

**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, 2011**

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number: **1-8303**

**The Hallwood Group Incorporated**  
(Exact name of registrant as specified in its charter)

**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**51-0261339**  
(I.R.S. Employer  
Identification No.)

**3710 Rawlins, Suite 1500, Dallas, Texas**  
(Address of principal executive offices)

**75219**  
(Zip Code)

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

**Not Applicable**  
(Former name, former address and former fiscal year, if changed since last report)

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 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  (Do not check if a smaller reporting company) 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.

Class  
Common Stock, \$0.10 par value per share

Outstanding at October 31, 2011  
1,525,166 shares

# THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

## TABLE OF CONTENTS

<u>ITEM NO.</u>	<u>PART I - FINANCIAL INFORMATION</u>	<u>PAGE</u>
1	Financial Statements (Unaudited):	
	Condensed Consolidated Balance Sheets as of September 30, 2011 and December 31, 2010 .....	3
	Condensed Consolidated Statements of Operations for the Nine Months Ended September 30, 2011 and 2010.....	4
	Condensed Consolidated Statements of Operations for the Three Months Ended September 30, 2011 and 2010 .....	5
	Condensed Consolidated Statements of Comprehensive Income (Loss) for the Three Months and Nine Months Ended September 30, 2011 and 2010	6
	Condensed Consolidated Statement of Changes in Stockholders' Equity for the Nine Months Ended September 30, 2011 .....	7
	Condensed Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2011 and 2010.....	8
	Notes to Condensed Consolidated Financial Statements .....	9
2	Management's Discussion and Analysis of Financial Condition and Results of Operations.....	24
4	Controls and Procedures .....	34
	 <b><u>PART II - OTHER INFORMATION</u></b>	
1 thru 6	Other Information .....	35
	Signature Page .....	37
	Index to Exhibits.....	38

# THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

## CONDENSED CONSOLIDATED BALANCE SHEETS

(dollars in thousands)

(unaudited)

	<u>September 30,</u> <u>2011</u>	<u>December 31,</u> <u>2010</u>
<b>ASSETS</b>		
<b>Current Assets</b>		
Cash and cash equivalents.....	\$ 9,396	\$11,159
Marketable securities - short-term investments.....	--	7,490
Accounts receivable, net		
Factors.....	17,229	14,043
Trade and other.....	10,338	8,916
Related parties.....	40	12
Inventories, net.....	28,948	19,136
Deferred income tax, net.....	4,235	1,597
Prepays, deposits and other assets.....	1,228	700
Prepaid income taxes.....	<u>660</u>	<u>1,093</u>
	72,074	64,146
<b>Noncurrent Assets</b>		
Property, plant and equipment, net.....	19,994	20,984
Other assets.....	164	147
Investments in Hallwood Energy, net.....	<u>--</u>	<u>--</u>
	<u>20,158</u>	<u>21,131</u>
<b>Total Assets</b> .....	<u>\$92,232</u>	<u>\$85,277</u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>Current Liabilities</b>		
Accounts payable.....	\$11,631	\$ 7,996
Accrued expenses and other current liabilities.....	6,022	6,016
Payable – Hallwood Energy matters		
Litigation reserve.....	7,500	--
Contingent additional investment in Hallwood Energy.....	3,201	3,201
Income taxes payable.....	<u>14</u>	<u>27</u>
	28,368	17,240
<b>Noncurrent Liabilities</b>		
Long term portion of loans payable.....	2,000	2,000
Deferred income tax.....	<u>566</u>	<u>566</u>
	<u>2,566</u>	<u>2,566</u>
<b>Total Liabilities</b> .....	30,934	19,806
<b>Contingencies and Commitments (Note 14)</b>		
<b>Stockholders' Equity</b>		
Common stock, issued 2,396,105 shares for both periods;		
outstanding 1,525,166 shares for both periods.....	240	240
Additional paid-in capital.....	51,700	51,700
Retained earnings.....	22,762	26,935
Treasury stock, 870,939 shares for both periods; at cost.....	<u>(13,404)</u>	<u>(13,404)</u>
<b>Total Stockholders' Equity</b> .....	<u>61,298</u>	<u>65,471</u>
<b>Total Liabilities and Stockholders' Equity</b> .....	<u>\$92,232</u>	<u>\$85,277</u>

See accompanying notes to condensed consolidated financial statements.

**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**

**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

(in thousands, except per share amounts)  
(unaudited)

	<b>Nine Months Ended</b>	
	<b>September 30,</b>	
	<b><u>2011</u></b>	<b><u>2010</u></b>
<b>Revenues</b>		
Textile products sales.....	\$101,117	\$131,848
<b>Expenses</b>		
Textile products cost of sales .....	82,426	95,498
Administrative and selling expenses .....	17,358	19,636
Litigation reserve – Hallwood Energy matters .....	<u>7,500</u>	<u>--</u>
	<u>107,284</u>	<u>115,134</u>
Operating income (loss) .....	(6,167)	16,714
<b>Other Income (Loss)</b>		
Interest expense .....	(74)	(207)
Interest and other income .....	<u>35</u>	<u>8</u>
	<u>(39)</u>	<u>(199)</u>
Income (loss) before income taxes .....	(6,206)	16,515
Income tax expense (benefit) .....	<u>(2,033)</u>	<u>6,062</u>
<b>Net Income (Loss)</b> .....	<u>\$ (4,173)</u>	<u>\$ 10,453</u>
 <b>Net Income (Loss) Per Common Share</b>		
Basic.....	\$( <u>2.74</u> )	\$ <u>6.85</u>
Diluted.....	\$( <u>2.74</u> )	\$ <u>6.85</u>
 <b>Weighted Average Shares Outstanding</b>		
Basic.....	<u>1,525</u>	<u>1,525</u>
Diluted.....	<u>1,525</u>	<u>1,525</u>

See accompanying notes to condensed consolidated financial statements.

**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**

**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

(in thousands, except per share amounts)  
(unaudited)

	<b>Three Months Ended</b>	
	<b>September 30,</b>	
	<b><u>2011</u></b>	<b><u>2010</u></b>
<b>Revenues</b>		
Textile products sales.....	\$37,649	\$36,771
<b>Expenses</b>		
Textile products cost of sales.....	30,116	28,454
Administrative and selling expenses.....	6,881	7,361
Litigation reserve – Hallwood Energy matters.....	--	--
	<u>36,997</u>	<u>35,815</u>
Operating income.....	652	956
<b>Other Income (Loss)</b>		
Interest expense.....	(25)	(89)
Interest and other income.....	<u>5</u>	<u>2</u>
	<u>(20)</u>	<u>(87)</u>
Income before income taxes.....	632	869
Income tax expense.....	<u>282</u>	<u>462</u>
<b>Net Income</b> .....	<u>\$ 350</u>	<u>\$ 407</u>
<b>Net Income Per Common Share</b>		
Basic.....	<u>\$0.23</u>	<u>\$0.27</u>
Diluted.....	<u>\$0.23</u>	<u>\$0.27</u>
<b>Weighted Average Shares Outstanding</b>		
Basic.....	<u>1,525</u>	<u>1,525</u>
Diluted.....	<u>1,525</u>	<u>1,525</u>

See accompanying notes to condensed consolidated financial statements.

# THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS) (in thousands) (unaudited)

	<u>Three Months Ended</u> <u>September 30,</u>		<u>Nine Months Ended</u> <u>September 30,</u>	
	<u>2011</u>	<u>2010</u>	<u>2011</u>	<u>2010</u>
<b>Net Income (Loss)</b> .....	\$350	\$407	\$(4,173)	\$10,453
Other Comprehensive Income (Loss)				
None.....	<u>  --</u>	<u>  --</u>	<u>  --</u>	<u>  --</u>
<b>Comprehensive Income (Loss)</b> .....	<u>\$350</u>	<u>\$407</u>	<u>\$(4,173)</u>	<u>\$10,453</u>

See accompanying notes to condensed consolidated financial statements.

**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**

**CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY**  
(in thousands)  
(unaudited)

	<u>Common Stock</u>		<u>Additional</u>	<u>Retained</u>	<u>Treasury Stock</u>		<u>Total</u>
	<u>Shares</u>	<u>Par Value</u>	<u>Paid-In</u>	<u>Earnings</u>	<u>Shares</u>	<u>Cost</u>	<u>Stockholders'</u>
			<u>Capital</u>				<u>Equity</u>
<b>Balance, January 1, 2011</b> .....	2,396	\$240	\$51,700	\$26,935	871	\$(13,404)	\$65,471
Net loss .....	--	--	--	(4,173)	--	--	(4,173)
<b>Balance, September 30, 2011</b> .....	<u>2,396</u>	<u>\$240</u>	<u>\$51,700</u>	<u>\$22,762</u>	<u>871</u>	<u>\$(13,404)</u>	<u>\$61,298</u>

See accompanying notes to condensed consolidated financial statements.

**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**

**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(in thousands)

(unaudited)

	<b>Nine Months Ended</b>	
	<b>September 30,</b>	
	<b><u>2011</u></b>	<b><u>2010</u></b>
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net income (loss).....	\$(4,173)	\$10,453
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Litigation reserve – Hallwood Energy matters .....	7,500	--
Deferred tax expense (benefit) .....	(2,638)	174
Depreciation, amortization and impairment .....	1,886	1,684
Provision for obsolete inventory .....	96	219
Provision for doubtful accounts and factor dilution .....	(30)	--
Changes in assets and liabilities:		
(Increase) decrease in inventories .....	(9,908)	2,404
(Increase) decrease in accounts receivable .....	(4,606)	9,812
Increase (decrease) in accounts payable .....	4,128	(3,999)
Increase (decrease) in accrued expenses and other current liabilities .....	6	(1,553)
Net change in other assets and liabilities .....	(545)	10
Net change in income taxes receivable/payable .....	<u>420</u>	<u>(159)</u>
Net cash provided by (used in) operating activities .....	(7,864)	19,045
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Proceeds from redemption of short-term investments .....	7,500	--
Investments in short-term investments.....	(10)	--
Investments in property, plant and equipment, net .....	<u>(1,389)</u>	<u>(6,116)</u>
Net cash provided by (used in) investing activities.....	6,101	(6,116)
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Proceeds from revolving credit facility.....	2,000	11,745
Repayments of revolving credit facility.....	(2,000)	(15,195)
Redemption of preferred stock .....	<u>--</u>	<u>(1,000)</u>
Net cash provided by (used in) financing activities .....	<u>--</u>	<u>(4,450)</u>
<b>INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS .....</b>	<b>(1,763)</b>	<b>8,479</b>
<b>CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD .....</b>	<b><u>11,159</u></b>	<b><u>7,838</u></b>
<b>CASH AND CASH EQUIVALENTS, END OF PERIOD.....</b>	<b><u>\$ 9,396</u></b>	<b><u>\$16,317</u></b>

See accompanying notes to condensed consolidated financial statements.

# THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Nine Months Ended September 30, 2011 and 2010

(unaudited)

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

*Organization.* The Hallwood Group Incorporated (the “Company”) (NYSE Amex: HWG) was incorporated in Delaware in 1981. The Company operates as a holding company. The Company operates its principal business in the textile products industry through its wholly owned subsidiary, Brookwood Companies Incorporated (“Brookwood”).

*Interim Condensed Consolidated Financial Statements.* The interim condensed consolidated financial statements of the Company and its subsidiaries (collectively, the “Hallwood Group”) have been prepared in accordance with the instructions to Form 10-Q and do not include all of the information and disclosures required by accounting principles generally accepted in the United States of America. Although condensed, in the opinion of management, all adjustments considered necessary for a fair presentation have been included. These condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and related disclosures thereto included in the Company’s annual report on Form 10-K for the year ended December 31, 2010.

*Textile Products.* Textile products operations are conducted through Brookwood. Brookwood is an integrated textile firm that develops and produces innovative fabrics and related products through specialized finishing, treating and coating processes. Brookwood has two principal subsidiaries at September 30, 2011:

- Kenyon Industries, Inc. (“Kenyon”). Kenyon, located in Rhode Island, uses the latest technologies and processes in dyeing, finishing, coating and printing of woven synthetic products. Kenyon provides quality finishing services for fabrics used in a variety of markets, such as military, luggage and knapsacks, flag and banner, apparel, industrial and sailcloth.
- Brookwood Laminating Inc. (“Brookwood Laminating”). Brookwood Laminating, located in Connecticut, uses the latest in processing technology to provide quality laminating services for fabrics used in military clothing and equipment, sailcloth, medical equipment, industrial applications and consumer apparel. Up to five layers of textile materials can be processed using both wet and dry lamination techniques.

Textile products accounts for all of Hallwood Group’s operating revenues. See Note 4 for additional information on Brookwood.

*Investments in Financial Instruments.* In the 2011 first quarter, the Company opened an investment account with UBS AG, a global financial services firm, and intended to transfer a significant portion of the cash it holds from time to time to the UBS account to invest. As of November 14, 2011, no funds have been transferred into the UBS account. In connection with the Hallwood Energy litigation matters discussed in Note 14, on July 25, 2011, the Court issued Proposed Findings of Fact, Conclusions of Law and Judgment Awarding Various Monetary Damages (the “Proposed Findings”) in the Adversary proceedings. The Court proposed damage awards plus interest and attorney fees. The Company has filed objections to the Proposed Findings and will vigorously defend against the entry of any final judgment. Until this matter is concluded, the Company does not intend to pursue its previously announced intention to transfer funds into the UBS account.

*Energy.* Prior to October 2009, the Company held an investment in Hallwood Energy, L.P. (“Hallwood Energy”). Hallwood Energy was a privately held independent oil and gas limited partnership and operated as an upstream energy company engaged in the acquisition, development, exploration, production, and sale of hydrocarbons, with a primary focus on natural gas assets. The Company accounted for the investment in Hallwood Energy using the equity method of accounting, recording its pro rata share of Hallwood Energy’s net income (loss), partners’ capital transactions and comprehensive income (loss). As further discussed in Note 5, Hallwood Energy filed for bankruptcy in March 2009. In connection with the confirmation of Hallwood Energy’s bankruptcy in October 2009, the Company’s ownership interest in Hallwood Energy was extinguished and the Company no longer accounts for the investment in Hallwood Energy using the equity method of accounting.

*Consolidation Policy.* The Company’s Brookwood subsidiary operates on a 5-4-4 accounting cycle with its months always ending on a Saturday for accounting purposes, while the Company operates on a traditional fiscal month accounting cycle. For purposes of the year-end financial statements the Brookwood cycle always ends on December 31, however, quarterly interim financial statements may not correspond to the fiscal quarter-end. Hallwood Group’s condensed consolidated financial statements as of September 30, 2011 and 2010 include Brookwood’s operations through October 1, 2011 and September 26, 2010, respectively. Estimated operating results of Brookwood for the intervening periods to September 30, 2011 and 2010, respectively, are provided below (in thousands):

# THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Nine Months Ended September 30, 2011 and 2010

(unaudited)

	Amounts in Intervening Periods	
	Nine Months Ended September 30,	
	2011	2010
	(one business day)	(four business days)
Textile products sales .....	\$ 6	\$2,293
Textile products costs of sales .....	4	1,780
Administrative and selling expenses .....	80	404

*New Accounting Pronouncements.* In June 2011, the Financial Accounting Standards Board issued Accounting Standards Update No. 2011-05 (ASU 2011-05), *Presentation of Comprehensive Income*. This standard eliminates the current option to present other comprehensive income and its components in the statement of changes in equity. It will require companies to report the total of comprehensive income including the components of net income and the components of other comprehensive income in either a single continuous statement of comprehensive income or in two separate but consecutive statements. Hallwood Group will adopt ASU 2011-05 in its annual financial statements for the year ended December 31, 2011. The adoption of ASU 2011-05 will not affect Hallwood Group's financial position, results of operations or cash flows.

### Note 2 — Cash, Cash Equivalents and Marketable Securities

The following tables summarize the estimated fair value of Hallwood Group's cash, cash equivalents and marketable securities and the gross unrealized holding gains and losses (in thousands):

	September 30, 2011			Fair Value
	Cost	Gross Unrealized Losses	Gross Unrealized Gains	
Cash and Cash Equivalents				
Cash.....	\$4,149	\$ --	\$ --	\$4,149
Available for-sale-securities:				
Money market funds .....	<u>5,247</u>	<u>--</u>	<u>--</u>	<u>5,247</u>
Total cash and cash equivalents .....	<u>\$9,396</u>	<u>\$--</u>	<u>\$--</u>	<u>\$9,396</u>
Marketable Securities				
Short-term investments				
Variable-rate demand notes .....	\$ <u>--</u>	\$ <u>--</u>	\$ <u>--</u>	\$ <u>--</u>

# THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Nine Months Ended September 30, 2011 and 2010

(unaudited)

	December 31, 2010			Fair Value
	Cost	Gross Unrealized Losses	Gross Unrealized Gains	
Cash and Cash Equivalents				
Cash.....	\$ 5,909	\$ --	\$ --	\$ 5,909
Available for-sale-securities:				
Money market funds .....	<u>5,250</u>	<u>--</u>	<u>--</u>	<u>5,250</u>
Total cash and cash equivalents .....	<u>\$11,159</u>	<u>\$--</u>	<u>\$--</u>	<u>\$11,159</u>
Marketable Securities				
Short-term investments				
Variable-rate demand notes .....	<u>\$ 7,490</u>	<u>\$ --</u>	<u>\$ --</u>	<u>\$ 7,490</u>

There are no unrealized gains or losses for the variable-rate demand notes because of the frequent resetting nature of such notes. Variable-rate demand notes are considered highly liquid and although the variable-rate demand notes have long-term nominal maturity dates, the interest rates generally reset weekly. Despite the long-term nature of the variable-rate demand notes, they are classified as short-term due to Hallwood Group's ability to quickly liquidate these securities at par plus accrued interest with seven-day notice. The variable-rate demand notes were sold at par during 2011 in connection with Brookwood's recurring operations.

### Note 3 — Inventories

All inventories relate to Brookwood. Inventories as of the balance sheet dates were as follows (in thousands):

	September 30, December 31,	
	2011	2010
Raw materials.....	\$ 7,864	\$ 6,796
Work in progress .....	8,714	4,782
Finished goods .....	<u>13,666</u>	<u>8,758</u>
	30,244	20,336
Less: Obsolescence reserve.....	<u>(1,296)</u>	<u>(1,200)</u>
Total .....	<u>\$28,948</u>	<u>\$19,136</u>

### Note 4 — Operations of Brookwood Companies Incorporated

*Receivables.* Brookwood maintains factoring agreements with several factors, which provide that receivables resulting from credit sales to customers, excluding the U.S. Government, may be sold to the factor, subject to a commission and the factor's prior approval. Factored receivables were \$17,229,000 and \$14,043,000 at September 30, 2011 and December 31, 2010, which were net of a returned goods dilution allowance of \$80,000 and \$114,000, respectively.

Brookwood monitors its factors and their ability to fulfill their obligations to Brookwood in a timely manner. As of November 14, 2011, all of Brookwood's factors were complying with payment terms in accordance with factor agreements.

