. Schwarz, who solely controls Newcastle Partners, became chairman of our board of directors in October 2001. Mr. Schwarz was named our Chief

Executive Officer in January 2003 and served in such capacity until August 2006, at which time he became our Executive Chairman.

In December 2002, we acquired the standard commercial property/casualty insurance operations we now refer to as our HGA Operating Unit. We also acquired PIIC in January 2003, and consolidated its operations into AHIC s existing non-standard personal automobile operations. Both of these acquisitions were funded with a $9.0 million loan from Newcastle Partners which was repaid with the proceeds of a $10.0 million stockholder rights offering completed in September 2003. As a result of this rights offering, Mr. Schwarz and Newcastle Partners increased their beneficial ownership to approximately 63% of our outstanding common stock.

During 2005, we completed a capital plan which raised $45.0 million through another stockholder rights offering and $30.0 million through a private placement of trust preferred securities. The successful completion of this capital plan enabled us to retain additional non-standard personal automobile business marketed by our Phoenix Operating Unit, to directly write the standard commercial lines business previously marketed by our HGA Operating Unit as a general agent for a third-party insurer and to achieve more favorable financial strength ratings from A.M. Best for AHIC and PIIC. As a result of the 2005 stockholder rights offering, the beneficial ownership of Newcastle Partners and Mr. Schwarz increased to approximately 78% of our outstanding common stock.

Effective January 1, 2006, we acquired the various entities now comprising our TGA Operating Unit and our Aerospace Operating Unit. We funded these acquisitions by borrowing $15.0 million under our existing revolving credit facility, borrowing $12.5 million from Newcastle Partners and issuing an aggregate of $25.0 million in subordinated convertible promissory notes to two partnerships affiliated with Mr. Schwarz and Newcastle Partners. The subordinated convertible promissory notes were subsequently converted to shares of our common stock, resulting in an increase in the beneficial ownership of Mr. Schwarz, Newcastle Partners and the affiliated partnerships to approximately 82% of our outstanding common stock.

Effective July 31, 2006, we implemented a one-for-six reverse split of all issued and unissued shares of our authorized common stock. Unless otherwise indicated, all historical share and per share information contained in this prospectus has been adjusted to reflect this reverse stock split. On August 11, 2006, we filed an application to transfer the listing of our common stock from the American Stock Exchange to the Nasdaq Global Market effective upon the consummation of this offering.

Table of Contents

Operational Structure

Our three insurance company subsidiaries retain a portion of the premiums produced by our four operating units. The following chart reflects the operational structure of our organization and the subsidiaries comprising our operating units as of the date of this prospectus:

Contact Information

Our principal executive offices are located at 777 Main Street, Suite 1000, Fort Worth, Texas 76102 and our telephone number at such address is (817) 348-1600. Our Web site address is http://www.hallmarkgrp.com. The information found on our Web site is not, however, a part of this prospectus and any reference to our Web site is intended to be an inactive textual reference only and is not intended to create any hypertext link.

Table of Contents

The Offering

Common stock offered:	
By Hallmark Financial Services, Inc.	3,375,000 shares
By the selling stockholder	3,375,000 shares
Total	6,750,000 shares
Common stock outstanding after the offering	21,134,905 shares
Offering price	$ per share
Use of proceeds	We intend to use the net proceeds from this offering, estimated as approximately $32.2 million, substantially as follows: $15.0 million to reduce the outstanding principal balance on our revolving credit facility, which currently bears interest at 7.4% per annum and matures on January 27, 2008; $12.5 million to repay the principal on a loan from Newcastle Partners evidenced by a promissory note dated January 3, 2006, in the original principal amount of $12.5 million which bears interest at 10% per annum and became payable on demand as of June 30, 2006; and The balance for working capital and general corporate purposes, some or all of which may be contributed to the capital of our insurance company subsidiaries. We will not receive any of the proceeds from the sale of shares by the selling stockholder.
Risk factors	See Risk Factors and other information included in this prospectus for a discussion of certain factors you should carefully consider before deciding to invest in shares of our common stock.
Current American Stock Exchange symbol	HAF
Proposed post-offering Nasdaq Global Market symbol	HALL

Table of Contents

Dividend policy	Our board of directors does not intend to declare cash dividends on our common stock for the foreseeable future.
Common stock outstanding as of September 6, 2006	17,759,905 shares
The number of shares of common stock outstanding at September 6, 2006, excludes the following	341,083 shares issuable upon exercise of outstanding options, as well as 635,833 shares reserved for future grants under our 2005 Long Term Incentive Plan.

Unless otherwise indicated, all information contained in this prospectus:

Assumes that the underwriters will not elect to exercise their over-allotment option to purchase an additional 1,012,500 shares from the selling stockholder; and

Has been adjusted as necessary to reflect a one-for-six reverse split of all issued and unissued shares of our authorized common stock effected July 31, 2006, and a corresponding increase in the par value of our authorized common stock from $0.03 per share to $0.18 per share.

