

HALLMARK FINANCIAL SERVICES INC
Form 10-Q
November 12, 2009

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2009

Commission file number 001-11252

Hallmark Financial Services, Inc.
(Exact name of registrant as specified in its charter)

Nevada
(State or other jurisdiction of
Incorporation or organization)

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

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

76102
(Zip Code)

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

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

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

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

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

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: Common Stock, par value \$.18 per share – 20,113,670 shares outstanding as of November 12, 2009.

PART I
FINANCIAL INFORMATION

Item 1. Financial Statements

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

	September 30 2009 (unaudited)	December 31 2008
ASSETS		
Investments:		
Debt securities, available-for-sale, at fair value	\$ 295,452	\$ 268,513
Equity securities, available-for-sale, at fair value	40,959	25,003
Total investments	336,411	293,516
Cash and cash equivalents	84,422	59,134
Restricted cash and cash equivalents	5,918	8,033
Premiums receivable	48,794	44,032
Accounts receivable	3,729	4,531
Receivable for securities	181	1,031
Prepaid reinsurance premiums	11,198	1,349
Reinsurance recoverable	11,695	8,218
Deferred policy acquisition costs	22,629	19,524
Excess of cost over fair value of net assets acquired	41,080	41,080
Intangible assets, net	29,789	28,969
Current federal income tax recoverable	1,080	696
Deferred federal income taxes	-	6,696
Prepaid expenses	816	1,007
Other assets	18,264	20,582
Total assets	\$ 616,006	\$ 538,398
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities:		
Notes payable	\$ 59,502	\$ 60,919
Reserves for unpaid losses and loss adjustment expenses	180,179	156,363
Unearned premiums	130,467	102,192
Unearned revenue	266	2,037
Reinsurance balances payable	2,680	-
Accrued agent profit sharing	1,908	2,151
Accrued ceding commission payable	8,600	8,605
Pension liability	4,427	4,309
Deferred federal income taxes	92	-
Payable for securities	688	3,606
Accounts payable and other accrued expenses	9,148	18,067
Total liabilities	397,957	358,249
Commitments and Contingencies (Note 15)		

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Redeemable non-controlling interest	1,011	737
Stockholders' equity:		
Common stock, \$.18 par value (authorized 33,333,333 shares in 2009 and 2008; issued 20,871,498 shares in 2009 and 20,841,782 shares in 2008)	3,757	3,751
Capital in excess of par value	121,261	119,928
Retained earnings	89,186	72,242
Accumulated other comprehensive income (loss)	8,161	(16,432)
Treasury stock, at cost (757,828 shares in 2009 and 7,828 in 2008)	(5,327)	(77)
Total stockholders' equity	217,038	179,412
	\$ 616,006	\$ 538,398

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

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

	Three Months Ended September 30		Nine Months Ended September 30	
	2009	2008	2009	2008
Gross premiums written	\$ 74,013	\$ 59,005	\$ 220,545	\$ 186,357
Ceded premiums written	(11,222)	(2,493)	(16,714)	(6,503)
Net premiums written	62,791	56,512	203,831	179,854
Change in unearned premiums	1,447	2,416	(17,844)	(1,918)
Net premiums earned	64,238	58,928	185,987	177,936
Investment income, net of expenses	3,467	4,100	11,203	11,682
Net realized gains (losses)	597	(2,496)	1,116	(1,405)
Finance charges	1,525	1,307	4,324	3,894
Commission and fees	2,018	3,127	10,834	16,280
Processing and service fees	7	20	33	98
Other income	51	3	60	9
Total revenues	71,903	64,989	213,557	208,494
Losses and loss adjustment expenses	40,579	38,981	115,552	110,514
Other operating expenses	23,428	24,041	71,056	71,114
Interest expense	1,147	1,186	3,456	3,557
Amortization of intangible assets	916	620	2,412	1,766
Total expenses	66,070	64,828	192,476	186,951
Income before tax	5,833	161	21,081	21,543
Income tax expense (benefit)	1,585	(485)	5,766	6,222
Net income	4,248	646	15,315	15,321
Less: Net income attributable to non-controlling interest	34	15	36	15
Net income attributable to Hallmark Financial Services, Inc.	\$ 4,214	\$ 631	\$ 15,279	\$ 15,306
Net income per share attributable to Hallmark Financial Services, Inc. common stockholders:				
Basic	\$ 0.20	\$ 0.03	\$ 0.73	\$ 0.74
Diluted	\$ 0.20	\$ 0.03	\$ 0.73	\$ 0.73