Trade receivables were \$10,000,000 and \$8,387,000 at September 30, 2011 and December 31, 2010, which were net of an allowance for doubtful accounts of \$133,000 and \$129,000, respectively. The trade receivable balance at September 30, 2011 and December 31, 2010 includes approximately \$1,639,000, which was the balance remaining related to fabric sold in two products to a Brookwood customer that supplies the U.S. military for which payment has been delayed due to a pending compliance issue (see also Note 14). Brookwood resolved the issue with respect to one of the products and received payment at full value in 2009. Additionally,

# THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Nine Months Ended September 30, 2011 and 2010

(unaudited)

resolution with respect to the second product with one of the procurement entities was achieved and Brookwood received payment at full value of \$3,242,000 in October 2010. Although Brookwood is continuing efforts to structure a resolution with the final procurement entity, Brookwood has communicated to its supplier regarding satisfaction of the unpaid receivable. Brookwood believes it is likely to collect the balance due.

*Sales Concentration.* Brookwood has two customers who accounted for more than 10% of Brookwood's sales. Sales to one Brookwood customer, Tennier Industries, Inc. ("Tennier"), accounted for more than 10% of Brookwood's sales during both the 2011 and 2010 periods. Brookwood's relationship with Tennier is ongoing. Sales to Tennier, which are included in military sales, were \$5,061,000 and \$11,456,000 in the 2011 third quarter and nine month periods, respectively, compared to \$8,296,000 and \$44,064,000 in 2010. Sales to Tennier represented 13.4% and 22.6% of Brookwood's net sales in the 2011 and 2010 third quarters, respectively, and 11.3% and 33.4% in the 2011 and 2010 nine month periods, respectively. Sales to another customer, ORC Industries, Inc. ("ORC"), accounted for more than 10% of Brookwood's sales in 2010. Brookwood's relationship with ORC is ongoing. Sales to ORC, which are included in military sales, were \$867,000 and \$1,958,000 in the 2011 third quarter and nine month periods, respectively, compared to \$2,583,000 and \$12,662,000 in 2010. Sales to ORC represented 2.3% and 7.0% of Brookwood's net sales in the 2011 and 2010 third quarters, respectively, and 1.9% and 9.6% in the 2011 and 2010 nine month periods, respectively. Brookwood received an increased level of military orders and sales in late March and into the subsequent 2011 periods, however not to the same level as the first half of 2010.

Military sales accounted for \$21,802,000 and \$52,212,000 in the 2011 third quarter and nine month periods, respectively, compared to \$23,295,000 and \$93,246,000 in 2010. The military sales represented 57.9% and 63.4% of Brookwood's net sales in the 2011 and 2010 third quarters, respectively, and 51.6% and 70.7% in the 2011 and 2010 nine month periods, respectively. Generally, military sales represent sales of a product to a customer (prime and sub-prime contractors) that will be incorporated into an end product that will be used to fulfill a U.S. or international military contract.

*Flood at Kenyon Facility.* On March 31, 2010, Kenyon was affected by the general flooding that took place in the State of Rhode Island and in particular from the Pawcatuck River. Kenyon was closed for a period of seven days after which it reinstated production of unaffected production lines. Only certain production lines were affected and production capacity was restored within a few weeks. Brookwood filed claims with its insurance carriers, through its Kenyon subsidiary. Brookwood recognized the \$100,000 insurance policy deductible in the 2010 third quarter and has received from its carriers \$1,235,000 for its building and contents claims, including \$229,000 received in the 2011 first quarter. No additional amounts are due. Brookwood also filed a claim under its business interruption insurance policy and received \$150,000 in July 2011 from its carrier in satisfaction of its claim, which was recognized as a recovery in the 2011 second quarter.

*Stockholders' Equity.* The Company is the holder of all of Brookwood's outstanding \$13,500,000 Series A, \$13.50 annual dividend per share, redeemable preferred stock and all of its 10,000,000 outstanding shares of common stock. The preferred stock has a liquidation preference of \$13,500,000 plus accrued but unpaid dividends. At September 30, 2011, cumulative dividends in arrears on the preferred stock amounted to approximately \$456,000.

*2005 Long-Term Incentive Plan for Brookwood.* In December 2005, the Company adopted The Hallwood Group Incorporated 2005 Long-Term Incentive Plan for Brookwood Companies Incorporated (the "2005 Long-Term Incentive Plan for Brookwood") to encourage employees of Brookwood to increase the value of Brookwood and to be employed by Brookwood. The terms of the incentive plan provide for a total award amount to participants equal to 15% of the fair market value of consideration received by the Company in a change of control transaction, as defined, in excess of the sum of the liquidation preference plus accrued unpaid dividends on the Brookwood preferred stock (approximately \$13,956,000 at September 30, 2011). The base amount will fluctuate in accordance with a formula that increases by the amount of the annual dividend on the preferred stock, currently \$1,823,000, and decreases by the amount of the actual preferred dividends paid by Brookwood to the Company. The plan generally defines a change of control transaction as a transaction approved by the Company's board of directors or by the holders of at least 50% of the voting capital stock of the Company that results in: (i) a change in beneficial ownership of the Company or Brookwood of 50% or more of the combined voting power, (ii) the sale of all or substantially all of the assets of Brookwood, or (iii) any other transaction that, in the Company's board of directors discretion, has substantially the same effect of item (i) or (ii). Certain transfers, generally among existing stockholders and their related parties, are exempted from the definition.

However, if the Company's board of directors determines that certain specified Brookwood officers, or other persons performing similar functions do not have, prior to the change of control transaction, in the aggregate an equity or debt interest of at least two

# THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Nine Months Ended September 30, 2011 and 2010

(unaudited)

percent in the entity with whom the change of control transaction is completed, then the minimum amount to be awarded under the plan shall be \$2,000,000. In addition, the Company agreed that, if members of Brookwood's senior management do not have, prior to a change of control transaction in the aggregate an equity or debt interest of at least two percent in the entity with whom the change of control transaction is completed (exclusive of any such interest any such individual receives with respect to his or her employment following the change of control transaction), then the Company will be obligated to pay an additional \$2,600,000.

### Note 5 — Investments in Hallwood Energy, L.P.

Hallwood Energy was a privately held independent oil and gas limited partnership and operated as an upstream energy company engaged in the acquisition, development, exploration, production, and sale of hydrocarbons, with a primary focus on natural gas assets. The Company had invested \$75,401,000 in Hallwood Energy comprised of a general partnership interest, Class A and Class C limited partnership interests and convertible notes.

Prior to the confirmation of Hallwood Energy's plan of reorganization in Bankruptcy Court in October 2009 (discussed below), the Company accounted for the investment in Hallwood Energy using the equity method of accounting and recorded its pro rata share of Hallwood Energy's net income (loss), partner capital transactions and comprehensive income (loss), as appropriate. In connection with Hallwood Energy's bankruptcy reorganization, the Company's general and limited partnership interests in Hallwood Energy were extinguished and the Company no longer accounts for the investment in Hallwood Energy using the equity method of accounting.

*Bankruptcy Reorganization by Hallwood Energy.* In March 2009, Hallwood Energy, Hallwood Energy Management, LLC (the general partner of Hallwood Energy, "HEM") and Hallwood Energy's subsidiaries, filed petitions for relief under Chapter 11 of the United States Bankruptcy Code. The cases were adjudicated in the United States Bankruptcy Court for the Northern District of Texas, Dallas Division, in *In re Hallwood Energy, L.P., et al Case No. 09-31253*. The Company was only an investor in and creditor of Hallwood Energy. The bankruptcy filing did not include the Company or any other of its assets.

In October 2009, the Bankruptcy Court confirmed a plan of reorganization of the debtors that, among other things, extinguished Hallwood Energy's general partnership and limited partnership interests, including those held by the Company. In addition, Hallwood Energy's convertible notes, including those held by the Company, are subordinated to recovery in favor of Hall Phoenix/Inwood, Ltd. ("HPI"), the secured lender to Hallwood Energy. As a result of these developments, the Company does not anticipate that it will recover any of its investments in Hallwood Energy.

*Contingent Commitment to Invest Additional Funds.* In connection with the then ongoing efforts to complete a transaction to raise additional capital by entering into an agreement for the sale and farmout of an undivided interest in up to 33.33% of substantially all of its assets to FEI Shale, L.P. ("FEI"), a subsidiary of Talisman Energy, Inc. (the "Talisman Energy Transaction"), the Company loaned Hallwood Energy \$2,961,000 in May 2008. Concurrent with the completion of the Talisman Energy Transaction in June 2008, the Company entered into an equity support agreement (the "Equity Support Agreement") with Hallwood Energy under which the Company committed, under certain conditions, to contribute equity or debt capital to Hallwood Energy to maintain a reasonable liquidity position for Hallwood Energy or prevent or cure any default under Hallwood Energy's credit facilities with respect to interest payments, up to a maximum amount of \$12,500,000. The Company contributed \$2,039,000 at the completion date (for a total amount of \$5,000,000) to Hallwood Energy and committed to provide an additional amount of up to \$7,500,000 in certain circumstances under the terms of a \$12,500,000 convertible subordinated note agreement that was issued by Hallwood Energy in May 2008 and underwritten by the Company. In September 2008, the Company loaned an additional \$4,300,000 to Hallwood Energy under the Equity Support Agreement.

An obligation and related additional equity loss were recorded in 2008 to the extent of the Company's contingent commitment to provide additional financial support to Hallwood Energy pursuant to the Equity Support Agreement, in accordance with generally accepted accounting principles. The Equity Support Agreement terminated not later than October 2009 in connection with the confirmation of Hallwood Energy's plan of reorganization. The Equity Support Agreement is no longer in effect, although (as previously discussed) the obligation, subject to certain defenses raised by the Company, to pay the remaining contingent commitment amount of \$3,201,000 is at issue in the pending adversary proceeding against the Company. The \$3,201,000 amount is included in the "Payable – Hallwood Energy matters" reported on Hallwood Group's consolidated balance sheets.

# THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Nine Months Ended September 30, 2011 and 2010

(unaudited)

*Litigation.* In connection with Hallwood Energy's bankruptcy proceeding, Hallwood Energy and other parties have filed lawsuits and threatened to assert additional claims against the Company and certain related parties alleging actual, compensatory and exemplary damages in excess of \$200,000,000, based on purported breach of contract, fraud, breach of fiduciary duties, neglect, negligence and various misleading statements, omissions and misrepresentations. See Note 14.

*Other.* For further information on Hallwood Energy's activities, including its bankruptcy reorganization, refer to the Company's annual report on Form 10-K for the year ended December 31, 2010.

### Note 6 — Loans Payable

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

	September 30, December 31,	
	2011	2010
Working Capital Revolving Credit Facility; due January 2014.....	\$2,000	\$2,000
Current portion.....	--	--
Noncurrent portion.....	<u>\$2,000</u>	<u>\$2,000</u>

*Working Capital Revolving Credit Facility.* The Company's Brookwood subsidiary has a revolving credit facility in an amount up to \$25,000,000 with KeyBanc (the "Working Capital Revolving Credit Facility"). Borrowings are collateralized by all accounts receivable, certain finished goods inventory, machinery and equipment and all of the issued and outstanding capital stock of Brookwood and its subsidiaries. The interest rate was a blended rate of 1.73% and 3.02% at September 30, 2011 and December 31, 2010, respectively. The outstanding balance was \$2,000,000 at September 30, 2011 and Brookwood had \$22,879,000 of borrowing availability under this facility, which is net of a standby letter of credit for \$121,000.

*Renewal of Credit Facility.* In September 2010, Brookwood entered into an amendment of the Working Capital Revolving Credit Facility, to extend the term to January 31, 2014. The interest rate payable on the facility is dependent on the leverage ratio, as defined, and can vary from LIBOR + 1.50% - 2.00% and KeyBanc's Base Rate, typically prime rate + 0.50% - 1.00%, at Brookwood's option. The principal amount of \$25,000,000 and the loan covenants were not changed.

*Loan Covenants.* The Working Capital Revolving Credit Facility provides for a maximum total debt to tangible net worth ratio of 1.50 and a covenant that Brookwood shall maintain a quarterly minimum income before taxes of not less than one dollar. In October 2009, an additional covenant was added that provides for a total funded debt to EBITDA (earnings before interest, taxes, depreciation and amortization) ratio, for the trailing four quarters, of not greater than 2.00 to be calculated on a quarterly basis, commencing December 31, 2009.

As of December 31, 2010 and for all interim periods in 2010 Brookwood was in compliance with its loan covenants. Due to a decline in military sales for the 2011 first quarter, Brookwood was unable to meet the financial covenant that requires income before taxes of at least \$1 in each quarter. Brookwood's loss before taxes for the 2011 first quarter was \$299,000. Accordingly, in May 2011, Brookwood requested and received a waiver from KeyBanc for the income covenant for the 2011 first quarter. Future compliance with the covenants under its Working Capital Revolving Credit Facility depends on Brookwood's military orders increasing from the levels in the 2010 fourth quarter and 2011 first quarter. Brookwood received an increased level of military orders in late March and into the subsequent 2011 periods, and reported income before taxes of \$2,395,000 and \$3,304,000 in the 2011 third quarter and second quarter, respectively, and was in compliance with its loan covenants for the 2011 second and third quarters.

*Payments of Dividends.* Brookwood submits a quarterly loan compliance certificate to KeyBanc and concurrently requests the bank's consent to pay cash dividends and tax sharing payments to the Company. Brookwood paid to the Company dividends of \$1,000,000 in February 2011, May 2011 and September 2011. Brookwood anticipates requesting from KeyBanc the ability to borrow additional amounts from its Working Capital Revolving Credit Facility to pay cash dividends or to make advances to the Company to

# THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

**Nine Months Ended September 30, 2011 and 2010**

**(unaudited)**

enable the Company to receive not only its quarterly cash dividends but an undetermined portion (in excess of the cash currently held by the Company) of its potential obligations relating to the Hallwood Energy litigation. KeyBanc has not yet agreed to allow Brookwood to borrow funds to pay any such cash dividend or other advance to the Company and has indicated that it will only agree to a limited amount to be determined depending on additional financial information to be supplied by Brookwood. If for any reason Brookwood is unable to draw upon additional borrowings under its Working Capital Revolving Credit Facility or otherwise advance funds to the Company, the Company would be required to seek alternative sources of funding. The Company has not yet determined what, if any, sources would be available to it, but will consider such alternatives as an additional or new facility or term loan and potential sales of assets or additional securities. No assurance can be given that any such additional sources of funding will be available to the Company.

Additionally, any payment of a dividend or advance to the Company by Brookwood is dependent on a number of other factors including approval of Brookwood's board of directors, Brookwood's ability to meet the requirements of the Delaware corporate laws for payment of dividends, and compliance with other applicable laws and requirements. As a result, no assurance can be given that these amounts will be available when needed or required.

*Restricted Net Assets.* Cash dividends and tax sharing payments by Brookwood to the Company are contingent upon compliance with the KeyBanc loan covenants and the other restrictions described above. This limitation on the transferability of assets constitutes a restriction of Brookwood's net assets, which were \$61,052,000 and \$60,596,000 as of September 30, 2011 and December 31, 2010, respectively.

### Note 7 – Redeemable Preferred Stock

The Company completed the redemption of its Series B Preferred Stock, at \$4.00 per share on July 20, 2010, the mandatory redemption date, in the total amount of \$1,000,000 and the Series B Preferred Stock was cancelled on the stock records of the Company.

### Note 8 — Stockholders' Equity

*Stock Options.* At September 30, 2011, there were no outstanding stock options. The Company's former stock option plan terminated in 2005 and no stock options are available for issuance.

### Note 9 – Income Taxes

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

	<u>Three Months Ended</u>		<u>Nine Months Ended</u>	
	<u>September 30,</u>		<u>September 30,</u>	
	<u>2011</u>	<u>2010</u>	<u>2011</u>	<u>2010</u>
Federal				
Current.....	\$208	\$152	\$ 398	\$5,157
Deferred.....	(13)	174	(2,638)	174
Sub-total.....	195	326	(2,240)	5,331
State				
Current.....	87	136	207	731
Deferred.....	--	--	--	--
Sub-total.....	87	136	207	731
Total.....	<u>\$282</u>	<u>\$462</u>	<u>\$(2,033)</u>	<u>\$6,062</u>

The net deferred tax asset was \$3,669,000 and \$1,031,000 at September 30, 2011 and December 31, 2010, respectively. The deferred tax asset at September 30, 2011 was comprised of \$3,669,000 attributable to temporary differences, including \$2,625,000 for

# THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

**Nine Months Ended September 30, 2011 and 2010**

**(unaudited)**

a litigation reserve and \$1,120,000 associated with the Company's investment in Hallwood Energy. The deferred tax asset at December 31, 2010 was comprised of \$1,031,000 attributable to temporary differences, including \$1,120,000 associated with the Company's investment in Hallwood Energy. The statutory federal tax rate in both periods was 35%, while state taxes were determined based upon taxable income apportioned to those states in which the Company does business at their respective tax rates.

Hallwood Group had a federal income tax receivable of \$75,000 and \$473,000 at September 30, 2011 and December 31, 2010, respectively, and net state tax receivable of \$571,000 and \$593,000, at September 30, 2011 and December 31, 2010, respectively.

### Note 10 — Fair Value of Financial Instruments

The following table summarizes the valuation of the Company's financial instruments based upon the inputs used to measure fair value in the three levels of the fair value hierarchy as of September 30, 2011 and December 31, 2010.

- Level 1 – Quoted market prices in active markets for identical assets or liabilities
- Level 2 – Quoted prices for similar assets or liabilities in active markets or inputs that are observable
- Level 3 – Inputs that are unobservable

	<u>September 30, 2011</u>		
	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
Cash Equivalents			
Money market funds .....	\$5,247	\$ --	\$ --
Marketable Securities			
Short-term investments			
Variable-rate demand notes .....	--	--	--
Total .....	<u>\$5,247</u>	<u>\$ --</u>	<u>\$ --</u>
	<u>December 31, 2010</u>		
	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
Cash Equivalents			
Money market funds .....	\$5,250	\$ --	\$ --
Marketable Securities			
Short-term investments			
Variable-rate demand notes .....	--	7,490	--
Total .....	<u>\$5,250</u>	<u>\$7,490</u>	<u>\$ --</u>

Money market funds are classified as Level 1 instruments as they are traded in active markets with sufficient volume and frequency of transactions.

The variable-rate demand notes were classified as Level 2 instruments. Their fair values are based on quoted prices for similar assets or liabilities or determined using inputs that use readily observable market data that are actively quoted and can be validated through external sources, including third-party pricing services, brokers and market transactions.

The fair value of financial instruments that are short-term or reprice frequently and have a history of negligible credit losses are considered to approximate their carrying value. These include cash, short term receivables, accounts payable and other liabilities.

# THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Nine Months Ended September 30, 2011 and 2010

(unaudited)

### Note 11 — Supplemental Disclosures to the Condensed Consolidated Statements of Cash Flows

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

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

Description	Nine Months Ended September 30,	
	2011	2010
Accrued capital expenditures in accounts payable and accrued expenses:		
Amount at end of period .....	\$ <u>51</u>	\$ <u>234</u>

*Supplemental disclosures of cash payments:*

Income taxes paid .....	\$202	\$6,061
Interest paid .....	76	181

### Note 12 — Computation of Income (Loss) Per Common Share

The following table reconciles weighted average shares outstanding from basic to diluted methods and reconciles net income (loss) used in the computation of income (loss) per share for the basic and diluted methods (in thousands):

Description	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
<b>Weighted Average Shares Outstanding</b>				
Basic and diluted.....	1,525	1,525	1,525	1,525
<b>Net Income (Loss)</b>				
Basic and diluted.....	\$ <u>350</u>	\$ <u>407</u>	\$ <u>(4,173)</u>	\$ <u>10,453</u>

For the three months and nine months ended September 30, 2011 and 2010, there were no outstanding stock options. No shares were excluded from the calculation of diluted earnings per share.