Table of Contents

Summary Historical Consolidated Financial Information

The following tables provide a summary of our historical consolidated financial and operating data as of the dates and for the periods indicated. We derived the summary historical consolidated financial data as of December 31, 2005 and 2004 and for the years ended December 31, 2005, 2004 and 2003 from our audited consolidated financial statements included in this prospectus. We derived the summary historical consolidated financial data as of December 31, 2003, 2002 and 2001 and for the years ended December 31, 2002 and 2001 from our audited consolidated financial statements not included in this prospectus. We derived the summary historical financial data as of June 30, 2006 and 2005 and for the six months ended June 30, 2006 and 2005 from our unaudited consolidated financial statements included in this prospectus, which include all adjustments, consisting only of normal recurring adjustments, that management considers necessary for a fair presentation of our financial position and results of operations as of the dates and for the periods presented. The results of operations for past accounting periods are not necessarily indicative of the results to be expected for any future accounting period. In conjunction with this summary and in order to more fully understand this summary financial information, you should also read Management s Discussion and Analysis of Financial Condition and Results of Operations and our consolidated financial statements and accompanying notes included in this prospectus.

	Six Months Ended June 30,		Year Ended December 31,				
	2006[1]	2005	2005	2004	2003	2002	2001
	(unaudited)		(in thousands, except per share data)				
Statement of Operations Data:							
Gross premiums written	$ 95,611	$ 19,473	$ 89,467	$ 33,389	$ 43,338	$ 51,643	$ 49,614
Ceded premiums written	(4,440)		(1,215)	(322)	(6,769)	(29,611)	(33,822)
Net premiums written	91,171	19,473	88,252	33,067	36,569	22,032	15,792
Change in unearned premiums	(28,478)	230	(29,068)	(622)	5,406	(1,819)	584
Net premiums earned	62,693	19,703	59,184	32,445	41,975	20,213	16,376
Investment income, net of expenses	4,593	862	3,836	1,386	1,198	773	1,043
Realized gains (losses)	(1,366)	(41)	58	(27)	(88)	(5)	
Finance charges	1,903	1,049	2,044	2,183	3,544	2,503	3,095
Commission and fees	22,280	10,440	16,703	21,100	17,544	1,108	
Processing and service fees	1,584	3,204	5,183	6,003	4,900	921	1,120
Other income	20	13	27	31	486	284	368
Total revenues	91,707	35,230	87,035	63,121	69,559	25,797	22,002
Losses and loss adjustment expenses	36,889	11,541	33,784	19,137	30,188	15,302	15,878
Other operating costs and expenses	41,053	17,855	38,492	35,290	37,386	9,474	6,620
Interest expense	3,247	105	1,264	64	1,271	983	1,021
Interest expense from amortization of discount on	9,625						

convertible notes[2]							
Amortization of intangible assets	1,146	14	27	28	28	2	157
Total expenses	91,960	29,515	73,567	54,519	68,873	25,761	23,676
Income (loss) before income tax, cumulative effect of change in accounting principle and extraordinary gain	(253)	5,715	13,468	8,602	686	36	(1,674)
Income tax expense (benefit)	163	1,896	4,282	2,753	25	13	(544)
Income (loss) before cumulative effect of change in accounting principle and extraordinary gain	(416)	3,819	9,186	5,849	661	23	(1,130)
Cumulative effect of change in accounting principle, net of tax[3]						(1,694)	
Extraordinary gain[4]					8,084		
Net income (loss)	$ (416)	$ 3,819	$ 9,186	$ 5,849	$ 8,745	$ (1,671)	$ (1,130)