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of the consolidated financial statements

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
Common Stock				
Balance, beginning of period	\$ 3,757	\$ 3,747	\$ 3,751	\$ 3,740
Issuance of common stock upon option exercises	-	-	6	7
Balance, end of period	3,757	3,747	3,757	3,747
Additional Paid-In Capital				
Balance, beginning of period	120,736	119,369	119,928	118,459
Accretion of redeemable noncontrolling interest	(87)	(25)	(259)	(25)
Equity based compensation	612	305	1,488	1,078
Exercise of stock options	-	-	104	137
Balance, end of period	121,261	119,649	121,261	119,649
Retained Earnings				
Balance, beginning of period	84,972	74,018	72,242	59,343
Adjustment to opening balance, net of tax (note 2)	-	-	1,665	-
Adjusted balance, beginning of period	84,972	74,018	73,907	59,343
Net income attributable to Hallmark Financial Services, Inc.	4,214	631	15,279	15,306
Balance, end of period	89,186	74,649	89,186	74,649
Accumulated Other Comprehensive Income (Loss)				
Balance, beginning of period	836	(4,756)	(16,432)	(1,844)
Adjustment to opening balance, net of tax (note 2)	-	-	(1,665)	-
Adjusted balance, beginning of period	836	(4,756)	(18,097)	(1,844)
Additional minimum pension liability, net of tax	80	10	239	31
Net unrealized holding gains (losses) arising during period	7,881	(2,982)	27,197	(4,340)
Reclassification adjustment for losses included in net income	(636)	(734)	(1,178)	(2,309)
Balance, end of period	8,161	(8,462)	8,161	(8,462)
Treasury Stock				
Balance, beginning of period	(77)	(77)	(77)	(77)
Acquisition of treasury shares	(5,250)	-	(5,250)	-
Balance, end of period	(5,327)	(77)	(5,327)	(77)
Total Stockholders' Equity	\$ 217,038	\$ 189,506	\$ 217,038	\$ 189,506
Net income	\$ 4,248	\$ 646	\$ 15,315	\$ 15,321

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Additional minimum pension liability, net of tax	80	10	239	31
Net unrealized holding gains (losses) arising during period	7,881	(2,982)	27,197	(4,340)
Reclassification adjustment for losses included in net income	(636)	(734)	(1,178)	(2,309)
Comprehensive income (loss)	11,573	(3,060)	41,573	8,703
Less: Comprehensive income attributable to non-controlling interest	34	15	36	15
Comprehensive income (loss) attributable to Hallmark Financial Services, Inc.	\$ 11,539	\$ (3,075)	\$ 41,537	\$ 8,688