### Note 13 – Related Party Transactions

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

# THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS Nine Months Ended September 30, 2011 and 2010 (unaudited)

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Consulting fees .....	\$249	\$249	\$ 747	\$ 747
Office space and administrative services .....	71	62	238	192
Travel and other expenses .....	<u>71</u>	<u>20</u>	<u>151</u>	<u>110</u>
Total.....	<u>\$391</u>	<u>\$331</u>	<u>\$1,136</u>	<u>\$1,049</u>

In addition, from time to time, HIL and Mr. Gumbiner have performed services for certain affiliated entities that are not subsidiaries of the Company, for which they receive consulting fees, bonuses, stock options, profit interests or other forms of compensation and expenses. The Company recognizes a proportionate share of such compensation and expenses, based upon its ownership percentage in the affiliated entities, through the utilization of the equity method of accounting. HIL or Mr. Gumbiner received no compensation from these affiliated entities during 2011 or 2010.

HIL and certain of its affiliates in which Mr. Gumbiner has an indirect financial interest share common offices, facilities and certain staff in the Company's Dallas office for which these companies reimburse the Company. Certain individuals employed by the Company, in addition to their services provided to the Company, perform services on behalf of the HIL-related affiliates. In addition, HIL utilizes some of the office space for purposes unrelated to the Company's business. The Company pays certain common general and administrative expenses for salaries, rent and other offices expenses and charges the HIL-related companies an overhead reimbursement fee for the share of the expenses allocable to these companies. For the three months ended September 30, 2011 and 2010, these companies reimbursed the Company \$25,000 and \$28,000, respectively, for such expenses. For the nine months ended September 30, 2011 and 2010, these companies reimbursed the Company \$72,000 and \$82,000, respectively.

### Note 14 — Litigation, Contingencies and Commitments

Reference is made to Note 16 to the consolidated financial statements contained in the Company's annual report on Form 10-K for the year ended December 31, 2010.

*Litigation.* From time to time, the Company, its subsidiaries, certain of its affiliates and others have been named as defendants in lawsuits relating to various transactions in which it or its affiliated entities participated. The Company and its subsidiaries are involved in a number of litigation matters. As discussed below, in the Hallwood Energy litigation, the court proposed an award of damages of \$18.7 million plus interest and attorney fees. The Company does not currently have sufficient cash, directly or through Brookwood, to make a cash payment of these amounts, if ultimately required to do so, and payment of a significant judgment based on the Proposed Findings would have a material adverse effect on the Company's financial position, results of operations or cash flows. The Company does not believe that the results of any other litigation matters would have a material adverse effect on the Company's financial position, results of operations or cash flows. In addition, the Company has spent and will likely continue to spend significant amounts in professional fees in connection with its defense of its pending litigation matters. The Company expenses professional fees and other costs associated with litigation matters as incurred.

In July 2007, Nextec Applications, Inc. filed *Nextec Applications, Inc. v. Brookwood Companies Incorporated and The Hallwood Group Incorporated* in the United States District Court for the Southern District of New York (SDNY No. CV 07-6901) claiming that the defendants infringed five United States patents. In October 2007, The Hallwood Group Incorporated was dismissed without prejudice on stipulation from the lawsuit. Nextec later added additional patents to the lawsuit. On March 31, 2010, the Court issued its Order on various motions for summary judgment, which in part dismissed Nextec's infringement claims as to two of the four remaining patents in the case. Brookwood then requested reconsideration of certain of the Court's rulings with respect to the two remaining patents. On June 8, 2010, the Court denied Brookwood's request with respect to one of the remaining patents, but granted Brookwood leave to renew its motion for summary judgment for the second remaining patent. Brookwood filed a renewed motion for summary judgment of patent invalidity for the second remaining patent, which motion was later denied on March 8, 2011 due to a disputed issue

# THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Nine Months Ended September 30, 2011 and 2010

(unaudited)

of fact. Brookwood intends to vigorously defend against any remaining claims. Trial on this matter is currently scheduled to begin on January 30, 2012. While Brookwood believes it possesses valid defenses to these claims, due to the nature of litigation, the ultimate outcome of this case is indeterminable at this time.

*Hallwood Energy.* In March 2009, Hallwood Energy, HEM (the general partner of Hallwood Energy) and Hallwood Energy's subsidiaries, filed petitions for relief under Chapter 11 of the United States Bankruptcy Code. The cases were adjudicated in the United States Bankruptcy Court for the Northern District of Texas, Dallas Division, in *In re Hallwood Energy, L.P., et al Case No. 09-31253*. The Company was only an investor in and creditor of Hallwood Energy. The bankruptcy filing did not include the Company or any other of its assets.

In October 2009, the Bankruptcy Court confirmed a plan of reorganization of the debtors that, among other things, extinguished the Company's interest in Hallwood Energy's general partnership and limited partnership interests. In addition, Hallwood Energy's convertible notes, including those held by the Company, are subordinated to recovery in favor of HPI. As a result of these developments, the Company does not anticipate that it will recover any of its investments in Hallwood Energy.

The confirmed plan of reorganization in the Hallwood Energy bankruptcy proceeding also provides that a creditors' trust created by the plan will pursue various claims against the Company, its officers, directors and affiliates and Hallwood Energy's officers and directors, including claims assigned to the creditors' trust by HPI.

In connection with an Acquisition and Farmout Agreement entered into between Hallwood Energy and FEI Shale, L.P. ("FEI"), in June 2008, the Company and Hallwood Energy entered into an Equity Support Agreement dated June 9, 2008, under which the Company agreed, under certain conditions, to contribute to Hallwood Energy up to \$12,500,000, in consideration for which the Company would receive equity or debt securities of Hallwood Energy. As of February 25, 2009 the Company had contributed \$9,300,000 to Hallwood Energy pursuant to the Equity Support Agreement. On that date, Hallwood Energy demanded that the Company fund the additional \$3,200,000, which the Company has not done. On March 30, 2009, Hallwood Energy filed an adversary proceeding against the Company seeking a judgment for the additional \$3,200,000. The case was originally styled *Hallwood Energy, L.P. v. The Hallwood Group Incorporated, Adversary No. 09-03082*, and was brought in the United States Bankruptcy Court for the Northern District of Texas, Dallas Division.

HPI and FEI intervened in the lawsuit and filed their respective complaints in intervention. Among the arguments advanced in the complaints in intervention is that the Company's failure to fund \$3,200,000 under the Equity Support Agreement damaged Hallwood Energy in an amount in excess of \$3,200,000. FEI generally claims that, in addition to not paying the \$3,200,000, the Company defrauded FEI and tortiously interfered with its rights under the Acquisition and Farmout Agreement, and it seeks approximately \$38,000,000 in additional damages. In their second amended complaint, HPI and the trustee for the creditors' trust contend that the additional damage is at least \$20,000,000 because they allege that the failure of the Company to fund the \$3,200,000 caused FEI to not fund \$20,000,000 due under the Farmout Agreement between Hallwood Energy and FEI. HPI and the trustee also assert that the Company is liable for exemplary damages of \$100,000,000 on account of its failure to fund the last \$3,200,000 under the Equity Support Agreement. Also in the second amended complaint, HPI and the trustee had named as additional defendants Hallwood Family (BVI) L.P., Hallwood Investments Limited, Hallwood Company Limited, the Hallwood Trust, Hallwood Financial Limited and Brookwood Companies Incorporated contending that the additional defendants are liable to the plaintiffs under the remedy of substantive consolidation. On May 5, 2010, the Court dismissed with prejudice the substantive consolidation and abuse of the bankruptcy process claims against all parties, resulting in the Company remaining as the sole defendant. In light of the Court's disposition of the theories advanced in the second amended complaint, the adversary proceeding is now styled as *Ray Balestri, Trustee of the Hallwood Energy I Creditors' Trust, as successor in interest to Hallwood Energy, L.P., Plaintiffs and FEI Shale L.P. and Hall Phoenix/Inwood Ltd., Plaintiffs in Intervention vs. The Hallwood Group Incorporated, Defendant; Adversary No. 09-03082-SGJ*. The parties participated in a Court-ordered mediation, held on July 8, 2010, but the parties were unable to reach a settlement of all or part of the lawsuit. The trial took place over a 13 day period from October 2010 to December 2010 and was followed up with the Bankruptcy Court's proposed findings in July 2011.

On July 25, 2011, the Bankruptcy Court issued the Proposed Findings of Fact, Conclusions of Law and Judgment Awarding Various Monetary Damages (the "Proposed Findings") in the matter. The court proposed that the United States District Court award damages of \$3,200,000 for the Company's alleged breach of the Equity Support Agreement, to be allocated among the three plaintiffs and damages of \$15,485,714 to FEI, for the Company's alleged tortious interference with the Farmout Agreement, and, in the alternative, for the Company's alleged fraud in failing to disclose to FEI that the Company allegedly did not intend to fund the

# THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Nine Months Ended September 30, 2011 and 2010

(unaudited)

remaining obligation under the Equity Support Agreement, plus prejudgment and postjudgment interest and attorneys' fees as may be requested and awarded pursuant to subsequent motions and hearings. With respect to the issue of fraud by nondisclosure, the Bankruptcy Court proposed a finding that the Company (i) failed to disclose a belief that the Equity Support Agreement could legally be treated as terminated, (ii) failed to disclose its alleged intention not to fund the final \$3,200,000 under the Equity Support Agreement and (iii) orchestrated an alleged misimpression that Hallwood Energy was not contemplating bankruptcy while planning Hallwood Energy's bankruptcy and how to use FEI's funding in a Hallwood Energy bankruptcy against FEI's wishes. The court also proposed that the District Court reject HPI and the trustee's claim that the Company's failure to fund the \$3,200,000 caused FEI to not fund \$20,000,000 under the Farmout Agreement, that the District Court reject HPI and the trustee's claim that the Company tortiously interfered with certain contractual rights, and that the District Court reject HPI and the trustee's claim for exemplary or punitive damages. The Bankruptcy Court's Proposed Findings (including the awards) are not final. The United States District Court will be reviewing the objections that have been filed by all parties in the case on a de novo basis and will eventually accept the Proposed Findings, decline to adopt the Proposed Findings and issue its own findings, or accept some of the Proposed Findings while declining to adopt the remaining Proposed Findings and issuing its own findings in their place. The District Court will then enter any final judgment accordingly. The reference of the case to the Bankruptcy Court has been withdrawn and it now resides in the United States District Court for the Northern District of Texas, Dallas Division.

In August 2011, the Company's board of directors authorized the Audit Committee, consisting solely of independent directors of the Company, to investigate the facts giving rise to the Proposed Findings and various allegations that have been made arising out of Hallwood Energy's bankruptcy. In addition, the Company's board of directors authorized the Audit Committee to hire, at the Company's expense, independent counsel and other advisors to assist the Audit Committee with such investigation. This investigation is currently ongoing.

As a result of Proposed Findings, the Company believes that for accounting purposes it is probable that a liability has been incurred and that an estimate of the amount of the loss for accounting purposes may be made. Accordingly, taking into consideration the Company's objections to the Proposed Findings, the Company reserved \$7,500,000 at June 30, 2011. The Company does not believe a change to the reserve is necessary at September 30, 2011. This noncash, accrued reserve of \$7,500,000 is reported in the Company's balance sheet under "Hallwood Energy matters - Litigation reserve" in addition to the \$3,201,000 that was previously recorded in connection with the Equity Support Agreement, for a total reserve of \$10,701,000 at September 30, 2011. This reserve amount has been established in consultation with the Company's litigation counsel in the Hallwood Energy litigation, based on their best judgment of the probabilities of success related to, among other factors, the objections filed by the Company and the adverse parties. However, the actual results of litigation cannot be predicted with any certainty and the amount of the Company's liability may exceed any estimates or reserves.

On August 3, 2009, the Company was served with a complaint in *Hall Phoenix/Inwood Ltd. and Hall Performance Energy Partners 4, Ltd. v. The Hallwood Group Incorporated, et al.* filed in the 298<sup>th</sup> District of Texas, No. 09-09551. The other defendants include Anthony J. Gumbiner, the Chairman and Chief Executive Officer of the Company, Bill Guzzetti, the President of the Company, certain affiliates of Mr. Gumbiner and certain officers of Hallwood Energy. The complaint alleges that the defendants defrauded plaintiffs in connection with plaintiffs acquiring interests in and providing loans to Hallwood Energy and seeks actual and exemplary damages. On September 15, 2010, Ray Balestri, Trustee of the Hallwood Energy I Creditors Trust, intervened in this proceeding and added certain of the Company's officers, directors, and an employee as defendants. The complaint alleges, among other things, claims against the defendants for breach of fiduciary duties, gross negligence and willful misconduct and seeks indeterminable actual and exemplary damages. The Company believes that the allegations and claims are without merit and intends to defend the lawsuit and any future claims vigorously. On November 5, 2010, this case was removed to the United States Bankruptcy Court for the Northern District of Texas, Dallas Division, Adversary No. 10-03358, but is subject to a pending motion to remand filed by the plaintiff.

On July 30, 2010, Hallwood Energy's trustee filed a complaint captioned *Ray Balestri, Trustee of the Hallwood Energy I Creditor's Trust v. Anthony J. Gumbiner, et al* in the Dallas County Court at Law No. 4, No. CC-10-05212D. The other defendants include certain current and former directors, officers and employees of the Company, certain of Hallwood Energy's former officers and directors, as well as outside legal counsel. The complaint alleges, among other things, claims against the defendants for breach of fiduciary duties, gross negligence and willful misconduct and seeks indeterminable actual and exemplary damages. The Company believes that the allegations and claims are without merit and intends to defend the lawsuit and any future claims vigorously. This case has been removed to the United States Bankruptcy Court for the Northern District of Texas, Dallas Division, Adversary No. 10-03263, but is subject to a pending motion to remand filed by the plaintiff.

# THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Nine Months Ended September 30, 2011 and 2010

(unaudited)

Following a hearing on August 4, 2011, the Bankruptcy Court ordered that the two matters that were removed to that court continue to be subject to a stay prohibiting further activities in those matters, other than dismissals of any parties, and that various parties, including the Company and its directors, HPI, FEI Shale, Hallwood Energy, Hallwood Energy's former counsel, and Hallwood Energy's former directors, participate in a series of mediations in September and October 2011, which were ultimately completed in November 2011. The parties participated in the court-ordered mediations but have been unable to reach a settlement. A status conference has been scheduled for December 1, 2011.

The allegations in these two later lawsuits allege different causes of action than those involved in the Proposed Findings but there is some overlap with the causes of actions and issues covered by the Proposed Findings. The Company is unable to estimate a possible loss, if any, in these two actions.

From time to time, HPI or Hallwood Energy's trustee have threatened to assert, or implied that there may be, additional claims against the Company or its officers, directors or affiliates. Most recently, in connection with a motion to conduct additional discovery, Hallwood Energy's trustee has suggested that certain of the individual current or former officers or directors of the Company or Hallwood Energy, or the Company, may have improperly appropriated certain intellectual property of Hallwood Energy in connection with business activities undertaken by those individuals in which the Company did not participate. However, no lawsuit has actually been filed and no specific damages have been asserted.

*Claim Filed by Company with Insurance Carrier for Directors' and Officers' Liability Insurance Policy.* The Company has incurred significant legal fees and associated costs in connection with these lawsuits. The Company has filed claims with the carrier for a directors' and officers' liability insurance policies maintained by the Company. The aggregate limit for each policy year under the Company's policies has been \$10,000,000. The insurance carrier has taken the position that all of the claims asserted in the Hallwood Energy litigation relate to the 2008-2009 policy year. In September 2009, the Company's insurance carrier indicated that it would reimburse the Company pursuant to the terms of its directors' and officers' liability insurance policy for a portion of these expenses, subject to a reservation of rights. The Company received reimbursement of legal fees and associated costs of approximately \$820,000 in the nine month period ended September 30, 2010, which were recorded as expense recoveries in administrative and selling expenses. Additionally, through September 30, 2010, the insurance carrier also paid approximately \$1,120,000 in reimbursement of legal fees and associated costs on behalf of other defendants in connection with the *Hall Phoenix/Inwood Ltd. and Hall Performance Energy Partners 4 Ltd v The Hallwood Group Incorporated, et al* matter. The insurance carrier had indicated that it would pay future legal fees and associated costs incurred on behalf of the Company directly to the service providers.

In August 2010, the insurance carrier informed the Company of a change in its coverage position whereby coverage was denied in reliance on the "insured vs. insured" exclusion in the policy. The Company believes it demonstrated that the exclusion does not apply and made demand that the insurance carrier provide coverage for these actions. In November 2010, the insurance carrier informally agreed to pay the previously unreimbursed defense costs of the Company and another insured party, in exchange for an agreement not to initiate a coverage lawsuit if the carrier performed promptly. In December 2010, the Company received additional reimbursement from the insurance carrier of legal fees and associated costs of approximately \$553,000. Additionally, in December 2010, the insurance carrier also paid \$1,288,000 of legal fees and associated costs on behalf of other defendants. In April 2011, the insurance carrier reimbursed the Company \$110,000 of legal fees and associated costs and paid \$849,000 of legal fees and costs on behalf of other defendants. In August 2011, the insurance carrier reimbursed the Company \$18,000 of legal fees and associated costs and paid \$251,000 of legal fees and costs on behalf of other defendants. Additional payments from the insurance carrier are pending.

Significant additional costs in excess of insurance reimbursements have been incurred by the Company and on behalf of other defendants. The Company continues to incur substantial litigation-related costs on these matters and the insurance carrier periodically processes claims for the reimbursement of such eligible and covered costs.

*Environmental Contingencies.* A number of jurisdictions in which the Company or its subsidiaries operate have adopted laws and regulations relating to environmental matters. Such laws and regulations may require the Company to secure governmental permits and approvals and undertake measures to comply therewith. Compliance with the requirements imposed may be time-consuming and costly. While environmental considerations, by themselves, have not significantly affected the Company's or its subsidiaries' business to date, it is possible that such considerations may have a significant and adverse impact in the future. The Company and its subsidiaries actively monitor their environmental compliance and while certain matters currently exist, management is not aware of any compliance issues which will significantly impact the financial position, results of operations or cash flows of the Company or its subsidiaries.

# THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Nine Months Ended September 30, 2011 and 2010

(unaudited)

Brookwood and its subsidiaries are subject to a number of environmental laws, regulations, licenses and permits and have ongoing discussions with environmental regulatory authorities, including the U.S. Environmental Protection Agency (the "EPA"), the Rhode Island Department of Health ("RIDOH"), the Rhode Island Department of Environmental Management ("RIDEM") and the Connecticut Department of Environmental Protection ("CTDEP") on a number of matters, including compliance with safe drinking water rules and wastewater discharge and treatment regulations, the control of chemicals used in the companies' coating operations that are classified as air pollutants, the presence of groundwater and soil contaminants at the companies' facilities, the removal of underground storage tanks, and hazardous waste management.