footnotes on following page

Table of Contents

	Six Months Ended June 30,		Year Ended December 31,				
	2006[1]	2005	2005	2004	2003	2002	2001
	(unaudited)		(in thousands, except per share data)				
Common stockholders basic earnings (loss) per share [5]:							
Income (loss) before cumulative effect of change in accounting principle and extraordinary gain	$ (0.03)	$ 0.45	$ 0.76	$ 0.83	$ 0.14	$ 0.01	$ (0.33)
Cumulative effect of change in accounting principle[3]						(0.50)	
Extraordinary gain[4]					1.66		
Net income (loss)	$ (0.03)	$ 0.45	$ 0.76	$ 0.83	$ 1.80	$ (0.49)	$ (0.33)
Common stockholders diluted earnings (loss) per share[5]:							
Income (loss) before cumulative effect of change in accounting principle and extraordinary gain	$ (0.03)	$ 0.44	$ 0.76	$ 0.82	$ 0.13	$ 0.01	$ (0.33)
Cumulative effect of change in accounting principle[3]						(0.50)	
Extraordinary gain[4]					1.64		
Net income (loss)	$ (0.03)	$ 0.44	$ 0.76	$ 0.82	$ 1.77	$ (0.49)	$ (0.33)
Key Measures:							
Total premium production[6]	$ 143,280	$ 61,912	$ 118,066	$ 119,305	$ 124,264	$ 56,458	$ 49,614
Net loss ratio[7]	61.7%	61.3%	60.3%	60.5%	72.5%	76.8%	98.6%
Net expense ratio[7]	31.1	32.5	34.6	27.8	26.5	18.2	15.5
Net combined ratio[7]	92.8%	93.8%	94.9%	88.3%	99.0%	95.0%	114.1%
Statutory surplus[8]	$ 106,554	$ 101,972	$ 99,873	$ 25,312	$ 20,278	$ 8,394	$ 6,018
Book value per share[9]	6.47	5.63	5.89	5.37	4.52	4.63	5.63

Net underwriting leverage ratio[10]	1.5x	0.4x	0.9x	1.3x	1.8x	2.6x	2.6x

	As of June 30, 2006	
	Actual	**As Adjusted[11]**
	(in thousands) (unaudited)	
Balance Sheet Data:		
Total cash and investments[12]	$ 226,192	$ 230,852
Total assets	387,106	391,766
Unpaid losses and loss adjustment expenses	52,099	52,099
Unearned premiums	69,264	69,264
Total liabilities	272,117	244,617
Total stockholders equity	114,989	147,149

(1) Includes the results of our TGA Operating Unit and our Aerospace Operating Unit, each of which was acquired effective January 1, 2006.

(2) In accordance with Financial Accounting Standards Board Emerging Issues Task Force Issue No. 98-5, Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios, and Issue No. 00-27, Application of Issue No. 98-5 to Certain Convertible Instruments, at the time of issuance we booked a $9.6 million deemed discount to convertible notes attributable to their conversion feature. Prior to conversion, this deemed discount was amortized as interest expense over the term of the notes, resulting in a $1.1 million non-cash interest expense during the first quarter of 2006. As a result of the subsequent conversion of the convertible notes, the $8.5 million balance of the deemed discount was written off as a non-cash interest expense during the quarter ended June 30, 2006. Neither the deemed discount on the convertible notes nor the resulting interest expense had any ultimate impact on cash flow or book value.

(3) In 2002, we adopted Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets, which prohibits amortization of goodwill and requires annual testing of goodwill for impairment. In the year of adoption, we

footnotes continued on following page

recognized a charge to earnings of $1.7 million to reflect an impairment loss that was reported as a cumulative effect of change in accounting principle.

(4) In January 2003, we acquired PIIC in satisfaction of $7.0 million of a $14.85 million balance on a note receivable due from Millers American Group, Inc. The acquisition resulted in us recognizing an $8.1 million extraordinary gain in 2003.

(5) In accordance with Statement of Financial Accounting Standards No. 128, Earnings Per Share, we have restated the basic and diluted weighted average shares outstanding for the years 2004 and prior for the effect of a bonus element from our stockholder rights offerings that were successfully completed in 2005 and 2003. According to SFAS 128, there is an assumed bonus element in a rights issue whose exercise price is less than market value of the stock at the close of the rights offering period. This bonus element is treated as a stock dividend for reporting earnings per share. All per share amounts have also been adjusted to reflect a one-for-six reverse stock split effected July 31, 2006.

(6) Total premium production represents all premium produced by our operating units regardless of whether such premium is retained by our insurance company subsidiaries or third parties.

(7) Net loss ratio is calculated as total net losses and loss adjustment expenses of our insurance company subsidiaries divided by net premiums earned, each determined in accordance with U.S. generally accepted accounting principles. Net expense ratio is calculated as total underwriting expenses, including allocated overhead expenses, of our insurance company subsidiaries divided by net premiums earned, each determined in accordance with U.S. generally accepted accounting principles. Net combined ratio is calculated as the sum of the net loss ratio and the net expense ratio.

(8) Statutory surplus is calculated as total statutory assets less total statutory liabilities of our insurance company subsidiaries.

(9) Book value per share is calculated as consolidated stockholders equity on the basis of U.S. generally accepted accounting principles divided by the number of outstanding common shares as of the end of the period. Book value per share has been adjusted to reflect a one-for-six reverse stock split effected July 31, 2006.

(10) Net underwriting leverage ratio is calculated as total net premiums written by our insurance company subsidiaries for the previous four quarters divided by statutory surplus as of the end of the most recent quarter.