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

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

	Nine Months Ended September 30	
	2009	2008
Cash flows from operating activities:		
Net income	\$ 15,315	\$ 15,321
Adjustments to reconcile net income to cash provided by operating activities:		
Depreciation and amortization expense	2,979	2,311
Deferred federal income tax benefit	(1,117)	(1,849)
Realized (gains) losses on investments	(1,116)	1,405
Change in prepaid reinsurance premiums	(5,036)	(1,694)
Change in premiums receivable	(4,787)	(1,026)
Change in accounts receivable	815	(24)
Change in deferred policy acquisition costs	(3,105)	(392)
Change in reserves for unpaid losses and loss adjustment expenses	15,252	29,950
Change in unearned premiums	23,462	2,295
Change in unearned revenue	(1,771)	(823)
Change in accrued agent profit sharing	(243)	(909)
Change in reinsurance recoverable	5,087	(6,573)
Change in reinsurance payable	2,680	-
Change in current federal income tax recoverable	(384)	(2,451)
Change in accrued ceding commission payable	(5)	94
Change in all other liabilities	(8,094)	(2,599)
Change in all other assets	5,763	4,122
Net cash provided by operating activities	45,695	37,158
Cash flows from investing activities:		
Purchases of property and equipment	(907)	(477)
Decrease in restricted cash and cash equivalents	3,470	7,080
Purchases of debt and equity securities	(74,430)	(642,260)
Maturities, sales and redemptions of investment securities	65,283	500,516
Payment for acquisition of subsidiaries	(7,246)	(14,799)
Net cash used in investing activities	(13,830)	(149,940)
Cash flows from financing activities:		
Proceeds from exercise of employee stock options	110	143
Net borrowings (repayments) of notes payable	(1,417)	946
Distribution (to) from non-controlling interest	(20)	-
Purchase of treasury shares	(5,250)	-
Repayment of structured settlement	-	(10,000)
Net cash used in financing activities	(6,577)	(8,911)

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Increase (decrease) in cash and cash equivalents	25,288	(121,693)
Cash and cash equivalents at beginning of period	59,134	145,884
Cash and cash equivalents at end of period	\$ 84,422	\$ 24,191

Supplemental cash flow information:

Interest paid	\$ 3,494	\$ 3,576
Taxes paid	\$ 7,267	\$ 10,521

Supplemental schedule of non-cash investing activities:

Change in receivable for securities related to investment disposals settled after the balance sheet date	\$ 850	\$ 27,395
Change in payable for securities related to investment purchases settled after the balance sheet date	\$ (2,918)	\$ (85,897)

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

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

1. General

Hallmark Financial Services, Inc. (“Hallmark” and, together with subsidiaries, “we,” “us” or “our”) is an insurance holding company which, 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 business and the excess commercial automobile and commercial umbrella risks produced by our Heath XS Operating Unit which are written on a national basis.

We pursue our business activities through subsidiaries whose operations are organized into five operating units which are supported by four of our insurance company subsidiaries. Our AHIS Operating Unit handles standard lines commercial insurance products and services and is comprised of American Hallmark Insurance Services, Inc. and Effective Claims Management, Inc. Our TGA Operating Unit handles primarily excess and surplus lines commercial insurance products and services and is comprised of TGA Insurance Managers, Inc., Pan American Acceptance Corporation (“PAAC”) and TGA Special Risk, Inc. Our Aerospace Operating Unit handles general aviation insurance products and services and is comprised of Aerospace Insurance Managers, Inc., Aerospace Special Risk, Inc. and Aerospace Claims Management Group, Inc. Our Heath XS Operating Unit handles excess commercial automobile and commercial umbrella risks on both an admitted and non-admitted basis and is comprised of Heath XS, LLC and Hardscrabble Data Solutions, LLC. Our Personal Lines Operating Unit handles non-standard personal automobile insurance and complementary personal insurance products and services and is comprised of American Hallmark General Agency, Inc. and Hallmark Claims Services, Inc., both of which do business as Hallmark Insurance Company.

These five operating units are segregated into three reportable industry segments for financial accounting purposes. The Standard Commercial Segment presently consists solely of the AHIS Operating Unit and the Personal Segment presently consists solely of our Personal Lines Operating Unit. The Specialty Commercial Segment includes our TGA Operating Unit, Aerospace Operating Unit, and Heath XS Operating Unit.

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, 2008 included in our Annual Report on Form 10-K filed with the SEC.

The interim financial data as of September 30, 2009 and 2008 is unaudited. However, in the opinion of management, the interim data includes all adjustments, consisting only of normal recurring adjustments, necessary for a fair statement of the results for the interim periods. The results of operations for the period ended September 30, 2009 are not necessarily indicative of the operating results to be expected for the full year.