From time to time Brookwood and its subsidiaries have paid fines or penalties for alleged failure to comply with certain environmental requirements, which did not exceed \$100,000 in the aggregate during the three years ended December 31, 2010 and the nine months ended September 30, 2011. In addition, Brookwood and its subsidiaries have entered into various settlements and agreements with the regulatory authorities requiring the companies to perform certain tests, undertake certain studies, and install remedial facilities. Brookwood and its subsidiaries incurred capital expenditures to comply with environmental regulations of approximately \$488,000 in the year ended December 31, 2010 and \$95,000 during the nine months ended September 30, 2011. In addition, Brookwood and its subsidiaries regularly incur expenses associated with various studies and tests to monitor and maintain compliance with diverse environmental requirements.

*Other Contingencies.* In May 2009, one of Brookwood's suppliers advised Brookwood that shipments to Brookwood during the period from September 2008 to April 2009 of a quantity of greige fabric from the supplier incorporated some fiber that was not of domestic origin in some yarn from the vendor. The fabric in question was ordered to fill contracts in support of the United States military, was required to be domestic and is subject to the preference for domestic source required flow down provisions of the Department of Defense Supplement to the Federal Acquisition Regulations implementing the provisions of 10 USC 2533a. Brookwood's suppliers have advised that the greige fabric containing the non-compliant yarn was supplied inadvertently to Brookwood in limited quantity. Brookwood has determined that this yarn affects two of their greige products. Brookwood advised its affected customers and the United States military of this circumstance. Brookwood resolved the issue with respect to one of the products and received payment at full value in 2009. Additionally, resolution on the second product with one of the procurement entities was achieved in July 2010 and Brookwood received payment at full value of \$3,242,000 in October 2010. Although Brookwood is continuing efforts to structure a resolution with the final procurement entity, Brookwood has communicated to its supplier regarding satisfaction of the unpaid receivable. Brookwood believes it is likely to collect the remaining amount due. The trade receivable balance at September 30, 2011 and December 31, 2010 includes \$1,639,000 for this matter.

# THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Nine Months Ended September 30, 2011 and 2010

(unaudited)

### Note 15 — Segments and Related Information

The following represents Hallwood Group's reportable segment operations for the three months and nine months ended September 30, 2011 and 2010, respectively (in thousands):

	<b>Textile Products</b>	<b>Other</b>	<b>Consolidated</b>
<b>Three months ended September 30, 2011</b>			
Total revenue from external sources .....	\$ <u>37,649</u>		\$ <u>37,649</u>
Operating income (loss) .....	\$ 2,420	\$ (1,768)	\$ 652
Other income (loss), net .....	<u>(25)</u>	<u>5</u>	<u>(20)</u>
Income (loss) before income taxes .....	\$ <u>2,395</u>	\$ <u>(1,763)</u>	\$ <u>632</u>
<b>Three months ended September 30, 2010</b>			
Total revenue from external sources .....	\$ <u>36,771</u>		\$ <u>36,771</u>
Operating income (loss) .....	\$ 4,063	\$ (3,107)	\$ 956
Other income (loss), net .....	<u>(56)</u>	<u>(31)</u>	<u>(87)</u>
Income (loss) before income taxes .....	\$ <u>4,007</u>	\$ <u>(3,138)</u>	\$ <u>869</u>
<b>Nine Months ended September 30, 2011</b>			
Total revenue from external sources .....	\$ <u>101,117</u>		\$ <u>101,117</u>
Operating income (loss) .....	\$ 5,447	\$(11,614)	\$ (6,167)
Other income (loss), net .....	<u>(47)</u>	<u>8</u>	<u>(39)</u>
Income (loss) before income taxes .....	\$ <u>5,400</u>	\$ <u>(11,606)</u>	\$ <u>(6,206)</u>
<b>Nine Months ended September 30, 2010</b>			
Total revenue from external sources .....	\$ <u>131,848</u>		\$ <u>131,848</u>
Operating income (loss) .....	\$ 23,064	\$ (6,350)	\$ 16,714
Other income (loss), net .....	<u>(174)</u>	<u>(25)</u>	<u>(199)</u>
Income (loss) before income taxes .....	\$ <u>22,890</u>	\$ <u>(6,375)</u>	\$ <u>16,515</u>

No differences have occurred in the basis or methodologies used in the preparation of this interim segment information from those used in the Company's annual report on Form 10-K for the year ended December 31, 2010. The total assets for Hallwood Group's operating segments have not materially changed since the Company's annual report on Form 10-K for the year ended December 31, 2010.

# THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

### Overview

*General.* The Hallwood Group Incorporated (the "Company") operates as a holding company with its principal business in the textile products industry.

*Textile Products.* In 2010 and 2011, the Company derived all of its operating revenues from the textile activities of its Brookwood Companies Incorporated ("Brookwood") subsidiary; consequently, the Company's success is highly dependent upon Brookwood's success. Brookwood's success will be influenced in varying degrees by its ability to continue sales to existing customers, costs, availability of supplies, its response to competition and its ability to generate new markets. Although the textile activities of the Company and its subsidiaries (collectively, the "Hallwood Group") have generated positive cash flow in recent years, there is no assurance that this trend will continue.

While Brookwood has enjoyed substantial revenues from its military business, there is no assurance that this trend will continue. Brookwood's sales to the customers from whom it derives its military business have been volatile and difficult to predict, a trend the Company believes will continue. In recent years, orders from the military for goods generally were significantly affected by the increased activity of the U.S. military. If this activity does not continue or declines, then orders from the military generally, including orders for Brookwood's products, may be similarly affected. Military sales of \$21,802,000 and \$52,212,000 for the 2011 third quarter and nine month periods, respectively, were 6.4% and 44.0% lower than the comparable periods in 2010 of \$23,295,000 and \$93,246,000. Orders for military goods in the 2010 fourth quarter and 2011 first quarter declined significantly, which affected the 2011 first quarter military sales. Brookwood received an increased level of military orders in late March and into the subsequent 2011 periods, however not to the same level as the first half of 2010.

From time to time, the military limits orders for existing products and adopts revised specifications for new products to replace the products for which Brookwood's customers have been suppliers. The U.S. government released orders in recent years that include Brookwood's products, which resulted in substantial military sales. Changes in specifications or orders present a potential opportunity for additional sales; however, it is a continuing challenge to adjust to changing specifications and production requirements. Brookwood has regularly conducted research and development on various processes and products intended to comply with the revised specifications and participates in the bidding process for new military products. However, to the extent Brookwood's products are not included in future purchases by the U.S. government for any reason, Brookwood's sales could be adversely affected. A provision of U.S. federal law, known as the Berry Amendment, generally requires the Department of Defense to give preference in procurement to domestically produced products, including textiles. Brookwood's sales of products to the U.S. military market is highly dependent upon the continuing application and enforcement of the Berry Amendment by the U.S. government. In addition, the U.S. government is releasing contracts for shorter periods than in the past. The Company acknowledges the unpredictability in revenues and margins due to military sales and is unable at this time to predict future sales trends.

Unstable global nylon and chemical pricing and volatile domestic energy costs, coupled with a varying product mix, have continued to cause fluctuations in Brookwood's margins, a trend that will potentially continue.

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

The textile products business is not interdependent with the Company's other business operations. The Company does not guarantee the Brookwood bank facility and is not obligated to contribute additional capital. Conversely, Brookwood does not guarantee debts of the Company or any of the Company's subsidiaries and is not obligated to contribute additional capital to the Company beyond dividend payments and the tax sharing agreement.

*Investments in Financial Instruments.* In the 2011 first quarter, the Company opened an investment account with UBS AG, a global financial services firm, and disclosed that it intended to transfer a significant portion of the cash it holds from time to time to the UBS account to be placed in various financial instruments and may borrow additional amounts from UBS to invest. As of November 14, 2011, no funds have been transferred into the UBS account. In connection with the litigation matters of Hallwood Energy, L.P. ("Hallwood Energy") discussed in Note 14, on July 25, 2011, the Court issued the Proposed Findings of Fact, Conclusions of Law and

# THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

Judgment Awarding Various Monetary Damages (the "Proposed Findings") in the Adversary proceeding. The Court proposed that the United States District Court award damages against the Company plus interest and attorney fees. The Company has filed its objections to the Proposed Findings in the United States District Court and will vigorously defend against the entry of any final judgment. Until this matter is concluded, the Company does not intend to pursue its previously announced intention to transfer funds into the UBS account.

The Company intended to place the amounts in the UBS account in various instruments, including equity and debt that is publicly traded or is issued by United States and foreign publicly traded companies, financial institutions, mutual funds and exchange traded funds. The Company does not intend to invest in instruments for which there is not a public market or not issued by publicly traded companies, financial institutions, mutual funds or exchange traded funds. The amounts invested will at all times remain in the Company's investment account and under its control, and will be invested for its own account.

The UBS account will be a margin account, under which the Company may borrow from UBS up to 70% (for equity) to 90% (for debt) of the loan value of investment securities held in the account at a current borrowing cost of 50 basis points over the interest rate applicable to dollar deposits in the London interbank market. All borrowings in the account will be secured by a pledge of all assets held in the account. If at any time the value of the assets in the account fall below the agreed margin, or if UBS should, for any other reason, consider the assets pledged as no longer adequate cover for its claims, the Company will be required, upon request by UBS, either to reduce the debt through repayments or to furnish sufficient additional security, so as to re-establish the required margin. If the Company fails to comply with this demand within such time limit as may be set by UBS at its discretion, the debt will become repayable and UBS will be allowed to sell the assets on the open market to pay the debt.

As noted above, until the Hallwood Energy litigation matter is concluded, the Company does not intend to pursue its previously announced intention to transfer funds into the UBS account.

*Energy.* Hallwood Energy was a privately held independent oil and gas limited partnership and operated as an upstream energy company engaged in the acquisition, development, exploration, production, and sale of hydrocarbons, with a primary focus on natural gas assets.

In March 2009, Hallwood Energy, HEM (the general partner of Hallwood Energy) and Hallwood Energy's subsidiaries, filed petitions for relief under Chapter 11 of the United States Bankruptcy Code. The cases were adjudicated in the United States Bankruptcy Court for the Northern District of Texas, Dallas Division, in *In re Hallwood Energy, L.P., et al Case No. 09-31253*. The Company was only an investor in and creditor of Hallwood Energy. The bankruptcy filing did not include the Company or any other of its assets. In October 2009, the Bankruptcy Court confirmed the plan of reorganization of the debtors.

Refer to the section "*Investments in Hallwood Energy*" for a further description of the Company's former energy activities, including the bankruptcy case.

### **Presentation**

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

### **Results of Operations**

The Company reported net income for the 2011 third quarter of \$350,000, compared to net income of \$407,000 in 2010. Revenue for the 2011 third quarter was \$37,649,000, compared to \$36,771,000 in 2010.

The net loss for the 2011 nine month period was \$4,173,000, compared to net income of \$10,453,000 in 2010. Revenue for the 2011 nine month period was \$101,117,000, compared to \$131,848,000 in 2010.

# THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

### Revenues

Textile products sales of \$37,649,000 increased by \$878,000, or 2.4%, in the 2011 third quarter, compared to \$36,771,000 in 2010. Sales for the 2011 nine month period decreased by \$30,731,000, or 23.3%, to \$101,117,000, compared to \$131,848,000 in 2010. The fluctuations in the 2011 periods were principally due to a decrease in sales of specialty fabric to U.S. military contractors as a result of decreases in orders from the military to Brookwood's customers, partially offset by increased sales in its other market segments. Military sales accounted for \$21,802,000 and \$52,212,000 in the 2011 third quarter and nine month periods, respectively, compared to \$23,295,000 and \$93,246,000 in 2010. The military sales represented 57.9% and 63.4% of Brookwood's net sales in the 2011 and 2010 third quarters, respectively, and 51.6% and 70.7% in the 2011 and 2010 nine month periods, respectively. Generally, military sales represent sales of a product to a customer (prime and sub-prime contractors) that will be incorporated into an end product that will be used to fulfill a U.S. or international military contract.

*Sales Concentration.* Brookwood has two customers who accounted for more than 10% of Brookwood's sales. Sales to one Brookwood customer, Tennier Industries, Inc. ("Tennier"), accounted for more than 10% of Brookwood's sales during both the 2011 and 2010 periods. Brookwood's relationship with Tennier is ongoing. Sales to Tennier, which are included in military sales, were \$5,061,000 and \$11,456,000 in the 2011 third quarter and nine month periods, respectively, compared to \$8,296,000 and \$44,064,000 in 2010. Sales to Tennier represented 13.4% and 22.6% of Brookwood's net sales in the 2011 and 2010 third quarters, respectively, and 11.3% and 33.4% in the 2011 and 2010 nine month periods, respectively. Sales to another customer, ORC Industries, Inc. ("ORC"), accounted for more than 10% of Brookwood's sales in 2010. Brookwood's relationship with ORC is ongoing. Sales to ORC, which are included in military sales, were \$867,000 and \$1,958,000 in the 2011 third quarter and nine month periods, respectively, compared to \$2,583,000 and \$12,662,000 in 2010. Sales to ORC represented 2.3% and 7.0% of Brookwood's net sales in the 2011 and 2010 third quarters, respectively, and 1.9% and 9.6% in the 2011 and 2010 nine month periods, respectively.

Orders for military goods in the 2010 fourth quarter and 2011 first quarter declined significantly, which affected the 2011 first quarter military sales. Brookwood received an increased level of military orders in late March and into the subsequent 2011 periods, however, not to the same level as the first half of 2010.

### Expenses

Textile products cost of sales of \$30,116,000 for the 2011 third quarter increased by \$1,662,000, or 5.8%, compared to \$28,454,000 in 2010. For the nine month periods, textile products cost of sales of \$82,426,000 for 2011 decreased by \$13,072,000, or 13.7%, compared to \$95,498,000 in 2010. The 2011 fluctuations principally resulted from material and labor costs associated with the lower sales volume for the military segment, and from changes in product mix, offset by an increase in royalty expense related to certain military products. Cost of sales includes all costs associated with the manufacturing process, including but not limited to, materials, labor, utilities, royalties, depreciation on manufacturing equipment and all costs associated with the purchase, receipt and transportation of goods and materials to Brookwood's facilities, including inbound freight, purchasing and receiving costs, inspection costs, internal transfer costs and other costs of the distribution network. Brookwood believes that the reporting and composition of cost of sales and gross margin is comparable with similar companies in the textile converting and finishing industry.

The gross profit margin decreased for the 2011 third quarter, 20.0% versus 22.6%, and for the 2011 nine month period, 18.5% versus 27.6%. The lower gross profit margin was attributed to lower military sales volume and changes in product mix.

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

	<u>Three Months Ended</u>		<u>Nine Months Ended</u>	
	<u>September 30,</u>		<u>September 30,</u>	
	<u>2011</u>	<u>2010</u>	<u>2011</u>	<u>2010</u>
Textile products .....	\$5,113	\$4,253	\$13,244	\$13,285
Corporate .....	<u>1,768</u>	<u>3,108</u>	<u>4,114</u>	<u>6,351</u>
Total .....	<u>\$6,881</u>	<u>\$7,361</u>	<u>\$17,358</u>	<u>\$19,636</u>

Textile products administrative and selling expenses of \$5,113,000 for the 2011 third quarter increased by \$860,000, or 20.2%, from 2010. For the 2011 nine months, selling and administrative expenses decreased by \$41,000, or 0.3%, compared to 2010. The increase for the 2011 third quarter from the 2010 quarter was primarily attributable to an increase in professional services of

# THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

\$1,380,000, principally legal fees, partially offset by a decrease of \$494,000 related to performance and other related payroll costs. The decrease for the 2011 nine month period was primarily attributable to a decrease of \$1,088,000 related to performance and other related payroll costs, and reduced factor commissions of \$137,000 and was partially offset by an increase in professional services of \$1,487,000, principally legal fees and an increase in employee related expenses of \$156,000.

The textile products administrative and selling expenses included items such as payroll, professional fees, sales commissions, factor commissions, marketing, rent, insurance and travel. Brookwood conducts research and development activities related to the exploration, development and production of innovative products and technologies. Research and development costs were approximately \$149,000 and \$486,000 for the three months and nine months ended September 30, 2011, compared to \$165,000 and \$598,000 for the three months and nine months ended September 30, 2010, respectively.

Corporate administrative expenses decreased \$1,340,000, or 43.1%, for the 2011 third quarter, compared to 2010. For the 2011 nine months, corporate expenses decreased \$2,237,000, or 35.2%, compared to 2010. The decreases were principally attributable to a decrease in professional fees of \$1,344,000 for the 2011 three month period and \$2,330,000 for the 2011 nine month period, respectively. The decline in professional fees is principally attributable to the December 2010 conclusion of the trial in the Adversary proceeding and the reimbursement of previously expensed legal fees from the insurance carrier for the Company's directors' and officers' liability insurance policy for costs related to the Hallwood Energy litigation matters.

In connection with the Hallwood Energy litigation matters discussed in Note 14, on July 25, 2011, the bankruptcy court issued Proposed Findings in the Adversary proceedings. The court proposed that the United States District Court award damages against the Company totaling approximately \$18,700,000 plus prejudgment and post judgment interest and attorneys' fees as may be requested and awarded pursuant to a subsequent motion. The Proposed Findings (including the awards) are not final. The Company and each of the other parties has objected to various aspects of the Proposed Findings to the United States District Court, which will review the portions to which objections have been raised on a de novo basis. The Company intends to vigorously defend against the entry of any final judgment.

As a result of the Proposed Findings, the Company believes that for accounting purposes it is probable that a liability has been incurred and that an estimate of the amount of the loss for accounting purposes may be made. Accordingly, taking into consideration the Company's objections to the Proposed Findings, the Company reserved \$7,500,000 at June 30, 2011. The Company does not believe a change to the reserve is necessary at September 30, 2011. This noncash, accrued reserve of \$7,500,000 is reported in the Company's balance sheet under "Hallwood Energy matters - Litigation reserve", in addition to the \$3,201,000 that was previously recorded in connection with the Equity Support Agreement, for a total reserve of \$10,701,000 at September 30, 2011. This reserve amount has been established in consultation with the Company's litigation counsel in the Hallwood Energy litigation, based on their best judgment of the probabilities of success related to, among other factors, the objections filed by the Company and the adverse parties. However, the actual results of litigation cannot be predicted with any certainty and the amount of liability to the Company may exceed any estimates or reserves.

### Other Income (Loss)

Interest expense was \$25,000 and \$74,000 in the 2011 third quarter and nine month periods, respectively, compared to \$89,000 and \$207,000 in the 2010 periods. Interest expense principally relates to Brookwood's revolving credit facility in an amount up to \$25,000,000 with KeyBanc (the "Working Capital Revolving Credit Facility"). The decreases in interest expense were due to a decline in the average outstanding loan amount and lower interest rates.

Interest and other income was \$5,000 and \$35,000 in the 2011 third quarter and nine month periods, respectively, compared to \$2,000 and \$8,000 in 2010. The 2011 increases were principally due to interest earned on short-term investments.

# THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

### Income Taxes

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

	<u>Three Months Ended</u>		<u>Nine Months Ended</u>	
	<u>September 30,</u>		<u>September 30,</u>	
	<u>2011</u>	<u>2010</u>	<u>2011</u>	<u>2010</u>
Federal				
Current.....	\$208	\$152	\$ 398	\$5,157
Deferred.....	<u>(13)</u>	<u>174</u>	<u>(2,638)</u>	<u>174</u>
Sub-total .....	195	326	(2,240)	5,331
State				
Current.....	87	136	207	731
Deferred.....	<u>--</u>	<u>--</u>	<u>--</u>	<u>--</u>
Sub-total .....	<u>87</u>	<u>136</u>	<u>207</u>	<u>731</u>
Total.....	<u>\$282</u>	<u>\$462</u>	<u>\$(2,033)</u>	<u>\$6,062</u>

At September 30, 2011, the net deferred tax asset was attributable to temporary differences that upon reversal, could be utilized to offset income from operations. The statutory federal tax rate in both periods was 35%, while state taxes were determined based upon taxable income apportioned to those states in which the Company does business at their respective tax rates.

### Investments in Hallwood Energy

Hallwood Energy was a privately held independent oil and gas limited partnership and operated as an upstream energy company engaged in the acquisition, development, exploration, production, and sale of hydrocarbons, with a primary focus on natural gas assets.

Prior to the confirmation of Hallwood Energy's plan of reorganization by Hallwood Energy (discussed below) in October 2009, the Company had invested \$61,481,000 in Hallwood Energy's general partnership interest and Class A and Class C limited partnership interests. In addition, the Company loaned Hallwood Energy \$13,920,000 in the form of convertible notes issued by Hallwood Energy. The Company accounted for the investment in Hallwood Energy using the equity method of accounting and recorded its pro rata share of Hallwood Energy's net income (loss), partners' capital transactions, and comprehensive income (loss), as appropriate. In connection with Hallwood Energy's bankruptcy reorganization, the Company's general and limited partnership interests in Hallwood Energy were extinguished and the Company no longer accounts for the investment in Hallwood Energy using the equity method of accounting. Certain of the Company's officers and directors were investors in Hallwood Energy. In addition, as a member of management of Hallwood Energy, one officer of the Company held a profit interest in Hallwood Energy that was also extinguished in the bankruptcy.

*Bankruptcy Reorganization by Hallwood Energy.* In March 2009, Hallwood Energy, HEM (the general partner of Hallwood Energy) and Hallwood Energy's subsidiaries, filed petitions for relief under Chapter 11 of the United States Bankruptcy Code. The cases were adjudicated in the United States Bankruptcy Court for the Northern District of Texas, Dallas Division, in *In re Hallwood Energy, L.P., et al Case No. 09-31253*. The Company was only an investor in and creditor of Hallwood Energy. The bankruptcy filing did not include the Company or any other of its assets.

In October 2009, the Bankruptcy Court confirmed a plan of reorganization of the debtors that, among other things, extinguished Hallwood Energy's general partnership and limited partnership interests, including those held by the Company. In addition, Hallwood Energy's convertible notes, including those held by the Company, are subordinated to recovery in favor of Hall Phoenix/Inwood, Ltd. ("HPI"), the secured lender to Hallwood Energy. As a result of these developments, the Company does not anticipate that it will recover any of its investments in Hallwood Energy.

*Litigation.* In connection with Hallwood Energy's bankruptcy proceeding, Hallwood Energy and other parties have filed lawsuits and threatened to assert additional claims against the Company and certain related parties alleging actual, compensatory and exemplary damages in excess of \$200,000,000, based on purported breach of contract, fraud, breach of fiduciary duties, neglect, negligence and various misleading statements, omissions and misrepresentations. See Note 14 to the condensed consolidated financial statements of this report.

# THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

In one of these matters, the court has issued the Proposed Findings proposing that damages be awarded against the Company totaling approximately \$18,700,000 plus prejudgment and postjudgment interest and attorney's fees as may be requested and awarded pursuant to a subsequent motion. The Proposed Findings (including the awards) are not final. As a result of the Proposed Findings, the Company has reserved \$7,500,000 on its balance sheet as a noncash accrual under Hallwood Energy matters – Litigation Reserve, in addition to the \$3,200,000 that was previously recorded in connection with the Equity Support Agreement.

### Critical Accounting Policies

There have been no changes to the critical accounting policies identified and set forth in the Company's annual report on Form 10-K for the year ended December 31, 2010.

### Related Party Transactions

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

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

	<u>Three Months Ended</u> <u>September 30,</u>		<u>Nine Months Ended</u> <u>September 30,</u>	
	<u>2011</u>	<u>2010</u>	<u>2011</u>	<u>2010</u>
Consulting fees .....	\$249	\$249	\$ 747	\$ 747
Office space and administrative services .....	71	62	238	192
Travel and other expenses.....	<u>71</u>	<u>20</u>	<u>151</u>	<u>110</u>
Total.....	<u>\$391</u>	<u>\$331</u>	<u>\$1,136</u>	<u>\$1,049</u>

In addition, from time to time, HIL and Mr. Gumbiner have performed services for certain affiliated entities that are not subsidiaries of the Company, for which they receive consulting fees, bonuses, stock options, profit interests or other forms of compensation and expenses. The Company recognizes a proportionate share of such compensation and expenses, based upon its ownership percentage in the affiliated entities, through the utilization of the equity method of accounting. HIL or Mr. Gumbiner received no compensation from these affiliated entities during 2011 or 2010.

HIL and certain of its affiliates in which Mr. Gumbiner has an indirect financial interest share common offices, facilities and certain staff in the Company's Dallas office for which these companies reimburse the Company. Certain individuals employed by the Company, in addition to their services provided to the Company, perform services on behalf of the HIL-related affiliates. In addition, HIL utilizes some of the office space for purposes unrelated to the Company's business. The Company pays certain common general and administrative expenses for salaries, rent and other office expenses and charges the HIL-related companies an overhead reimbursement fee for the share of the expenses allocable to these companies. For the three months ended September 30, 2011 and 2010, these companies reimbursed the Company \$25,000 and \$28,000, respectively, for such expenses. For the nine months ended September 30, 2011 and 2010, these companies reimbursed the Company \$72,000 and \$82,000, respectively.

## THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

#### Contractual Obligations and Commercial Commitments

The Company and its subsidiaries have entered into various contractual obligations and commercial commitments in the ordinary course of conducting its business operations, which are provided below as of September 30, 2011 (in thousands):

	<u>Payments Due During the Year Ending December 31,</u>						
	<u>2011*</u>	<u>2012</u>	<u>2013</u>	<u>2014</u>	<u>2015</u>	<u>Thereafter</u>	<u>Total</u>
<b>Contractual Obligations</b>							
Long term debt .....	\$ --	\$ --	\$ --	\$2,000	\$ --	\$ --	\$ 2,000
Operating leases .....	<u>188</u>	<u>677</u>	<u>443</u>	<u>364</u>	<u>364</u>	<u>212</u>	<u>2,248</u>
Total .....	<u>\$188</u>	<u>\$677</u>	<u>\$443</u>	<u>\$2,364</u>	<u>\$364</u>	<u>\$212</u>	<u>\$4,248</u>

\* For the three months ending December 31, 2011.

Interest costs associated with the Company's debt, which bears interest at variable rates, are not a material component of the Company's expenses. Estimated interest payments, based on the current principal balances and weighted average interest rates, assuming the renewal of the revolving credit facility at its loan balance as of September 30, 2011, are \$9,000 for the three months ending December 31, 2011 and \$35,000 for each of the years ending December 31, 2012 through December 31, 2015, respectively.

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

*2005 Long-Term Incentive Plan for Brookwood.* In December 2005, the Company adopted The Hallwood Group Incorporated 2005 Long-Term Incentive Plan for Brookwood Companies Incorporated ("2005 Long-Term Incentive Plan for Brookwood") to encourage employees of Brookwood to increase the value of Brookwood and to continue to be employed by Brookwood. The terms of the incentive plan provide for a total award amount to participants equal to 15% of the fair market value of consideration received by the Company in a change of control transaction, as defined, in excess of the sum of the liquidation preference plus accrued unpaid dividends on the Brookwood preferred stock (approximately \$13,956,000 at September 30, 2011). The base amount will fluctuate in accordance with a formula that increases by the annual amount of the dividend on the preferred stock accrued, currently \$1,823,000, and decreases by the amount of the cash dividends actually paid. The plan generally defines a change of control transaction as a transaction approved by the Company's board of directors or by the holders of at least 50% of the voting capital stock of the Company that results in: (i) a change in beneficial ownership of the Company or Brookwood of 50% or more of the combined voting power, (ii) the sale of all or substantially all of the assets of Brookwood, or (iii) any other transaction that, in the Company's board of directors discretion, has substantially the same effect of item (i) or (ii). Certain transfers, generally among existing stockholders and their related parties, are exempted from the definition.

However, if the Company's board of directors determines that certain specified Brookwood officers, or other persons performing similar functions do not have, prior to the change of control transaction, in the aggregate an equity or debt interest of at least two percent in the entity with whom the change of control transaction is completed, then the minimum amount to be awarded under the plan shall be \$2,000,000. In addition, the Company agreed that, if members of Brookwood's senior management do not have, prior to a change of control transaction, in the aggregate an equity or debt interest of at least two percent in the entity with whom the change of control transaction is completed (exclusive of any such interest any such individual receives with respect to his or her employment following the change of control transaction), then the Company will be obligated to pay an additional \$2,600,000.

#### Off-Balance Sheet Arrangements

The Company has no off-balance sheet arrangements.

## THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

#### Financial Covenants

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

<u>Description</u>	<u>Requirement</u>	<u>Quarters Ended</u>			
		<u>September 30,</u> <u>2011</u>	<u>June 30,</u> <u>2011</u>	<u>March 31,</u> <u>2011</u>	<u>December 31,</u> <u>2010</u>
Total debt to tangible net worth	must be less than ratio of 1.50..	0.34	0.31	0.29	0.29
Total funded debt to EBITDA	must be less than ratio of 2.00..	0.21	0.28	0.12	0.07
Income before income taxes	must exceed \$1 .....	Yes	Yes	No	Yes

Brookwood was in compliance with its loan covenants under the Working Capital Revolving Credit Facility as of December 31, 2010 and for all interim periods in 2010.

Due to a decline in military sales for the 2011 first quarter, Brookwood was unable to meet the financial covenant that requires income before taxes of at least \$1 in each quarter. Brookwood's loss before taxes for the 2011 first quarter was \$299,000. Accordingly, in May 2011, Brookwood requested and received a waiver from KeyBanc for the income covenant for the 2011 first quarter. Future compliance with the covenants under its Working Capital Revolving Credit Facility depends on Brookwood's military orders increasing from the levels in the 2010 fourth quarter and 2011 first quarter. Brookwood received an increased level of military orders in late March and into the 2011 subsequent periods and reported income before taxes of \$2,395,000 and \$3,304,000 in the 2011 third quarter and second quarter, respectively, and was in compliance with its loan covenants for the 2011 second and third quarters.

Cash dividends and tax sharing payments by Brookwood to the Company are contingent upon compliance with the loan covenants in the Working Capital Revolving Credit Facility. This limitation on the transferability of assets constitutes a restriction of Brookwood's net assets, which were \$61,052,000 and \$60,596,000 as of September 30, 2011 and December 31, 2010, respectively.

# THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

### Liquidity and Capital Resources

*General.* The Company, through its Brookwood subsidiary, principally operates in the textile products segment. The Hallwood Group's cash position decreased by \$1,763,000 during the 2011 nine month period to \$9,396,000 as of September 30, 2011. The principal source of cash in the 2011 nine month period was \$7,490,000 of proceeds from the redemption of short-term investments. The primary uses of cash were \$7,864,000 used in operations (principally an increase in inventories) and \$1,389,000 for property, plant and equipment, principally at Brookwood. The amount outstanding under the Working Capital Revolving Credit Facility was \$2,000,000 at September 30, 2011 and December 31, 2010.

The Company is dependent on fees, dividends and advances from Brookwood for its liquidity requirements. Brookwood's ability to generate cash flow from operations will depend on its future performance, including the level and timing of military sales, and its ability to successfully implement business and growth strategies.

*Textiles.* Hallwood Group's textile products segment generates funds from the dyeing, laminating and finishing of fabrics and their sales to customers in the military, consumer, industrial and medical markets. Brookwood maintains a \$25,000,000 Working Capital Revolving Credit Facility with KeyBanc. The facility has a maturity date of January 31, 2014. At September 30, 2011, Brookwood had approximately \$22,879,000 of unused borrowing capacity on its Working Capital Revolving Credit Facility.

Brookwood maintains factoring agreements which provide that receivables resulting from credit sales to customers, excluding the U.S. Government, may be sold to the factor, subject to a commission and the factor's prior approval. Brookwood monitors its factors and their ability to fulfill their obligations to Brookwood in a timely manner. As of November 14, 2011, all of Brookwood's factors were complying with payment terms in accordance with factor agreements.

Brookwood paid cash dividends to the Company of \$3,000,000 and \$3,000,000 in the 2011 and 2010 nine month periods, respectively and \$4,000,000 for all of 2010. In addition, Brookwood made tax sharing payments to the Company of \$2,655,000 and \$8,236,000 in the 2011 and 2010 nine month periods, respectively, and \$10,434,000 for all of 2010 under its tax sharing agreement. Future cash dividends and tax sharing payments are contingent upon Brookwood's continued profitability and compliance with its loan covenants contained in the Working Capital Revolving Credit Facility. Brookwood's total debt to total tangible net worth ratio of 0.34 at September 30, 2011 increased slightly from 0.29 at December 31, 2010, which was substantially below the maximum allowable ratio of 1.50. Brookwood's total funded debt to EBITDA (earnings before interest, taxes, depreciation and amortization) ratio, for the trailing four quarters, was 0.21 and 0.07 at September 30, 2011 and December 31, 2010, respectively, which was substantially below the maximum allowable ratio of 2.0. Due to a decline in military sales for the 2011 first quarter, Brookwood was unable to meet the financial covenant that requires income before taxes of at least \$1 in each quarter. Brookwood's loss before taxes for the 2011 first quarter was \$299,000. Accordingly, in May 2011 Brookwood requested and received a waiver from KeyBanc for the income covenant. Future compliance with the covenants under its Working Capital Revolving Credit Facility depends on Brookwood's military orders increasing from the levels in the 2010 fourth quarter and 2011 first quarter. Brookwood noted an increased level of military orders in late March and into the subsequent 2011 periods and Brookwood reported income before taxes of \$2,395,000 and \$3,304,000 in the 2011 third quarter and second quarter, respectively, and was in compliance with its loan covenants for the 2011 second and third quarters.

Brookwood continuously evaluates opportunities to reduce production costs and expand its manufacturing capacity and portfolio of products. Accordingly, Brookwood incurs capital expenditures to pursue such opportunities, as well as for environmental and safety compliance, building upgrades, energy efficiencies, and various strategic objectives. In the 2011 nine month period and for all of 2010, Brookwood met its capital expenditure and equipment maintenance requirements from its operating cash flows and availability under its Working Capital Revolving Credit Facility. There were no material capital commitments as of September 30, 2011. It is anticipated that Brookwood's future capital expenditure projects will be funded from operations and, if necessary, availability under its Working Capital Revolving Credit Facility. Brookwood estimates its 2011 capital expenditures will be within a range of \$1,500,000 to \$2,500,000.

*Impact of Litigation on the Company's Liquidity.* The Company and its subsidiaries are involved in a number of litigation matters, as described in Note 14 to the Condensed Consolidated Financial Statements as of and for the nine months ended September 30, 2011 and 2010 included in Part 1 of this report and the court in the Hallwood Energy litigation has issued the Proposed Findings proposing that the United States District Court award damages against the Company totaling approximately \$18,700,000 plus prejudgment and postjudgment interest and attorneys' fees as may be requested and awarded pursuant to a subsequent motion. The Proposed Findings (including the awards) are not final. The Company and each of the other parties has objected to various aspects of the Proposed Findings

# THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

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

to the United States District Court, which will review the portions to which objections have been raised on a de novo basis. The Company intends to vigorously defend against the entry of any final judgment.

The Company does not currently have sufficient cash, directly or through Brookwood, to pay the amount of the damages proposed in the Proposed Findings. Payment of a significant judgment based on the Proposed Findings, if ultimately required to do so, would have a material adverse effect on the Company, its financial position, results of operation and cash flows. The Company's ability to meet in cash a final judgment arising out of the Proposed Findings, including any requirement to post any supersedeas bond to appeal any such judgment or any agreed to cash settlement, would be dependent on the Company's then available cash (approximately \$6,500,000 at September 30, 2011) and its ability to receive cash dividends or other advances from Brookwood. To pay any such cash dividends or advances to the Company, Brookwood has indicated that it will (as required pursuant to the terms thereof) request its lender, KeyBanc, to approve additional borrowings under its Working Capital Revolving Credit Facility. The Working Capital Revolving Credit Facility provides for aggregate borrowings of up to \$25,000,000, of which \$2,121,000 was utilized at October 31, 2011. KeyBanc has not yet agreed to allow Brookwood to pay any such cash dividend or other advance to the Company and has indicated that it will only agree to a limited amount to be determined depending on additional financial information to be supplied by Brookwood. If for any reason Brookwood is unable to draw upon additional borrowings under its Working Capital Revolving Credit Facility, the Company would be required to seek alternative sources of funding. The Company has not yet determined what, if any, sources would be available to it, but will consider such alternatives as an additional or new facility or term loan and potential sales of assets or additional securities. No assurance can be given that any such additional sources of funding will be available to the Company.

Additionally, any payment of a dividend or advance by Brookwood to the Company is dependent on a number of other factors including approval of Brookwood's board of directors, Brookwood's ability to meet the requirements of the Delaware corporate laws for payment of dividends, and compliance with other applicable laws and requirements. As a result, no assurance can be given that these amounts will be available when needed or required. In addition, the Company has spent and will likely continue to spend significant amounts in professional fees in connection with its defense of its pending litigation matters. The Company expenses professional fees and other costs associated with litigation matters as incurred.

*Investments in Financial Instruments.* In the 2011 first quarter, the Company opened an investment account with UBS and disclosed that it intended to transfer a significant portion of the cash it holds from time to time to the UBS account to be placed in various financial instruments and may borrow additional amounts from UBS to invest. As of November 14, 2011, no funds have been transferred into the UBS account. The Company's ability to transfer funds to the UBS account will also depend in part on the availability of dividends and advances from Brookwood. Given the potential requirements necessary in connection with the Hallwood Energy litigation matter described above, the Company does not intend to pursue its previously announced intention to transfer funds into the UBS account.