(11) The historical consolidated balance sheet as of June 30, 2006, as adjusted, gives effect to our sale of shares of common stock in this offering at an assumed offering price of $10.35 per share. Assuming the number of shares offered by us as set forth on the cover page of this prospectus remains the same, after deducting the estimated underwriting discounts and commissions and estimated offering expenses payable by us in connection with the offering, a $1.00 increase (decrease) in the assumed offering price per share would increase (decrease) total cash and investments, total assets and total stockholders equity by $3.2 million.

(12) Includes $41.2 million of restricted cash and investments.

Table of Contents

RISK FACTORS

An investment in our common stock involves a number of risks. You should carefully consider the risks described below, together with the other information contained in this prospectus, before you decide to buy shares of our common stock.

Risks Relating to Our Business

Our success depends on our ability to price accurately the risks we underwrite.

Our results of operations and financial condition depend on our ability to underwrite and set premium rates accurately for a wide variety of risks. Adequate rates are necessary to generate premiums sufficient to pay losses, loss settlement expenses and underwriting expenses and to earn a profit. To price our products accurately, we must collect and properly analyze a substantial amount of data; develop, test and apply appropriate pricing techniques; closely monitor and timely recognize changes in trends; and project both severity and frequency of losses with reasonable accuracy. Our ability to undertake these efforts successfully, and as a result price our products accurately, is subject to a number of risks and uncertainties, some of which are outside our control, including:

- the availability of sufficient reliable data and our ability to properly analyze available data;
- the uncertainties that inherently characterize estimates and assumptions;
- our selection and application of appropriate pricing techniques; and
- changes in applicable legal liability standards and in the civil litigation system generally.

Consequently, we could underprice risks, which would adversely affect our profit margins, or we could overprice risks, which could reduce our sales volume and competitiveness. In either case, our profitability could be materially and adversely affected.

Our results may fluctuate as a result of cyclical changes in the property/casualty insurance industry.

Our revenue is primarily attributable to property/casualty insurance, which as an industry is cyclical in nature and has historically been characterized by soft markets followed by hard markets. A soft market is a period of relatively high levels of price competition, less restrictive underwriting standards and generally low premium rates. A hard market is a period of capital shortages resulting in lack of insurance availability, relatively low levels of competition, more selective underwriting of risks and relatively high premium rates. If we find it necessary to reduce premiums or limit premium increases due to competitive pressures on pricing in a softening market, we may experience a reduction in our premiums written and in our profit margins and revenues, which could adversely affect our financial results.

Estimating reserves is inherently uncertain. If our loss reserves are not adequate, it will have an unfavorable impact on our results.

We maintain loss reserves to cover our estimated ultimate liability for unpaid losses and loss adjustment expenses for reported and unreported claims incurred as of the end of each accounting period. Reserves represent management s estimates of what the ultimate settlement and administration of claims will cost and are not reviewed by an independent actuary. These estimates, which generally involve actuarial projections, are based on management s assessment of facts and circumstances then known, as well as estimates of future trends in claim severity and frequency, judicial theories of liability, and other factors. These variables are affected by both internal and external events, such as changes in claims handling procedures, inflation, judicial trends and legislative changes. Many of these factors are not quantifiable.

Additionally, there may be a significant reporting lag between the occurrence of an event and the time it is reported to us. The inherent uncertainties of estimating reserves are greater for certain types of liabilities, particularly those in which the various considerations affecting the type of claim are subject to change and in which long periods of time may elapse before a definitive determination of liability is made. Reserve estimates are continually refined in a regular and ongoing process as experience develops and further claims are reported and settled. Adjustments to reserves are reflected in the results of the periods in which such estimates are changed. For example, a 1% change in June 30, 2006 unpaid losses and loss adjustment expenses would have produced a $0.5 million change to pretax earnings. Our gross loss and loss adjustment expense reserves totaled $52.1 million at June 30, 2006. Our loss and loss adjustment expense reserves, net of reinsurance recoverables, were $50.6 million at that date. Because setting reserves is inherently uncertain, there can be no assurance that the current reserves will prove adequate.

Our failure to maintain favorable financial strength ratings could negatively impact our ability to compete successfully.

Third-party rating agencies assess and rate the claims-paying ability of insurers based upon criteria established by the agencies. During 2005, A.M. Best, a nationally recognized insurance industry rating service and publisher, upgraded the financial strength rating of PIIC, from B (Fair) to B+ (Very Good), and upgraded the financial strength rating of AHIC, from B (Fair) to A- (Excellent). Our insurance company subsidiaries have historically been rated on an individual basis. However, effective January 1, 2006, our insurance company subsidiaries entered into a pooling arrangement whereby AHIC would retain 59.9% of the net premiums written, PIIC would retain 34.1% of the net premiums written and GSIC would retain 6.0% of the net premiums written. As a result, in June 2006, A.M. Best notified us that our insurance company subsidiaries would be rated on a pooled basis and assigned a rating of A- (Excellent) to each of our individual insurance company subsidiaries and to the pool formed by our insurance company subsidiaries.