Redeemable non-controlling interest

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

Reclassification

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

Income taxes

Income taxes are accounted for under the asset and liability method. At December 31, 2008, we had recorded a valuation allowance of \$4.5 million primarily attributable to capital losses from investments, impairments and unrealized losses in excess of gains. The valuation allowance was decreased by \$4.5 million during the nine months ended September 30, 2009, due to changes in unrealized and realized gains and losses on investments. The changes in valuation allowance attributable to continuing operations and to accumulated comprehensive income were approximately \$0.5 million and \$4.0 million, respectively, for the nine months ended September 30, 2009.

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. Actual results could differ materially from those estimates.

Fair Value of Financial Instruments

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

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

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

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

Notes Payable: The carrying value of our bank credit facility of \$2.8 million approximates the fair value based on the current interest rate. Our trust preferred securities have a carried value of \$56.7 million and a fair value of \$51.5 million as of September 30, 2009. The fair value of our trust preferred securities is based on discounted cash flows using a current yield to maturity of 8.5% based on similar issues to discount future cash flows.

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

Recently Issued Accounting Standards

In June 2009, the Financial Accounting Standards Board (“FASB”) issued Statement of Financial Accounting Standards No. 168, “The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles” — a replacement of FASB Statement No. 162 (the “Codification”). The Codification reorganized existing U.S. accounting and reporting standards issued by the FASB and other related private sector standard setters into a single source of authoritative accounting principles arranged by topic. The Codification supersedes all existing U.S. accounting standards. All other accounting literature not included in the Codification (other than SEC guidance for publicly-traded companies) is considered non-authoritative. The Codification was effective on a prospective basis for interim and annual reporting periods ending after September 15, 2009. The adoption of the Codification changed our references to U.S. GAAP accounting standards but did not impact our results of operations, financial position or liquidity.

In September 2006, FASB issued Statement of Financial Accounting Standards No. 157, “Fair Value Measurements,” which was codified in the FASB Accounting Standards Codification (“ASC”) Topic 820, “Fair Value Measurements and Disclosures (“FASB ASC 820”). FASB ASC 820 establishes a separate framework for determining fair values of assets and liabilities that are required by other authoritative GAAP pronouncements to be measured at fair value. In addition, FASB ASC 820 incorporates and clarifies the guidance in FASB Concepts Statement 7 regarding the use of present value techniques in measuring fair value. FASB ASC 820 does not require any new fair value measurements. FASB ASC 820 is effective for financial statements issued for fiscal years beginning after November 15, 2007. The adoption of FASB ASC 820 had no impact on our financial statements or results of operations but did require additional disclosures. (See Note 4, “Fair Value.”)

In February 2007, FASB issued Statement of Financial Accounting Standards No. 159, “The Fair Value Option for Financial Assets and Liabilities”, which was codified into FASB ASC Topic 825, “Financial Instruments” (“FASB ASC 825”). FASB ASC 825 permits entities to choose to measure many financial instruments and certain other items at fair value with changes in fair value included in current earnings. The election is made on specified election dates, can be made on an instrument-by- instrument basis, and is irrevocable. FASB ASC 825 is effective for financial statements issued for fiscal years beginning after November 15, 2007. The adoption of FASB ASC 825 had no impact on our financial statements or results of operations as we did not elect to apply FASB ASC 825 to any eligible items.