### Forward-Looking Statements

In the interest of providing stockholders with certain information regarding the Company's future plans and operations, certain statements set forth in this quarterly report on Form 10-Q relate to management's future plans, objectives and expectations. Such statements are forward-looking statements. Although any forward-looking statement expressed by or on behalf of the Company is, to the knowledge and in the judgment of the officers and directors, expected to prove true and come to pass, management is not able to predict the future with absolute certainty. Forward-looking statements involve known and unknown risks and uncertainties, which may cause the Company's actual performance and financial results in future periods to differ materially from any projection, estimate or forecasted result. Among others, these risks and uncertainties include those described in the Company's annual report on Form 10-K for the year ended December 31, 2010 in Item 1A – Risk Factors and in this quarterly report on Form 10-Q for the quarterly period ended September 30, 2011 in Part II – Item 1A – Risk Factors. These risks and uncertainties are difficult or impossible to predict accurately and many are beyond the control of the Company. Other risks and uncertainties may be described, from time to time, in the Company's periodic reports and filings with the Securities and Exchange Commission.

# THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

## Item 4. CONTROLS AND PROCEDURES

### **Evaluation of Disclosure Controls and Procedures.**

We performed an evaluation, under the supervision and with the participation of management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this report pursuant to Rule 13a – 15 promulgated under the Securities Exchange Act of 1934, as amended (the “Exchange Act”). Based upon that evaluation, our management, including our Chief Executive Officer and Chief Financial Officer, has concluded that, as of September 30, 2011, our disclosure controls and procedures were effective to provide reasonable assurance that material information required to be disclosed by us (including our consolidated subsidiaries) in the reports that we file or submit under the Exchange Act, as amended, was (i) recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission’s rules and forms, and (ii) information required to be disclosed by us in the reports we file or submit under the Exchange Act is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer to allow timely decisions regarding required disclosure.

### **Changes in Internal Control over Financial Reporting.**

There were no changes in the Company’s internal control over financial reporting that occurred during the quarterly period covered by this report that have materially affected, or are reasonably likely to materially affect, the Company’s control over financial reporting.

# THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

## PART II - OTHER INFORMATION

### Item

#### 1 Legal Proceedings

Reference is made to Note 14 to the Company's condensed consolidated financial statements included within this quarterly report on Form 10-Q.

#### 1A Risk Factors

*Litigation and costs related thereto may adversely affect the Company's financial position, results of operations and cash flows.* The Company and its executive officers are involved in a number of litigation matters, as described in Note 14 to the Condensed Consolidated Financial Statements as of and for the nine months ended September 30, 2011 and 2010 included in Part 1 of this report and the court in the Hallwood Energy litigation has issued the Proposed Findings proposing that the United States District Court award damages against the Company totaling approximately \$18,700,000 plus prejudgment and postjudgment interest and attorneys' fees as may be requested and awarded pursuant to a subsequent motion. The Proposed Findings (including the awards) are not final. The Company and each of the other parties has objected to various aspects of the Proposed Findings to the United States District Court, which will review the portions to which objections have been raised on a de novo basis. The Company intends to vigorously defend against the entry of any final judgment. The Company does not currently have sufficient cash, directly or through Brookwood, to pay the amount of the damages proposed in the Proposed Findings. Payment of a significant judgment based on the Proposed Findings, if ultimately required to do so, would have a material adverse effect on the Company, its financial position, results of operation and cash flows. The Company's ability to meet in cash a final judgment arising out of the Proposed Findings, including any requirement to post any supersedeas bond to appeal any such judgment or any agreed to cash settlement, would be dependent on the Company's then available cash (approximately \$6,500,000 at September 30, 2011) and its ability to receive cash dividends or other advances from Brookwood. To pay any such cash dividends or advances to the Company, Brookwood has indicated that it will (as required pursuant to the terms thereof) request KeyBanc to approve additional borrowings under its Working Capital Revolving Credit Facility. The Working Capital Revolving Credit Facility provides for aggregate borrowings of up to \$25,000,000, of which \$2,121,000 was utilized at October 31, 2011. KeyBanc has not yet agreed to allow Brookwood to borrow funds to pay any such cash dividend or other advance to the Company and has indicated that it will only agree to a limited amount to be determined depending on additional financial information to be supplied by Brookwood. If for any reason Brookwood is unable to draw upon additional borrowings under its Working Capital Revolving Credit Facility, the Company would be required to seek alternative sources of funding. The Company has not yet determined what, if any, sources would be available to it, but will consider such alternatives as an additional or new facility or term loan and potential sales of assets or additional securities. No assurance can be given that any such additional sources of funding will be available to the Company.

Additionally, any payment of a dividend or advance to the Company by Brookwood is dependent on a number of other factors including approval of Brookwood's board of directors, Brookwood's ability to meet the requirements of the Delaware corporate laws for payment of dividends, and compliance with other applicable laws and requirements. As a result, no assurance can be given that these amounts will be available when needed or required.

Although the Company does not believe that the results of the other litigation matters, other than the Hallwood Energy litigation matter, are likely to have a material adverse effect on its financial position, results of operations or cash flows, it is possible that any of the litigation matters, including the other matters that have been stayed as part of the Hallwood Energy bankruptcy proceedings, could result in material liability to the Company. In addition, the Company's insurance carrier has reimbursed the Company for certain legal fees and other associated costs relating to the defense of certain of these Hallwood Energy litigation matters under a reservation of rights. No assurance can be given that the insurance carrier will continue to reimburse the Company or contribute toward a judgment arising therefrom. As a result, significant additional costs may be incurred by the Company. See Note 14 to the Company's condensed consolidated financial statements included with this quarterly report on Form 10-Q.

#### 2 Unregistered Sales of Equity Securities and Use of Proceeds

None

# THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

## PART II - OTHER INFORMATION (continued)

3	Defaults upon Senior Securities	None
4	(Removed and Reserved)	
5	Other Information	None
6	Exhibits	
3.1	Second Restated Certificate of Incorporation, dated September 1, 1995, and related Certificates of Amendment to the Second Restated Certificate of Incorporation dated May 12, 2004 and May 13, 2009, respectively.	
3.2	Amended and Restated Bylaws of the Company and related Amendment to the Amended and Restated Bylaws, dated November 14, 2007.	
31.1	Certification of the Chief Executive Officer, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.	
31.2	Certification of the Chief Financial Officer, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.	
32.1	Certification of Chief Executive Officer and Chief Financial Officer, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.	
101.INS	XBRL Instance Document*	
101.SCH	XBRL Taxonomy Extension Schema*	
101.CAL	XBRL Taxonomy Extension Calculation Linkbase*	
101.DEF	XBRL Additional Taxonomy Extension Definition Linkbase*	
101.LAB	XBRL Taxonomy Extension Label Linkbase*	
101.PRE	XBRL Taxonomy Extension Presentation Linkbase*	

\* Furnished electronically herewith. XBRL information is furnished and not filed or a part of a registration statement or prospectus for purposes of sections 11 or 12 of the Securities Act of 1933, as amended, is deemed not filed for purposes of section 18 of the Securities Exchange Act of 1934, as amended, and otherwise is not subject to liability under these sections.

**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**

**SIGNATURE**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

**THE HALLWOOD GROUP INCORPORATED**

Dated: November 14, 2011

By: /s/ Richard Kelley

Richard Kelley, Vice President  
(Duly Authorized Officer and  
Principal Financial and  
Accounting Officer)

# THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

## INDEX TO EXHIBITS

<u>Exhibit Number</u>	<u>Description</u>
3.1	Second Restated Certificate of Incorporation, dated September 1, 1995, and related Certificates of Amendment to the Second Restated Certificate of Incorporation dated May 12, 2004 and May 13, 2009, respectively.
3.2	Amended and Restated Bylaws of the Company and related Amendment to the Amended and Restated Bylaws, dated November 14, 2007.
31.1	Certification of the Chief Executive Officer, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of the Chief Financial Officer, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer and Chief Financial Officer, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101.INS	XBRL Instance Document*
101.SCH	XBRL Taxonomy Extension Schema*
101.CAL	XBRL Taxonomy Extension Calculation Linkbase*
101.DEF	XBRL Additional Taxonomy Extension Definition Linkbase*
101.LAB	XBRL Taxonomy Extension Label Linkbase*
101.PRE	XBRL Taxonomy Extension Presentation Linkbase*

\* Furnished electronically herewith. XBRL information is furnished and not filed or a part of a registration statement or prospectus for purposes of sections 11 or 12 of the Securities Act of 1933, as amended, is deemed not filed for purposes of section 18 of the Securities Exchange Act of 1934, as amended, and otherwise is not subject to liability under these sections.

SECOND RESTATED CERTIFICATE OF INCORPORATION  
OF  
THE HALLWOOD GROUP INCORPORATED

The undersigned does hereby certify that this Second Restated Certification of Incorporation of The Hallwood Group Incorporated (the "Restated Certificate") is duly adopted in accordance with Section 245 of the General Corporation Law of the State of Delaware and only restates and integrates and does not further amend the provisions the Certificate of Incorporation of The Hallwood Group Incorporated as theretofore amended or supplemented, and that there is no discrepancy between those provisions and the provisions of this Restated Certificate. The Corporation was originally incorporated on September 30, 1981 under the name Atlantic Metropolitan Corporation.

FIRST: The name of the corporation is The Hallwood Group Incorporated.

SECOND: The address of the registered office of the corporation in the State of Delaware is 1209 Orange Street, New Castle County, Wilmington, Delaware 19801. The name of the registered agent of the corporation at such address is The Corporation Trust Company.

THIRD: The purpose of the corporation is to engage in any lawful act or activity for which corporations may be organized under the General Corporation Law of the State of Delaware.

FOURTH: The total number of shares of capital stock which the corporation shall have authority to issue is 10,500,000 shares, consisting of 10,000,000 shares of common stock, par value \$.10 per share (hereinafter referred to as "Common Stock"), and 500,000 shares of preferred stock, par value \$.10 per share (hereinafter referred to as "Preferred Stock"). A statement of the voting powers and of the designations, preferences and relative participating, optional or other special rights, and the qualifications, limitations or restrictions thereof, of each class of stock is as follows:

1. Common Stock

(a) The Common Stock is subject to such powers, rights, privileges, preferences and priorities of the Preferred Stock as are stated and expressed herein or in any resolution or resolutions adopted by the Board of Directors pursuant to authority expressly granted to and vested in it by the provisions of Section 2 of this Article Fourth.

(b) Each share of Common Stock shall entitle the holder or holders thereof to one vote for such share upon all matters upon which stockholders have the right to vote.

(c) Restrictions on Transfer

(i) Until the earliest of July 31, 2009, such date as the Corporation shall no longer have any unutilized federal income tax net operating loss carryovers, capital loss carryovers or tax credit carryovers, whether or not such carryovers are currently in existence (the "Carryforwards") or such date after which Section 382 of the Internal Revenue Code of 1986, as amended (the "Code"), is repealed or so substantially modified such that, in the opinion of counsel to the Corporation, the restrictions on transfer described herein are no longer necessary to accomplish their intended purpose: (A) any attempted sale, transfer, assignment or other disposition (including the granting of any option (within the meaning of Section 382 of the Code and the Income Tax Regulations as now in effect or hereafter promulgated pursuant thereto (the "Regulations")) (any such option being referred to hereinafter as an "Option") or entering into of any agreement for the sale, transfer or other disposition), whether voluntary or involuntary, whether of record or beneficially and whether by operation of law or otherwise (a "Transfer"), of any share or shares of the Common Stock of the Corporation or of any Option to acquire such stock, to any person or entity or group of persons or entities acting in concert (a "Transferee") who or that owns or owned, directly, indirectly or by application of the constructive ownership rules set forth in Sections 382 and 318 of the Code and the Regulations, or in any other manner representing "ownership" under any circumstances for purposes of Section 382 of the Code and the Regulations (collectively, "Owns" or "Owned"), at any time during the four-year period ending on the day of the Transfer, an aggregate number of shares of the Corporation's stock (taking into account for this purpose all interests in the Corporation that are treated as stock for purposes of Section 382(g)(1) of the Code and no other interests in the Corporation (any interest that is so treated being referred to hereinafter as "Stock")) having a fair market value equal to or greater than 4.75% of the fair market value of the Corporation's then outstanding Stock shall be void ab initio insofar as it purports to transfer ownership to such Transferee of any shares of Common Stock or any Option to acquire Common Stock and (B) any attempted Transfer of any share or shares of the Common Stock of the Corporation or of any Option to acquire Common Stock to any Transferee not described in clause (A) hereof who or that would Own, as a result of the Transfer of any share or shares of the Corporation's Stock or of any Option to acquire the Corporation's Stock, an aggregate number of shares of the Corporation's Stock having a fair market value equal to or greater than 4.75% of the aggregate fair market value of all of the Corporation's Stock then outstanding, shall, as to the number of shares representing such excess over 4.75%, be void ab initio insofar as it purports to transfer

ownership to such Transferee of any shares of Common Stock or any Option to acquire Common Stock.

(ii) The restrictions contained in subparagraph (i) of this Paragraph 1(c) of this Article Fourth have been included herein for the purpose of reducing the risk of occurrence of an "ownership change" within the meaning of Section 382(g) of the Code and the Regulations that would result in the disallowance or limitation of the Corporation's utilization of the Carryforwards and to maintain the tax advantage of the Corporation associated with the Carryforwards.

(iii) Neither clause (A) nor clause (B) of subparagraph (i) of this Paragraph 1(c) of this Article Fourth shall restrict any Transfer of Common Stock of the Corporation if (A) the prior written approval of the Board of Directors of the Corporation (based on a majority vote of the Board of Directors) shall have been obtained with respect to such Transfer and (B) if so requested by the Board of Directors, counsel to the Corporation shall have delivered its opinion that such Transfer would not result in an "ownership change" within the meaning of Section 382(g) of the Code and the Regulations that would result in the elimination or limitation of the Corporation's utilization of the Carryforwards. The Board of Directors shall have the authority, in its sole discretion, to adopt procedures for the orderly and effective administration and implementation of this Paragraph (c) and, in deciding whether to approve any proposed Transfer of Common Stock of the Corporation, the Corporation acting through any officer may request all relevant information, as well as an opinion of counsel in form and substance reasonably satisfactory to the Board of Directors. No employee or agent of the Corporation shall be permitted to record any attempted or purported Transfer of Common Stock of the Corporation made in violation of this Article Fourth and no Transferee of Common Stock of the Corporation attempted to be Transferred in violation of this Article Fourth shall be deemed to have acquired ownership of Common Stock for any purpose. Such intended Transferee shall not be entitled to any rights as a shareholder of the Corporation with respect to such Common Stock including, but not limited to, the right to vote such Common Stock or to receive any distributions in respect thereof, whether as dividends or in liquidation.

(iv) If the procedures adopted by the Board of Directors so require, the Corporation's transfer agent shall not issue any certificates effecting the Transfer, assignment or disposition or purported Transfer, assignment or other disposition of legal ownership of any shares of Common Stock unless the transfer agent receives from the proposed Transferee, in addition to any other information requested by it, a certificate signed under penalty of perjury attesting to the fact that the

Transferee does not, and will not as a result of the proposed Transfer, assignment or other disposition, own an aggregate number of shares of the Corporation's outstanding Stock having a fair market value equal to or greater than 4.75% of the aggregate fair market value of all of the Corporation's outstanding Stock. If at any time the Corporation's transfer agent receives a request to make a change in record ownership of shares of Common Stock of the Corporation that, if effected, would appear to the transfer agent on the basis of information in its possession to constitute a violation of this Article Fourth, then, prior to registering such change in ownership on the books of the Corporation, the transfer agent shall notify the Corporation. If the Board of Directors or an officer of the Corporation designated by the Board of Directors determines that the proposed change in ownership would violate this Article Fourth, then the Corporation shall so advise the transfer agent and the transfer agent shall not make such change in ownership on the books of the Corporation and shall return the stock certificates representing such shares to an agent designated by the Corporation (the "Agent").

(v) Unless approval of the Board of Directors is obtained as provided in subparagraph (iii) above, any attempted Transfer of shares of Common Stock of the Corporation or any Option to acquire shares of Common Stock of the Corporation in excess of the shares that could be Transferred to the Transferee without restriction under subparagraph (i) above shall not be effective to Transfer ownership of such excess shares or Options (the "Prohibited Shares") to the purported acquiror thereof (the "Purported Acquiror"), who shall not be entitled to any rights as a shareholder of the Corporation with respect to the Prohibited Shares (including, without limitation, the right to vote or to receive dividends with respect thereto). All rights with respect to the Prohibited Shares shall be the property of the Agent until such time as the Prohibited Shares are resold as set forth in subparagraph (A) or subparagraph (B) below. The Purported Acquiror, by acquiring ownership of shares of Common Stock of the Corporation that are not Prohibited Shares, shall be deemed to have consented to all of the provisions of this Paragraph (1)(c) and to have agreed to act as provided in the following subparagraph (A).

(A) Upon demand by the Corporation, the Purported Acquiror shall transfer any certificate, or other evidence of purported ownership of the Prohibited Shares within the Purported Acquiror's possession or control, along with any dividends or other distributions paid by the Corporation with respect to the Prohibited Shares that were received by the Purported Acquiror (the "Prohibited Distributions"), to the Agent designated by the Corporation. If the Purported Acquiror has sold the Prohibited Shares to an unrelated party in any arm's-length transaction

after purportedly acquiring them, the Purported Acquiror shall be deemed to have sold the Prohibited Shares as agent for the Agent, and in lieu of transferring the Prohibited Shares and Prohibited Distributions to the Agent shall transfer to the Agent the Prohibited Distributions and the proceeds of such sale (the "Resale Proceeds") except to the extent that the Agent grants written permission to the Purported Acquiror to retain a portion of the Resale Proceeds not exceeding the amount that would have been payable by the Agent to the Purported Acquiror pursuant to the following subparagraph (B) if the Prohibited Shares had been sold by the Agent rather than by the Purported Acquiror. Any purported transfer of the Prohibited Shares by the Purported Acquiror other than a transfer described in one of the two preceding sentences shall not be effective to transfer any ownership of the Prohibited Shares.

(B) The Agent shall sell in an arm's-length transaction (through a stock exchange, if any, on which the Common Stock is traded, if possible) any Prohibited Shares transferred to the Agent by the Purported Acquiror, and the proceeds of such sale (the "Sales Proceeds"), or the Resale Proceeds, if applicable, shall be allocated to the Purported Acquiror up to the following amount: (i) where applicable, the purported purchase price paid or value of consideration surrendered by the Purported Acquiror for the Prohibited Shares, and (ii) where the purported Transfer of the Prohibited Shares to the Purported Acquiror was by gift, inheritance, or any similar purported transfer, the fair market value of the Prohibited Shares at the time of such purported Transfer. Subject to the succeeding provisions of this subparagraph, any Resale Proceeds or Sales Proceeds in excess of the amount allocable to the Purported Acquiror pursuant to the preceding sentence, together with any Prohibited Distributions, shall be paid over to a court or governmental agency, if applicable law permits, or otherwise shall be transferred to any entity designated by the Corporation that is described in Section 501(c)(3) of the Code. In no event shall any such amount inure to the benefit of the Corporation or the Agent, but said amounts may be used to cover expenses incurred by the Agent.