These financial strength ratings are used by policyholders, insurers, reinsurers and insurance and reinsurance intermediaries as an important means of assessing the financial strength and quality of insurers. These ratings are not evaluations directed to potential purchasers of our common stock and are not recommendations to buy, sell or hold our common stock. Our ratings are subject to change at any time and could be revised downward or revoked at the sole discretion of the rating agencies. We believe that the ratings assigned by A.M. Best are an important factor in marketing our products. Our ability to retain our existing business and to attract new business in our insurance operations depends largely on these ratings. Our failure to maintain our ratings, or any other adverse development with respect to our ratings, could cause our current and future independent agents and insureds to choose to transact their business with more highly rated competitors. If A.M. Best downgrades our ratings or publicly indicates that our ratings are under review, it is likely that we would not be able to compete as effectively with our competitors, and our ability to sell insurance policies could decline. If that happens, our sales and earnings would decrease. For example, many of our agencies and insureds have guidelines that require us to have an A.M. Best financial strength rating of A- or higher. A reduction of our A.M. Best rating below A- would prevent us from issuing policies to insureds or potential insureds with such ratings requirements. Because lenders and reinsurers will use our A.M. Best ratings as a factor in deciding whether to transact business with us, the failure of our insurance company subsidiaries to maintain their current ratings could dissuade a lender or reinsurance company from conducting business with us or might increase our interest or reinsurance costs. In addition, a ratings downgrade by A.M. Best below A- would require us to post collateral in support of our obligations under certain of our reinsurance agreements pursuant to which we assume business.

The loss of key executives could disrupt our business.

Our success will depend in part upon the continued service of certain key executives. Our success will also depend on our ability to attract and retain additional executives and personnel. We do not have employment agreements with our Chief Executive Officer or any other of our executive officers other than employment agreements entered into in connection with the acquisitions of the subsidiaries now comprising our TGA Operating Unit and our Aerospace Operating Unit. The loss of key personnel, or our inability to recruit and retain additional qualified personnel, could cause disruption in our business and could prevent us from fully implementing our business strategies, which could materially and adversely affect our business, growth and profitability.

Our industry is very competitive, which may unfavorably impact our results of operations.

The property/casualty insurance market, our primary source of revenue, is highly competitive and, except for regulatory considerations, has very few barriers to entry. According to A.M. Best, there were 3,120 property/casualty insurance companies and 2,019 property/casualty insurance groups operating in North America as of July 22, 2005. Our HGA Operating Unit and TGA Operating Unit compete with a variety of large national commercial lines carriers such as Hartford, Zurich, St. Paul Travelers and Safeco, as well as numerous smaller regional companies. Although our Phoenix Operating Unit competes with large national insurers such as Allstate, State Farm and Progressive, as a participant in the non-standard personal automobile marketplace, its primary competition consists of numerous regional companies and managing general agencies. Our Aerospace Operating Unit competes primarily with several other companies specializing in general aviation insurance, including Houston Casualty Corp., Phoenix Aviation, W. Brown & Company and London Aviation Underwriters. Our competitors include entities which have, or are affiliated with entities which have, greater financial and other resources than we have. In addition, competitors may attempt to increase market share by lowering rates. In that case, we could experience reductions in our underwriting margins, or sales of our insurance policies could decline as customers purchase lower-priced products from our competitors. Losing business to competitors offering similar products at lower prices, or having other competitive advantages, could adversely affect our results of operations.

Our results may be unfavorably impacted if we are unable to obtain adequate reinsurance.

As part of our overall risk and capacity management strategy, we purchase reinsurance for significant amounts of risk, especially catastrophe risks that we and our insurance company subsidiaries underwrite. Our catastrophe and non-catastrophe reinsurance facilities are subject to annual renewal. We may be unable to maintain our current reinsurance facilities or to obtain other reinsurance facilities in adequate amounts and at favorable rates. The amount, availability and cost of reinsurance are subject to prevailing market conditions beyond our control and may affect our ability to write additional premiums as well as our profitability. If we are unable to obtain adequate reinsurance protection for the risks we have underwritten, we will either be exposed to greater losses from these risks or we will reduce the level of business that we underwrite, which will reduce our revenue.

If the companies that provide our reinsurance do not pay our claims in a timely manner, we could incur severe losses.