In December 2007, the FASB issued Revised Statement of Financial Accounting Standards No. 141R, “Business Combinations”, which was codified into FASB ASC Topic 805, “Business Combinations”, (“FASB ASC 805”). FASB ASC 805 provides revised guidance on how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquired entity. In addition, it provides revised guidance on the recognition and measurement of goodwill acquired in the business combination. FASB ASC 805 also provides guidance specific to the recognition, classification, and measurement of assets and liabilities related to insurance and reinsurance contracts acquired in a business combination. FASB ASC 805 applies to business combinations for acquisitions occurring on or after January 1, 2009. The adoption of FASB ASC 805 did not have a material effect on our results of operations or liquidity. However, FASB ASC 805 will impact the accounting for any future acquisitions.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 160, “Noncontrolling Interests in Consolidated Financial Statements—an amendment of Accounting Research Bulletin No. 51”, which was codified into FASB ASC Topic 810, “Noncontrolling Interests” (“FASB ASC 810”). FASB ASC 810 amends Accounting Research Bulletin No. 51 to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. In addition, it clarifies that a noncontrolling interest in a subsidiary is an ownership interest in the consolidated entity that should be reported as a component of equity in the consolidated financial statements. FASB ASC 810 is effective on a prospective basis beginning January 1, 2009, except for the presentation and disclosure requirements which are applied on a retrospective basis for all periods presented. The adoption of FASB ASC 810 did not have a significant impact on our consolidated financial statements.

In April 2009, FASB issued FASB Staff Position No. FAS 157-4, “Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly”, which was codified into FASB ASC Topic 820. FASB ASC 820 provides guidance for estimating fair value when the volume and level of activity for the asset or liability have significantly decreased and identifying circumstances that may indicate that a transaction is not orderly. FASB ASC 820 is effective for interim and annual reporting periods ending after June 15, 2009, and is applied prospectively. The adoption of this guidance did not have a significant impact on our consolidated financial statements.

In April 2009, FASB issued FASB Staff Position No. FAS 115-2 and FAS 124-2, “Recognition and Presentation of Other-Than-Temporary Impairments”, which was codified into FASB ASC Topic 320, “Investment Securities” (“FASB ASC 320”), amending prior other-than-temporary impairment guidance for debt in order to make the guidance more operational and improve the presentation and disclosure of other-than-temporary impairments in the financial statements. FASB ASC 320 does not amend existing recognition and measurement guidance related to other-than-temporary impairments of equity securities. The provisions of FASB ASC 320 are effective for interim periods ending after June 15, 2009. We adopted FASB ASC 320 effective April 1, 2009 which resulted in a cumulative effect adjustment to the beginning balances of retained earnings and accumulated other comprehensive income of approximately \$2.6 million before tax and \$1.7 million net of tax.

In April 2009, FASB issued FASB Staff Position No. FAS 107-1 and APB Opinion No. 28-1, “Interim Disclosures about Fair Value of Financial Instruments”, which was codified into FASB ASC 825. FASB ASC 825 requires disclosures about fair value of financial instruments for interim reporting periods as well as in annual financial statements. This guidance is effective for interim periods ending after June 15, 2009 but did not impact our consolidated financial statements. However, additional footnote disclosures to our interim and annual financial statements were required.

In May 2009, FASB issued Statement of Financial Accounting Standard No. 165, "Subsequent Events", which was codified into FASB ASC Topic 855, "Subsequent Events" ("FASB ASC 855"), which provides authoritative accounting literature for a topic previously addressed only in the auditing literature (AICPA AU Section 560, Subsequent Events). The provisions of FASB ASC 855 are effective for interim financial periods ending after June 15, 2009. The adoption of FASB ASC 855 did not have a significant impact on our consolidated financial statements.

In June 2009, FASB issued Statement of Financial Accounting Standards No. 167, "Amendments to FASB Interpretation No. 46(R)" ("SFAS 167"), which has not yet been codified in the Codification. SFAS 167 addresses the effects of eliminating the qualifying special-purpose entity concept and responds to concerns about the application of certain key provisions of FASB Interpretation No. 46(R), "Consolidation of Variable Interest Entities", including concerns over the transparency of enterprises' involvement with variable interest entities. SFAS 167 is effective for calendar year end companies beginning on January 1, 2010 with earlier application prohibited. We do not expect the impact of adopting SFAS 167 to have a material impact on our consolidated financial statements.