(C) Within thirty (30) business days of learning of a purported Transfer of Prohibited Shares to a Purported Acquiror, the Corporation through its Secretary shall demand that the Purported Acquiror surrender to the Agent the certificates representing the Prohibited Shares, or any Resale Proceeds, and any Prohibited Distributions, and if such surrender is not made by the Purported Acquiror within thirty (30) business days from the date of such demand, the Corporation shall institute legal proceedings to compel such transfer; provided, however, that nothing in this subparagraph shall preclude the Corporation in its discretion from immediately bringing legal proceedings

without a prior demand, and also provided that failure of the Corporation to act within the time periods set out in this subparagraph shall not constitute a waiver of any right of the Corporation to compel any transfer required by this Paragraph (1)(c).

(D) For a period of ninety (90) days after learning of an attempted or purported Transfer or unpermitted registration of shares in violation of this Paragraph 1(c), the Corporation may elect to acquire such shares at the same purchase price agreed to be paid by the intended Transferee, in which case the Corporation shall be obligated to pay to the intended Transferee of such shares the amount of any payments made by such intended Transferee to the transferor for such shares; such amounts shall be payable to the intended Transferee in three equal installments, without interest. The first such installment shall be payable within ten days after the Corporation exercises such right and the remaining installments shall be payable on the first and second anniversaries, respectively, of such exercise. The Corporation may exercise such election by giving written notice thereof to the intended Transferee.

(E) Upon a determination by the Board of Directors that there has been or is threatened a purported Transfer of Prohibited Shares to a Purported Acquiror, the Board of Directors may take such action in addition to any action required by the preceding subparagraph as it deems advisable to give effect to the provisions of this Paragraph (1)(c) including, without limitation, refusing to give effect on the books of the Corporation to such purported Transfer or instituting proceedings to enjoin such purported Transfer.

(vi) Until the earliest of July 31, 2009, such date as the Corporation shall no longer have any unutilized Carryforwards or such date after which Section 382 of the Code is repealed or so substantially modified such that, in the opinion of counsel to the Corporation, the restrictions on transfer described in this Paragraph (1)(c) of this Article Fourth are no longer necessary to accomplish their intended purpose, all certificates representing shares of Common Stock shall conspicuously bear the following legend:

"THE SHARES REPRESENTED BY THIS CERTIFICATE ARE SUBJECT TO CERTAIN RESTRICTIONS ON TRANSFERS SET FORTH IN ARTICLE FOURTH OF THE CORPORATION'S CERTIFICATE OF INCORPORATION, THE TEXT OF WHICH IS SUMMARIZED ON THE REVERSE SIDE OF THIS CERTIFICATE. ANY ATTEMPT TO ACQUIRE COMMON STOCK OF THE CORPORATION IN VIOLATION OF SUCH RESTRICTIONS SHALL

BE NULL AND VOID AND MAY RESULT IN FINANCIAL LOSS TO THE PERSON OR ENTITY ATTEMPTING SUCH ACQUISITION."

(vii) Nothing in this Article Fourth shall preclude the settlement of any transaction entered into through the facilities of the New York Stock Exchange, Inc.

2. Preferred Stock

(a) The Board of Directors is expressly vested with authority to issue the Preferred Stock from time to time in one or more series of such distinctive serial designations as may be stated or expressed in the resolution or resolutions providing for the issue of such stock, and in such resolution or resolutions providing for the issue of shares of each particular series the Board of Directors is also expressly vested with authority to fix:

(i) the number of shares to constitute such series, provided that, unless otherwise stated in any such resolution or resolutions, such number of shares which are not outstanding may be increased or decreased by the Board of Directors;

(ii) the rate and times at which, and the conditions under which, dividends shall be payable on shares' of such series, and the status of such dividends as cumulative or noncumulative and as participating or nonparticipating and whether such dividends shall be payable in preference to, or the terms under which such dividends shall be payable in relation to, the dividends payable on any other class or classes of any other series of stock;

(iii) with respect to any series of Preferred Stock which is to be redeemable, whether shares of such series shall be redeemable at the option of the holder thereof or the corporation or upon the happening of a specified event, and the cash, property or rights, including securities of any other corporation, for which, the price or prices or rate or rates, including any adjustments, at which, and the time or times and/or terms or conditions, if any, at or upon which, shares of such series shall be redeemable;

(iv) with respect to any series of Preferred Stock which is to be convertible or exchangeable, whether shares of such series shall be convertible or exchangeable at the option of the holder thereof or the corporation or upon the happening of a specified event, the other class or classes of stock or other series of Preferred Stock for which, the price or prices or rate or rates of exchange, including any adjustments, at which,

and the time or times and/or conditions, if any, at or upon which, shares of such series shall be convertible or exchangeable;

(v) the terms of the sinking funds or redemption or purchase account, if any, to be provided for shares of such series, including the extent to and manner in which such sinking fund or redemption or purchase account shall be applied to the purchase or redemption of the shares of such series for retirement or for other corporate purposes;

(vi) the rights of the holders of shares of such series upon liquidation, dissolution or winding up of the affairs of, or upon any distribution of the assets of, the corporation;

(vii) limitations, if any, applicable while such series is outstanding, on the payment of dividends or making of distributions on, or the acquisition of, or the use of monies for the purchase or redemption of, the Common Stock or any class of stock ranking, as to dividends or upon liquidation, on a parity with or junior to the shares of such series;

(viii) the full or limited voting rights, if any, to be provided for shares of such series; and

(ix) any other preferences and relative, participating, optional or other such special rights, and the qualifications, limitations or restrictions thereof, of shares of such series;

so far as not inconsistent with the provisions of the Certificate of Incorporation, as amended to the date of such resolution or resolutions, and to the full extent now or hereafter permitted by the laws of the State of Delaware. All shares of Preferred Stock shall be identical and of equal rank except in respect to the particulars that may be fixed by the Board of Directors as provided above; provided, however, that all shares of each series shall be identical and of equal rank except as to the time from which cumulative dividends, if any, thereon shall cumulate.

(b) The Board of Directors is also expressly vested with authority to amend any of the provisions of any resolution or resolutions providing for the issue of any series of Preferred Stock, subject to any class voting rights of the holders of any series of Preferred Stock contained in the resolution or resolutions providing for the issue of such series and subject to the requirements of the laws of the State of Delaware.

(c) Shares of Preferred Stock which have been issued and reacquired in any manner by the corporation (excluding, until the corporation elects to retire

them, shares which are held as treasury shares but including shares redeemed, shares purchased and retired, whether through the operation of a retirement or sinking fund or otherwise, and shares which, if convertible or exchangeable, have been converted into or exchanged for shares of stock of any other class or classes or series) shall, upon compliance with any applicable provisions of the laws of the State of Delaware, have the status of authorized and unissued shares of Preferred Stock and may be reissued as a part of the series of which they were originally a part (if the terms of such series do not prohibit such reissue) or as part of a new series of Preferred Stock to be created by resolution or resolutions of the Board of Directors or as part of any other series of Preferred Stock the terms of which do not prohibit such reissue.

(d) Pursuant to this Article Fourth, the Board of Directors fixes the designation and preferences and relative, participating, optional and other special rights, and qualifications, limitations and restrictions of a series of Preferred Stock consisting of 250,000 shares designated as the Series B Preferred Stock (referred to herein as the "Series B Preferred Stock") which shall rank equally in all respects and shall be subject to the following provisions:

(i) Rank. The Series B Preferred Stock shall, with respect to dividend rights and rights upon liquidation, winding up and dissolution, rank prior to all classes of the Corporation's Common Stock.

(ii) Dividends.

(A) The holders of the Series B Preferred Stock shall be entitled to receive out of any funds legally available therefor, when and as declared by the Board of Directors, dividends in cash at a rate of \$.20 per share per annum, provided, however, that the Board of Directors shall declare a dividend on the Series B Preferred Stock annually in each of the first five years from and after July 20, 1995, the effective date of this Certificate of Designations. Such dividends (a) shall accrue and be cumulative from July 20, 1995 through the conclusion of the fifth anniversary of such date, whether or not earned or declared and whether or not funds are legally available therefor, and (b) after the conclusion of such fifth anniversary, shall not accrue, accumulate or be payable, unless and until declared by the Board of Directors.

(B) Dividends declared pursuant to Section (ii)(A) above shall be payable annually, in arrears, on March 1 of each year, to the holder of record on such respective dates as may be fixed by the Board of Directors in advance of payment of each such dividend. Dividends payable on the Series B Preferred Stock for any period less than a full year shall be computed based on a 365-day year or 366-day year, as the case may be, and the actual number of days elapsed in the period for

which payable. Any accumulation of such dividends on the Series B Preferred Stock not paid in full on the date fixed by the Board of Directors for payment of such dividends (the "Dividend Payment Date") shall bear simple interest at a rate of 9.0% per annum from the Dividend Payment Date until paid. All dividends paid with respect to shares of Series B Preferred Stock pursuant to Section (ii)(A) shall be paid pro rata to the holders of the Series B Preferred Stock. In the event that the funds of the Corporation legally available for the payment of dividends shall be insufficient for the payment of the entire amount of dividends payable in any dividend period with respect to the Series B Preferred Stock, the amount of such legally available funds shall be allocated for the payment of dividends with respect to the Series B Preferred Stock pro rata based upon the Liquidation Preference thereof (as defined in Section (iv)(A) below). At any time and from time to time thereafter when additional funds of the Corporation become legally available for the payment of dividends, such funds shall be used to pay the balance of any accrued but unpaid dividends and any interest thereon.

(C) So long as any shares of the Series B Preferred Stock shall remain outstanding, the Corporation will not declare or pay any cash dividend, make a cash distribution, or purchase, acquire, redeem, pay monies to the holders of, or set aside or make monies available for a sinking fund for the purchase or redemption of, any shares of Common Stock unless all accrued and unpaid dividends and interest in respect of the Series B Preferred Stock have been paid or declared and duly provided for.

(iii) Redemption.

(A) Mandatory Redemption. On July 20, 2010, to the extent the Corporation shall have legally available funds therefor, the Corporation shall redeem the remaining outstanding shares of Series B Preferred Stock, at a redemption price (hereinafter the "Redemption Price") of 100% of the Liquidation Preference per share, together with an amount equal to the sum of all accrued and unpaid dividends and interest thereon to such redemption date, in cash, and in the manner provided in subparagraphs (iii)(C)(1) through (iii)(C)(4) below; provided, however, that if there are insufficient legally available funds for redemption under this Section (iii)(A) at the redemption date, the Corporation shall redeem all or part of the remainder of the shares of Series B Preferred Stock subject to redemption from time to time or as soon as the Corporation has sufficient funds which are legally available therefor until all such shares of Series B Preferred Stock have been redeemed.

(B) Optional Redemption. The Corporation may redeem at any time, or from time to time, from any source of funds legally available therefor, in whole or in part, in the manner provided in subparagraphs (iii)(C)(1) through (iii)(C)(4) below, any and all shares of Series B Preferred Stock at a redemption price of 100% of the Liquidation Preference per share, together with an amount equal to the sum of all accrued and unpaid dividends and interest thereon to the date fixed for redemption.

(C) Procedure for Redemption.

(1) With respect to any redemption of fewer than all the outstanding shares of Series B Preferred Stock, the number of shares to be redeemed shall be determined by the Board of Directors and the shares to be redeemed shall be selected by lot or pro rata as may be determined by the Board of Directors.

(2) Not less than thirty (30) nor more than ninety (90) days prior to the redemption date, written notice of the time and place of redemption (hereinafter, the "Redemption Notice") shall be given to each holder of record of the Series B Preferred Stock so to be redeemed, addressed to such holder at his or its post office address as the same shall appear upon the books of the Corporation. The Redemption Notice shall state: (a) the redemption date; (b) the number of shares to be redeemed from such holder and the total number of shares of Series B Preferred Stock to be redeemed; (c) the Redemption Price; and (d) the place where certificates for such shares are to be surrendered for payment of the Redemption Price.

(3) On or before the redemption date, each holder of shares of Series B Preferred Stock to be redeemed shall present and surrender his or its certificate or certificates (endorsed in such manner as may be required by the Corporation, or not endorsed if not required by the Corporation) to the Corporation in the manner and at the place designated in the Redemption Notice, and thereupon the Redemption Price for such shares shall be paid to or on the order of such holder.

(4) In the event less than all the shares of Series B Preferred Stock represented by any such surrendered certificate are redeemed, a new certificate shall be issued by the Corporation to the registered holder of such surrendered certificate representing the unredeemed shares.

(D) Effect of Redemption.

(1) The shares of Series B Preferred Stock which have been redeemed shall not be reissued and each surrendered certificate shall be canceled. The Corporation shall from time to time cause all such shares redeemed to be retired in the manner provided by law. Such retired shares of Series B Preferred Stock shall resume the status of authorized but unissued and non-designated shares of Preferred Stock of the Corporation.

(2) From and after the date fixed for redemption, (a) the shares of Series B Preferred Stock so designated for redemption shall no longer be transferable on the books of the Corporation (except with the consent of the Corporation); (b) such shares shall not be deemed to be outstanding for any purpose whatsoever (unless default shall be made by the Corporation in payment of the Redemption Price); (c) the holders thereof shall cease to be stockholders with respect to such shares and shall be entitled only to receive the Redemption Price thereof and (d) dividends on the shares of Series B Preferred Stock so called for redemption shall cease to accrue. If the Corporation shall default in making payment of the Redemption Price, then such shares so called for redemption and then unpaid shall continue to be outstanding as if no such call for redemption had been made.

(iv) Rights on Liquidation, Dissolution, etc..

(A) Upon any voluntary or involuntary liquidation, dissolution or winding up of the affairs of the Corporation, the holders of the shares of Series B Preferred Stock then outstanding shall be entitled to receive out of the assets of the Corporation available for distribution to its stockholders an amount in cash equal to \$4.00 for each share outstanding (the "Liquidation Preference"), plus an amount in cash equal to any and all accrued but unpaid dividends and interest thereon to the date fixed for liquidation, before any payment shall be made or any assets distributed to the holders of any of the stock of the Corporation ranking as to liquidation, dissolution or winding up junior to the Series B Preferred Stock. If the assets of the Corporation are not sufficient to pay in full the liquidation payments payable to the holders of outstanding shares of the Series B Preferred Stock and outstanding shares of securities ("Parity Securities") of the Corporation ranking on a parity with the Series B Preferred Stock as to liquidation, then the holders of all such shares shall share ratably in such distribution of assets in accordance with the amount which would be payable on such distribution if the amounts to which the holders of outstanding shares of Series B Preferred Stock are entitled were paid in full.

(B) The sale, conveyance, exchange or transfer of all or substantially all of the property and assets of the Corporation or the merger or consolidation of the Corporation into or with any other corporation, or the merger of any other corporation into it, shall not be deemed a dissolution, liquidation or winding up of the affairs of the Corporation for purposes of this Section (iv).

(v) Voting; Consent.

(A) The holders of the shares of Series B Preferred Stock shall not be entitled to vote on matters which may be the subject of proper action by stockholders of the Corporation except as otherwise provided by law.

(B) In any vote by the holders of Series B Preferred Stock as may be required by law, each holder of Series B Preferred Stock shall be entitled to one (1) vote for each share of Series B Preferred Stock.

(C) No consent of holders of the Series B Preferred Stock shall be required for (i) the creation of any indebtedness of any kind of the Corporation, (ii) the creation of any class of stock of the Corporation subordinate, pari passu or senior to the Series B Preferred Stock as to the payment of dividends and upon liquidation of the Corporation, or (iii) any increase or decrease in the amount of authorized Common Stock or any increase, decrease or change in the par value thereof.

(D) Except as expressly set forth herein, the holders of the Series B Preferred Stock shall have no other rights other than those provided by applicable Delaware law.

### 3. General

(a) No dividend shall be declared or paid on any capital stock of the corporation which shall impair the capital of the corporation nor shall any distribution of assets be made to any stockholder unless the value of the assets of the corporation remaining after such payment or distribution is at least equal to the aggregate of its debts, liabilities and capital. A director shall be fully protected in relying in good faith upon the books of account of the corporation or statements prepared by any of its officers or by independent public accountants as to the value and amount of the assets, liabilities, net profits, capital stock and surplus of the corporation, or any other facts pertinent to the existence and amount of surplus or other funds from which dividends might properly be declared and paid.

(b) No holder of any shares of capital stock of the corporation of any class now or hereafter authorized shall be entitled as a matter of right to purchase, subscribe for or otherwise acquire any shares of capital stock of the corporation of any class now or hereafter authorized or any securities convertible into or exchangeable for any such shares, or any warrants or other instruments (or securities carrying such warrants or other instruments) evidencing rights or options to subscribe for, purchase or otherwise acquire any such shares, whether such shares, securities, warrants or other instruments be unissued or issued and thereafter acquired by the corporation; provided, however, that nothing herein shall preclude or limit the Board of Directors from granting any such rights in connection with the issuance of shares of any class or series of capital stock of the corporation.

(c) For the purposes of this Article Fourth, a dividend shall be deemed to have been paid or a distribution to have been made at such time as the corporation shall have irrevocably deposited with any disbursing agent therefor or otherwise irrevocably set aside for the payment or distribution thereof cash or other property of the corporation in an amount equal to such dividend or distribution.

FIFTH: The business and property of the corporation shall be managed by a Board of Directors. The number of directors constituting the board shall be such number not less than five nor more than fourteen as shall be determined from time to time by resolution adopted by the affirmative vote of a majority of the Board of Directors.

SIXTH: The Directors on the Board of Directors shall be classified with respect to the time for which they shall severally hold office by dividing them into three classes. If the total number of directors is evenly divisible by three, then each class shall have one-third of the total number of directors. If the total number of directors is not evenly divisible by three, the Board of Directors shall by resolution determine the number of directors in each class, which shall be, as nearly as possible, the same for each class. All directors of the corporation shall hold office until their resignation or removal or until their successors are duly elected and qualified. The directors of the first class shall hold office until the first annual meeting of the stockholders to be held after the Effective Date and until their successors are duly elected and qualified; the directors of the second class shall hold office until the second annual meeting of the stockholders to be held after such date and until their successors are duly elected and qualified; and the directors of the third class shall hold office until the third annual meeting of the stockholders to be held after such date and until their successors are duly elected and qualified. At each annual meeting of the stockholders, the successors to the class of directors whose terms shall expire in that year shall be elected, and said successors shall hold office until the third following annual meeting of stockholders and until the election and qualification of their respective successors. If successors to the class of directors whose term shall expire at an annual meeting of stockholders are not elected at such meeting or if such meeting is not held, directors may be elected at a special meeting of stockholders as successors to that class of directors.

SEVENTH: Subject to the provisions of Article Fourth, this Certificate of Incorporation may be amended by the vote of the holders of stock having a majority of the voting power of the stock of the corporation entitled to vote at any annual or special stockholders' meeting.

EIGHTH: The Bylaws of the corporation may be amended or repealed and new Bylaws may be adopted by the vote of the holders of stock having a majority of the voting power of the stock of the corporation entitled to vote at any annual or special stockholders' meeting or by the vote of a majority of the directors present at a duly called and held meeting of the Board of Directors at which a quorum is present or by unanimous written consent of the directors but such right of the directors cannot divest or limit such right of the stockholders to adopt, amend or repeal by Bylaws.

NINTH: The corporation shall indemnify to the full extent permitted by the laws of Delaware as from time to time in effect, the persons described in Section 145 of the General Corporation Law of Delaware, or other provisions of the laws of Delaware relating to the indemnification of officers, directors, employees and agents, as from time to time in effect. The foregoing shall not be construed to limit the powers of the Board of Directors to provide any other rights of indemnity which it may deem appropriate.