We purchase reinsurance by transferring, or ceding, part of the risk we have assumed to a reinsurance company in exchange for part of the premium we receive in connection with the risk. Although reinsurance makes the reinsurer liable to us to the extent the risk is transferred or ceded to the reinsurer, it does not relieve us of our liability to our policyholders. Accordingly, we bear credit risk with respect to our reinsurers. We cannot assure that our reinsurers will pay all of our reinsurance claims, or that they will pay our claims on a timely basis. At June 30, 2006, we had a total of $3.1 million due us from reinsurers, including $1.5 million of recoverables from losses and $1.6 million in prepaid reinsurance premiums. The largest amount due us from a single reinsurer as of June 30, 2006 was $1.1 million

Table of Contents

reinsurance and premium recoverable from GE Reinsurance Corp. If any of our reinsurers are unable or unwilling to pay amounts they owe us in a timely fashion, we could suffer a significant loss or a shortage of liquidity, which would have a material adverse effect on our business and results of operations.

Catastrophic losses are unpredictable and may adversely affect our results of operations, liquidity and financial condition.

Property/casualty insurance companies are subject to claims arising out of catastrophes that may have a significant effect on their results of operations, liquidity and financial condition. Catastrophes can be caused by various events, including hurricanes, windstorms, earthquakes, hail storms, explosions, severe winter weather and fires, and may include man-made events, such as the September 11, 2001 terrorist attacks on the World Trade Center. The incidence, frequency, and severity of catastrophes are inherently unpredictable. The extent of losses from a catastrophe is a function of both the total amount of insured exposure in the area affected by the event and the severity of the event. Claims from catastrophic events could reduce our net income, cause substantial volatility in our financial results for any fiscal quarter or year or otherwise adversely affect our financial condition, liquidity or results of operations. Catastrophes may also negatively affect our ability to write new business. Increases in the value and geographic concentration of insured property and the effects of inflation could increase the severity of claims from catastrophic events in the future.

Catastrophe models may not accurately predict future losses.

Along with other insurers in the industry, we use models developed by third-party vendors in assessing our exposure to catastrophe losses that assume various conditions and probability scenarios. However, these models do not necessarily accurately predict future losses or accurately measure losses currently incurred. Catastrophe models, which have been evolving since the early 1990s, use historical information about various catastrophes and detailed information about our in-force business. While we use this information in connection with our pricing and risk management activities, there are limitations with respect to their usefulness in predicting losses in any reporting period. Examples of these limitations are significant variations in estimates between models and modelers and material increases and decreases in model results due to changes and refinements of the underlying data elements and assumptions. Such limitations lead to questionable predictive capability and post-event measurements that have not been well understood or proven to be sufficiently reliable. In addition, the models are not necessarily reflective of company or state-specific policy language, demand surge for labor and materials or loss settlement expenses, all of which are subject to wide variation by catastrophe. Because the occurrence and severity of catastrophes are inherently unpredictable and may vary significantly from year to year, historical results of operations may not be indicative of future results of operations.

We are subject to comprehensive regulation, and our results may be unfavorably impacted by these regulations.

We are subject to comprehensive governmental regulation and supervision. Most insurance regulations are designed to protect the interests of policyholders rather than of the stockholders and other investors of the insurance companies. These regulations, generally administered by the department of insurance in each state in which we do business, relate to, among other things:

- approval of policy forms and rates;
- standards of solvency, including risk-based capital measurements, which are a measure developed by the National Association of Insurance Commissioners and used by the state insurance regulators to identify insurance companies that potentially are inadequately capitalized;

licensing of insurers and their agents;

restrictions on the nature, quality and concentration of investments;

restrictions on the ability of insurance company subsidiaries to pay dividends;

restrictions on transactions between insurance company subsidiaries and their affiliates;

requiring certain methods of accounting;

periodic examinations of operations and finances;

the use of non-public consumer information and related privacy issues;

the use of credit history in underwriting and rating;

limitations on the ability to charge policy fees;

the acquisition or disposition of an insurance company or of any company controlling an insurance company;

involuntary assignments of high-risk policies, participation in reinsurance facilities and underwriting associations, assessments and other governmental charges;

restrictions on the cancellation or non-renewal of policies and, in certain jurisdictions, withdrawal from writing certain lines of business;

prescribing the form and content of records of financial condition to be filed;

requiring reserves for unearned premium, losses and other purposes; and

with respect to premium finance business, the federal Truth-in-Lending Act and similar state statutes. In states where specific statutes have not been enacted, premium finance is generally subject to state usury laws that are applicable to consumer loans.

State insurance departments also conduct periodic examinations of the affairs of insurance companies and require filing of annual and other reports relating to the financial condition of insurance companies, holding company issues and other matters. Our business depends on compliance with applicable laws and regulations and our ability to maintain valid licenses and approvals for our operations. Regulatory authorities may deny or revoke licenses for various reasons, including violations of regulations. Changes in the level of regulation of the insurance industry or changes in laws or regulations themselves or interpretations by regulatory authorities could have a material adverse affect on our operations. In addition, we could face individual, group and class-action lawsuits by our policyholders and others for alleged violations of certain state laws and regulations. Each of these regulatory risks could have an adverse effect on our profitability.