3. Business Combinations

We account for business combinations using the purchase method of accounting. 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 amounts assigned to assets acquired and liabilities assumed is an asset referred to as "Excess of cost over fair value of net assets acquired." 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 the Heath XS Operating Unit for consideration of \$15.0 million. In connection with the acquisition of membership interests in the subsidiaries comprising the Heath XS Operating Unit, 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 comprising the Heath XS Operating Unit 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 Heath XS Operating 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 Heath XS Operating 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 \$2.0 million at September 30, 2009.

The fair value of the amortizable intangible assets acquired and respective amortization periods are as follows (\$ in thousands):

Tradename	\$	757	15 years
Non-compete agreement	\$	526	6 years
Agency relationships	\$	6,385	15 years

The Heath XS Operating Unit is an underwriting organization that produces lower hazard, middle market, excess commercial automobile and commercial umbrella insurance policies on both an admitted and non-admitted basis through a network of independent wholesale agencies throughout the United States.

Effective June 5, 2009, we acquired all of the issued and outstanding shares of CYR Insurance Management Company (“CYR”). CYR has as its primary asset a management agreement with State and County Mutual Fire Insurance Company (subsequently renamed Hallmark County Mutual Insurance Company, “HCM”) which provides for CYR to have management and control of HCM. We acquired all of the issued and outstanding shares of CYR for consideration of a base purchase price of \$4.0 million paid at closing plus an override commission in an amount equal to 1% of the net premiums and net policy fees of HCM for the years 2010 and 2011 subject to a maximum of \$1.25 million. The override commission will be paid monthly as the subject premiums and policy fees are written. The fair value of the management agreement acquired is \$3.2 million and will be amortized over 4 years. HCM is used to front certain lines of business in our Specialty Commercial and Personal Segments in Texas where we previously produced policies for third party county mutual insurance companies and reinsured 100% for a fronting fee.

4. Fair Value

FASB ASC 820 defines fair value, establishes a consistent framework for measuring fair value and expands disclosure requirements about fair value measurements. FASB 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, FASB 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.

Effective January 1, 2008, we determine the fair value of our financial instruments based on the fair value hierarchy established in FASB ASC 820. In accordance with FASB 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 FASB 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. If quoted prices are not available from active exchanges for identical instruments, then fair values are estimated using quoted prices from less active markets, quoted prices of securities with similar characteristics or by pricing models utilizing other significant observable inputs. Examples of such instruments, which would generally be classified within Level 2 of the valuation hierarchy, include corporate bonds, municipal bonds and U.S. Treasury securities. In cases where there is limited activity or less transparency around inputs to the valuation, investment securities are classified within Level 3 of the valuation hierarchy. Level 3 investments are valued based on the best available data in order to approximate fair value. This data may be internally developed and consider risk premiums that a market participant would require. Investment securities classified within Level 3 include other less liquid investment securities.

The following table presents for each of the fair value hierarchy levels, our assets that are measured at fair value on a recurring basis at September 30, 2009 (in thousands).

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Unobservable Inputs (Level 3)	Total
U.S. Treasury securities and obligations of U.S. government	\$ -	\$ 6,169	\$ -	\$ 6,169
Corporate debt securities	-	91,427	-	91,427
Municipal bonds	-	168,261	28,882	197,143
Asset backed	-	713	-	713
Total debt securities	-	266,570	28,882	295,452
Financial services	28,356	-	-	28,356
All other	12,603	-	-	12,603
Total equity securities	40,959	-	-	40,959
Total debt and equity securities	\$ 40,959	\$ 266,570	\$ 28,882	\$ 336,411

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

The following table summarizes the changes in fair value for all financial assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) during the nine months ended September 30, 2009 (in thousands).

Beginning balance as of January 1, 2009	\$ 46,104
Net purchases, issuances, sales and settlements	(16,450)
Total realized/unrealized gains included in net income	-
Net gains included in other comprehensive income	(772)
Transfers in and/or out of Level 3	-
Ending balance as of September 30, 2009	\$ 28,882

5. Investments

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

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.

Fixed Maturity 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.

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

Three Months Ended September 30		Nine Months Ended September 30	
2009	2008	2009	2008