State statutes limit the aggregate amount of dividends that our subsidiaries may pay Hallmark, thereby limiting its funds to pay expenses and dividends.

Hallmark is a holding company and a legal entity separate and distinct from its subsidiaries. As a holding company without significant operations of its own, Hallmark s principal sources of funds are dividends and other sources of funds from its subsidiaries. State insurance laws limit the ability of Hallmark s

insurance company subsidiaries to pay dividends and require our insurance company subsidiaries to maintain specified minimum levels of statutory capital and surplus. The aggregate maximum amount of dividends permitted by law to be paid by an insurance company does not necessarily define an insurance company s actual ability to pay dividends. The actual ability to pay dividends may be further constrained by business and regulatory considerations, such as the impact of dividends on surplus, by our competitive position and by the amount of premiums that we can write. Without regulatory approval, the aggregate maximum amount of dividends that could be paid to Hallmark in 2006 by our insurance company subsidiaries is $8.1 million. State insurance regulators have broad discretion to limit the payment of dividends by insurance companies and Hallmark s right to participate in any distribution of assets of one of our insurance company subsidiaries is subject to prior claims of policyholders and creditors except to the extent that its rights, if any, as a creditor are recognized. Consequently, Hallmark s ability to pay debts, expenses and cash dividends to our stockholders may be limited.

Our insurance company subsidiaries are subject to minimum capital and surplus requirements. Failure to meet these requirements could subject us to regulatory action.

Our insurance company subsidiaries are subject to minimum capital and surplus requirements imposed under the laws of their respective states of domicile and each state in which they issue policies. Any failure by one of our insurance company subsidiaries to meet minimum capital and surplus requirements imposed by applicable state law will subject it to corrective action, which may include requiring adoption of a comprehensive financial plan, revocation of its license to sell insurance products or placing the subsidiary under state regulatory control. Any new minimum capital and surplus requirements adopted in the future may require us to increase the capital and surplus of our insurance company subsidiaries, which we may not be able to do.

We are subject to assessments and other surcharges from state guaranty funds, mandatory reinsurance arrangements and state insurance facilities, which may reduce our profitability.

Virtually all states require insurers licensed to do business therein to bear a portion of the unfunded obligations of impaired or insolvent insurance companies. These obligations are funded by assessments, which are levied by guaranty associations within the state, up to prescribed limits, on all member insurers in the state on the basis of the proportionate share of the premiums written by member insurers in the lines of business in which the impaired, insolvent or failed insurer was engaged. Accordingly, the assessments levied on us by the states in which we are licensed to write insurance may increase as we increase our premiums written. In addition, as a condition to the ability to conduct business in certain states, insurance companies are required to participate in mandatory reinsurance funds such as the Texas Property and Casualty Insurance Guaranty Association. The effect of these assessments and mandatory reinsurance arrangements, or changes in them, could reduce our profitability in any given period or limit our ability to grow our business.

We are currently monitoring developments with respect to various state facilities, such as the Texas FAIR Plan and the Texas Windstorm Insurance Association, and the various guaranty funds in which we participate. The ultimate impact of recent catastrophe experience on these facilities is currently uncertain but could result in the facilities recognizing a financial deficit or a financial deficit greater than the level currently estimated. They may, in turn, have the ability to assess participating insurers when financial deficits occur, adversely affecting our results of operations. While these facilities are generally designed so that the ultimate cost is borne by policyholders, the exposure to assessments and the availability of recoupments or premium rate increases from these facilities may not offset each other in our financial statements. Moreover, even if they do offset each other, they may not offset each other in financial statements for the same fiscal period due to the ultimate timing of the assessments and recoupments or premium rate increases, as well as the possibility of policies not being renewed in subsequent years.

We are subject to tax compliance audits which could result in the assessment of additional taxes, interest and penalties.

Federal and state authorities may audit our compliance with the tax statutes, rules and regulations which they administer. In some instances, the application or interpretation of these tax statutes, rules and regulations is uncertain. During the third quarter of 2006, the State of Texas conducted field work for a sales and use tax audit of Hallmark Claims Services, Inc. We have received no indication from the examiner that this subsidiary is noncompliant with the relevant sales and use tax provisions in any material respect. However, we have not yet received any written report from the examiner and, therefore, there can be no assurance that this sales and use tax audit will not result in the assessment of material additional taxes, interest or penalties.

Adverse securities market conditions can have a significant and negative impact on our investment portfolio.

Our results of operations depend in part on the performance of our invested assets. As of June 30, 2006, 97.9% of our investment portfolio was invested in fixed-income securities. Certain risks are inherent in connection with fixed-income securities, including loss upon default and price volatility in reaction to changes in interest rates and general market factors. In general, the fair market value of a portfolio of fixed-income securities increases or decreases inversely with changes in the market interest rates, while net investment income realized from future investments in fixed-income securities increases or decreases along with interest rates. In addition, as of June 30, 2006, 6.3% of our fixed-income securities have call or prepayment options. This subjects us to reinvestment risk should interest rates fall and issuers call their securities. Furthermore, actual net investment income and/or cash flows from investments that carry prepayment risk, such as mortgage-backed and other asset-backed securities, may differ from those anticipated at the time of investment as a result of interest rate fluctuations. An investment has prepayment risk when there is a risk that cash flows from the repayment of principal might occur earlier than anticipated because of declining interest rates or later than anticipated because of rising interest rates. The fair value of our fixed-income securities as of June 30, 2006 was $201.7 million. If market interest rates were to change 1%, for example from 5% to 6%, the fair value of our fixed-income securities would change approximately $6.1 million as of June 30, 2006. The calculated change in fair value was determined using duration modeling assuming no prepayments.

In addition to the general risks described above, although we maintain an investment-grade portfolio, our fixed-income securities are also subject to credit risk. If any of the issuers of our fixed-income securities suffer financial setbacks, the ratings on the fixed-income securities could fall (with a concurrent fall in market value) and, in a worst case scenario, the issuer could default on its obligations. Future changes in the fair market value of our available-for-sale securities will be reflected in other comprehensive income. Similar treatment is not available for liabilities. Therefore, interest rate fluctuations could adversely affect our stockholders equity, total comprehensive income and/or our cash flows.

We rely on independent agents and specialty brokers to market our products and their failure to do so would have a material adverse effect on our results of operations.

We market and distribute our insurance programs exclusively through independent insurance agents and specialty insurance brokers. As a result, our business depends in large part on the marketing efforts of these agents and brokers and on our ability to offer insurance products and services that meet the requirements of the agents, the brokers and their customers. However, these agents and brokers are not obligated to sell or promote our products and many sell or promote competitors insurance products in addition to our products. Some of our competitors have higher financial strength ratings, offer a larger variety of products, set lower prices for insurance coverage and/or offer higher commissions than we do. Therefore, we may not be able to continue to attract and retain independent agents and brokers to sell

our insurance products. The failure or inability of independent agents and brokers to market our insurance products successfully could have a material adverse impact on our business, financial condition and results of operations.

We may experience difficulty in integrating recent or future acquisitions into our operations.

We completed the acquisitions of the subsidiaries now comprising both our TGA Operating Unit and our Aerospace Operating Unit during January 2006. We may pursue additional acquisitions in the future. The successful integration of newly acquired businesses into our operations will require, among other things, the retention and assimilation of their key management, sales and other personnel; the coordination of their lines of insurance products and services; the adaptation of their technology, information systems and other processes; and the retention and transition of their customers. Unexpected difficulties in integrating any acquisition could result in increased expenses and the diversion of management time and resources. If we do not successfully integrate any acquired business into our operations, we may not realize the anticipated benefits of the acquisition, which could have a material adverse impact on our financial condition and results of operations. Further, any potential acquisitions may require significant capital outlays and, if we issue equity or convertible debt securities to pay for an acquisition, the issuance may be dilutive to our existing stockholders.

Our geographic concentration ties our performance to the business, weather, economic and regulatory conditions of certain states.

The following five states accounted for 94.6% of our gross written premiums for the six months ended June 30, 2006: Texas (49.1%), Oregon (18.6%), New Mexico (12.9%), Idaho (8.4%) and Arizona (5.6%). Our revenues and profitability are subject to the prevailing regulatory, legal, economic, political, demographic, competitive, weather and other conditions in the principal states in which we do business. Changes in any of these conditions could make it less attractive for us to do business in such states and would have a more pronounced effect on us compared to companies that are more geographically diversified. In addition, our exposure to severe losses from localized natural perils, such as windstorms or hailstorms, is increased in those areas where we have written significant numbers of property/casualty insurance policies.

The exclusions and limitations in our policies may not be enforceable.

Many of the policies we issue include exclusions or other conditions that define and limit coverage, which exclusions and conditions are designed to manage our exposure to certain types of risks and expanding theories of legal liability. In addition, many of our policies limit the period during which a policyholder may bring a claim under the policy, which period in many cases is shorter than the statutory period under which these claims can be brought by our policyholders. While these exclusions and limitations help us assess and control our loss exposure, it is possible that a court or regulatory authority could nullify or void an exclusion or limitation, or legislation could be enacted modifying or barring the use of these exclusions and limitations. This could result in higher than anticipated losses and loss adjustment expenses by extending coverage beyond our underwriting intent or increasing the number or size of claims, which could have a material adverse effect on our operating results. In some instances, these changes may not become apparent until some time after we have i