TENTH: No director shall be personally liable to the corporation or any stockholder for monetary damages for breach of fiduciary duty as a director, except for any matter in respect of which such director shall be liable under Section 174 of Title 8 of the Delaware Code (relating to the Delaware General Corporation Law) or any amendment thereto or successor provision thereto or shall be liable by reason that, in addition to any and all other requirements for such liability, he (i) shall have breached his duty of loyalty to the corporation or its stockholders, (ii) shall not have acted in good faith or, in failing to act, shall not have acted in good faith, (iii) shall have acted in a manner involving intentional misconduct or a knowing violation of law or, in failing to act, shall have acted in a manner involving intentional misconduct or a knowing violation of law, or (iv) shall have derived an improper personal benefit. Neither the amendment nor repeal of this Article Tenth nor the adoption of any provision of the certificate of incorporation inconsistent with this Article Tenth, shall eliminate or reduce the effect of this Article Tenth in respect of any matter occurring, or any cause of action, suit or claim that, but for this Article Tenth would accrue or arise, prior to such amendment, repeal or adoption of an inconsistent provision.

IN WITNESS WHEREOF, The Hallwood Group Incorporated has caused this Restated Certificate to be signed by Melvin J. Melle, its Vice President, Chief Financial Officer and Secretary, this 1st day of September, 1995.

THE HALLWOOD GROUP INCORPORATED

By: /s/ Melvin J. Melle

-----  
Melvin J. Melle  
Vice President, Chief Financial  
Officer and Secretary

**CERTIFICATE OF AMENDMENT  
OF  
SECOND RESTATED CERTIFICATE OF INCORPORATION  
OF  
THE HALLWOOD GROUP INCORPORATED**

It is hereby certified that:

1. The name of the corporation The Hallwood Group Incorporated (the “Corporation”).
2. The Second Restated Certificate of Incorporation of the Corporation is hereby amended by deleting Section 1(c) of Article Fourth in its entirety.
3. The amendment of the Certificate of Incorporation is herein certified has been duly adopted in accordance with the provisions of Section 242 of the General Corporation Law of the State of Delaware.
4. The effective time of the amendment herein certified shall be the date this Certificate of Amendment is duly filed with the Secretary of State of the State of Delaware.

IN WITNESS WHEREOF, this Certificate of Amendment has been executed for The Hallwood Group Incorporated by Melvin J. Melle, its Secretary, this 12<sup>th</sup> day of May 2004.

/s/ Melvin J. Melle  
\_\_\_\_\_  
Melvin J. Melle, Secretary



AMENDED AND RESTATED  
BYLAWS  
OF  
THE HALLWOOD GROUP INCORPORATED  
A DELAWARE CORPORATION

ARTICLE I: OFFICES

SECTION 1.1 REGISTERED OFFICE. The registered office of The Hallwood Group Incorporated (the "Corporation") shall be at Corporate Trust Center, 1209 Orange Street, City of Wilmington, County of New Castle, State of Delaware, and the name of the registered agent in charge at that office shall be The Corporation Trust Company.

SECTION 1.2 PRINCIPAL OFFICE. The principal office for the transaction of the business of the Corporation shall be at the place, either within or without the State of Delaware, as the Board of Directors of the Corporation (the "Board") may determine. The Board is granted full power and authority to change the principal office from one location to another.

SECTION 1.3 OTHER OFFICES. The Corporation may also have an office or offices at any other place or places, either within or without the State of Delaware, as the Board may from time to time determine or as the business of the Corporation may require.

ARTICLE II: MEETINGS OF STOCKHOLDERS

SECTION 2.1 PLACE OF MEETINGS. All annual and other meetings of stockholders shall be held either at the principal office of the Corporation or at any other place within or without the State of Delaware as may be designated by the Board.

SECTION 2.2 ANNUAL MEETINGS. Annual meetings of stockholders of the Corporation for the purpose of electing directors and for the transaction of any other proper business as may come before the meetings may be held at the time and place and on the date as the Board shall determine.

SECTION 2.3 SPECIAL MEETINGS. Subject to the rights of the holders of any class or series of stock having a preference over the Common Stock as to dividends or upon liquidation, special meetings of the stockholders for any purposes may be called only by the Board and may be held at the time and place and on the date as the Board shall determine.

SECTION 2.4 NOTICE OF MEETINGS. Except as otherwise required by law, notice of each meeting of stockholders, whether annual or special, shall be given not less than 10 days nor more than 60 days before the date of the meeting to each stockholder of record entitled to vote at

the meeting by delivering a typewritten or printed notice of the meeting to the stockholder personally, or by depositing the notice in the U. S. mail, in a postage prepaid envelope, directed to the stockholder at the stockholder's post office address furnished by the stockholder to the Secretary of the Corporation for that purpose, or, if the stockholder shall not have furnished an address to the Secretary for that purpose, then at the stockholder's post office address last known to the Secretary, or by transmitting a notice of the meeting to the stockholder at that address by telegraph, cable, wireless or fax. Except as otherwise expressly required by law, no publication of any notice of a meeting of stockholders shall be required. Every notice of a meeting of stockholders shall state the place, date and hour of the meeting and, in the case of a special meeting, shall also state the purpose for which the meeting is called. Notice of any meeting of stockholders shall not be required to be given to any stockholder to whom notice may be omitted pursuant to applicable Delaware law or who shall have waived notice, and notice shall be deemed waived by any stockholder who shall attend the meeting in person or by proxy, except a stockholder who shall attend the meeting for the express purpose of objecting, at the beginning of the meeting, to the transaction of any business because the meeting is not lawfully called or convened. Except as otherwise expressly required by law, notice of any adjourned meeting of stockholders need not be given if the time and place thereof are announced at the meeting at which the adjournment is taken.

SECTION 2.5 QUORUM. Except as otherwise required by law, the holders of record of a majority in voting interest of the shares of stock of the Corporation entitled to be voted at the meeting, present in person or by proxy, shall constitute a quorum for the transaction of business at any meeting of stockholders of the Corporation or any adjournment thereof. Subject to the requirement of a larger percentage vote contained in the Certificate of Incorporation, these Bylaws or by statute, the stockholders present at a duly called or held meeting at which a quorum is present may continue to do business until adjournment, notwithstanding any withdrawal of stockholders that may leave less than a quorum remaining, if any action taken (other than adjournment) is approved by at least a majority of the shares required to constitute a quorum. In the absence of a quorum at any meeting or any adjournment thereof, a majority in voting interest of the stockholders present in person or by proxy and entitled to vote at the meeting, or, in the absence of all the stockholders, any officer entitled to preside at, or to act as secretary of, the meeting may adjourn the meeting from time to time. At any adjourned meeting at which a quorum is present, any business may be transacted that might have been transacted at the meeting as originally called.

SECTION 2.6 VOTING.

(A) Each stockholder shall, at each meeting of stockholders, be entitled to vote in person or by proxy each share of the stock of the Corporation that has voting rights on the matter in question and that shall have been held by the stockholder and registered in the stockholder's name on the books of the Corporation:

(i) on the date fixed pursuant to Section 6.5 of these Bylaws as the record date for the determination of stockholders entitled to notice of and to vote at the meeting; or

(ii) if no record date is fixed, then (a) at the close of business on the day before the notice of the meeting is given or (b) if notice of the meeting is waived, at the close of business on the day before the meeting is held.

(B) Shares of its own stock belonging to the Corporation or to another corporation, if a majority of the shares entitled to vote in the election of directors in any other corporation is held, directly or indirectly, by the Corporation, shall neither be entitled to vote nor be counted for quorum purposes. Persons holding stock of the Corporation in a fiduciary capacity shall be entitled to vote the stock. Persons whose stock is pledged shall be entitled to vote, unless in the transfer by the pledgor on the books of the Corporation the pledgor shall have expressly empowered the pledgee to vote, in which case only the pledgee, or the pledgee's proxy, may represent the stock and vote. Stock having voting power standing of record in the names of two or more persons, whether fiduciaries, members of a partnership, joint tenants, tenants in common, tenants by the entirety or otherwise, or with respect to which two or more persons have the same fiduciary relationship, shall be voted in accordance with the provisions of the Delaware General Corporation Law.

(C) Any voting rights may be exercised by the stockholder entitled thereto in person or by the stockholder's proxy appointed by an instrument in writing, subscribed by the stockholder or by the stockholder's attorney and delivered to the secretary of the meeting; provided, however, that no proxy shall be voted or acted upon after three years from its date unless the proxy shall provide for a longer period. The attendance at any meeting of a stockholder who may have given a proxy shall not have the effect of revoking the proxy unless the stockholder shall in writing so notify the secretary of the meeting prior to the voting of the proxy. The vote at any meeting of stockholders on any question need not be by ballot, unless so directed by the chairman of the meeting. On a vote by ballot, each ballot shall be signed by the stockholder voting, or by the stockholder's proxy, if there is a proxy, and it shall state the number of shares voted.

(D) At any meeting of stockholders, all matters, except as otherwise provided in the Certificate of Incorporation, in these Bylaws or by law, shall be decided by the vote of a majority in voting interest of the stockholders present in person or by proxy and entitled to vote at the meeting and on the particular matter, a quorum being present.

SECTION 2.7 INSPECTORS. If at any meeting of stockholders a vote by written ballot shall be taken on any question, the chairman of the meeting may appoint an inspector or inspectors to act with respect to the vote. Each inspector so appointed shall first subscribe an oath faithfully to execute the duties of an inspector at the meeting with strict impartiality and according to the best of the inspector's ability. The inspectors shall decide upon the qualification of the voters and shall report the number of shares represented at the meeting and entitled to vote on the question, shall conduct and accept the votes, and, when the voting is completed, shall ascertain and report the number of shares voted respectively for and against the question. Reports of inspectors shall be in writing and subscribed and delivered by them to the Secretary of the Corporation. The inspectors need not be stockholders of the Corporation, and any officer of the Corporation may

be an inspector on any question other than a vote for or against a proposal in which the officer has a material interest.

SECTION 2.8 ADVANCE NOTICE OF STOCKHOLDER PROPOSALS AND STOCKHOLDER NOMINATIONS.

(A) At any meeting of the stockholders, the only business that may be conducted is business that is brought before the meeting (i) by or at the direction of the Board or (ii) by any stockholder of the Corporation who complies with the notice procedures set forth in this Section 2.8(A) and Section 2.8(B). For business to be properly brought before any meeting of the stockholders by a stockholder, the stockholder must have given notice thereof in writing to the Secretary of the Corporation at least 90 days in advance of the meeting or, if later, the tenth day following the first public announcement of the date of the meeting, and the business must be a proper matter for stockholder action under the Delaware General Corporation Law. A stockholder's notice to the Secretary must set forth as to each matter the stockholder proposes to bring before the meeting (1) a brief description of the business desired to be brought before the meeting and the reasons for conducting the business at the meeting, (2) the name and address, as they appear on the Corporation's books, of the stockholder proposing the business, (3) the class and number of shares of the Corporation that are beneficially owned by the stockholder, and (4) any material interest of the stockholder in the business. In addition, the stockholder making the proposal shall promptly provide any other information reasonably requested by the Corporation. Notwithstanding anything in these Bylaws to the contrary, no business may be conducted at any meeting of the stockholders except in accordance with the procedures set forth in this Section 2.8. The chairman of any meeting shall have the power and the duty to determine whether any business proposed to be brought before the meeting has been made in accordance with the procedure set forth in these Bylaws and shall direct that any business not properly brought before the meeting will not be considered.

(B) Nominations for the election of directors may be made by the Board or by any stockholder entitled to vote in the election of directors; provided, however, that a stockholder may nominate a person for election as a director at a meeting only if written notice of the stockholder's intent to make the nomination has been given to the Secretary of the Corporation at least 90 days in advance of the meeting or, if later, the tenth day following the first public announcement of the date of the meeting. Each notice must set forth: (i) the name and address of the stockholder who intends to make the nomination and of the person or persons to be nominated; (ii) a representation that the stockholder is a holder of record of stock of the Corporation entitled to vote at the meeting and intends to appear in person or by proxy at the meeting and nominate the person or persons specified in the notice; (iii) a description of all arrangements or understandings between the stockholder and each nominee and any other person or persons (naming the person or persons) pursuant to which the nomination or nominations are to be made by the stockholder; (iv) any other information regarding each nominee proposed by the stockholder as would be required to be included in a proxy statement filed pursuant to the proxy rules of the United States Securities and Exchange Commission had the nominee been nominated, or intended to be nominated, by the Board; and (v) the consent of each nominee to serve as a director of the Corporation if so elected. In addition, the stockholder making the

nomination must promptly provide any other information reasonably requested by the Corporation. Notwithstanding the foregoing provisions of this Section 2.8(B), if the number of directors to be elected to the Board is increased and there is no public announcement naming either all of the nominees for director or specifying the size of the increased Board made by the Corporation at least 100 days in advance of the meeting, a stockholders notice required by this Section 2.8(B) shall be considered timely, but only with respect to nominees for any new positions created by the increase, if it is delivered to the Secretary of the Corporation not later than the tenth day following the day on which the public announcement is first made by the Corporation. No person shall be eligible for election as a director of the Corporation unless nominated in accordance with the procedures set forth in this Section 2.8(B). The chairman of any meeting of stockholders shall have the power and the duty to determine whether a nomination has been made in accordance with the procedure set forth in this Section 2.8(B) and shall direct that any nomination not made in accordance with these procedures be disregarded.

#### SECTION 2.9 RECORD DATE FOR STOCKHOLDER ACTION BY WRITTEN CONSENT.

(A) Unless otherwise provided in the Certificate of Incorporation, any action that may be taken at any annual or special meeting of stockholders of the Corporation, may be taken without a meeting, without prior notice and without a vote, if a consent in writing, setting forth the action so taken, is signed by the holders of outstanding shares having not less than the minimum voting power that would be necessary to authorize or take such action at a meeting at which all shares entitled to vote on the matter were present and voted. Prompt notice of the taking of the corporate action without a meeting by less than unanimous written consent shall be given to those stockholders who have not consented in writing.

(B) In order that the Corporation may determine the stockholders entitled to consent to corporate action in writing without a meeting, the Board may fix a record date, which may not precede the date upon which the resolution fixing the record date is adopted by the Board, and which may not be more than 10 days after the date upon which the resolution fixing the record date is adopted by the Board. Any stockholder of record seeking to have the stockholders authorize or take corporate action by written consent shall, by written notice to the Secretary, request the Board to fix a record date. The Board shall promptly, but in all events within 10 days after the date upon which the request is received, adopt a resolution fixing the record date. If no record date has been fixed by the Board within 10 days of the date upon which the request is received, the record date for determining stockholders entitled to consent to corporate action in writing without a meeting, when no prior action by the Board is required by applicable law, shall be the first date on which a signed written consent setting forth the action taken or proposed to be taken is delivered to the Corporation by delivery to its registered office in the State of Delaware, its principal place of business, or an officer or agent of the Corporation having custody of the book in which proceedings of meetings of stockholders are recorded, addressed to the attention of the Secretary. Delivery shall be by hand or by certified or registered mail, return receipt requested. If no record date has been fixed by the Board and prior action by the Board is required by applicable law, the record date for determining stockholders entitled to consent to corporate action in writing without a meeting shall be at the close of business on the day on which the Board adopts the resolution taking the prior action.

SECTION 2.10 STOCKHOLDER LISTS. The officer who has charge of the stock ledger of the Corporation shall prepare and make, at least 10 days before every meeting of stockholders a complete list of the stockholders entitled to vote at the meeting, arranged in alphabetical order, and showing the address of each stockholder and the number of shares registered in the name of each stockholder. Such list shall be open to the examination of any stockholder, for any purpose germane to the meeting, during ordinary business hours, for a period of at least 10 days prior to the meeting, either at a place within the city where the meeting is to be held, which place shall be specified in the notice of the meeting, or, if not so specified, at the place where the meeting is to be held. The list shall also be produced and kept at the time and place of the meeting during the whole time thereof, and may be inspected by any stockholder who is present.

#### ARTICLE III: BOARD OF DIRECTORS

SECTION 3.1 GENERAL POWERS. Subject to any requirements in the Certificate of Incorporation, these Bylaws, and of the Delaware General Corporation Law as to action which must be authorized or approved by the stockholders, any and all corporate powers shall be exercised by or under the authority of, and the business and affairs of the Corporation shall be under the direction of, the Board to the fullest extent permitted by law. Without limiting the generality of the foregoing, it is hereby expressly declared that the Board shall have the following powers:

(A) to select and remove all the officers, agents and employees of the Corporation, prescribe the powers and duties for them as may not be inconsistent with law, the Certificate of Incorporation or these Bylaws, fix their compensation, and require from them security for faithful service;

(B) to conduct, manage and control the affairs and business of the Corporation, and to make any rules and regulations for that purpose not inconsistent with law, the Certificate of Incorporation or these Bylaws, as it may deem best;

(C) to change the location of the registered office of the Corporation in Section 1.1 ; to change the principal office and the principal office for the transaction of the business of the Corporation from one location to another as provided in Section 1.2 ; to designate any place within or without the State of Delaware for the holding of any meeting or meetings of stockholders; and to adopt, make and use a corporate seal, and to prescribe the forms of certificates of stock, and to alter the form of the seal and of the certificates from time to time, and in its judgment as it may deem best, provided the seal and the certificate at all times complies with the provisions of law;

(D) to authorize the issue of shares of stock of the Corporation from time to time, upon any terms and for any considerations as may be lawful;

(E) to borrow money and incur indebtedness for the purposes of the Corporation, and to cause to be executed and delivered therefor, in the corporate name, promissory notes, bonds, debentures, deeds of trust and securities; and

(F) by resolution adopted by a majority of the authorized number of directors, to designate an executive and other committees of the Board, each consisting of one or more directors, to serve at the pleasure of the Board, and to prescribe the manner in which proceedings of the committee or committees shall be conducted.

#### SECTION 3.2 NUMBER AND TERM OF OFFICE.

(A) The authorized number of directors of the Corporation shall be not less than 5 nor more than 14. The exact number of directors shall be fixed from time to time, within the limits specified, by resolution of the Board. Directors need not be stockholders. Each of the directors of the Corporation shall hold office until the director's successor is duly elected and qualifies or until the director resigns or is removed in the manner provided in these Bylaws.

(B) The Directors on the Board shall be classified with respect to the time for which they shall severally hold office by dividing them into three classes. If the total number of directors is evenly divisible by three, then each class shall have one-third of the total number of directors. If the total number of directors is not evenly divisible by three, the Board of Directors shall by resolution determine the number of directors in each class, which shall be, as nearly as possible, the same for each class. The directors of the each class shall hold office as provided in the Corporation's Certificate of Incorporation. At each annual meeting of the stockholders, the successors to the class of directors whose terms shall expire in that year shall be elected, and the successors shall hold office until the third following annual meeting of stockholders and until the election and qualification of their respective successors. If successors to the class of directors whose term expire at an annual meeting of stockholders are not elected at the meeting or if the meeting is not held, directors may be elected at a special meeting of stockholders as successors to that class of directors.

SECTION 3.3 ELECTION OF DIRECTORS. The directors shall be elected by the stockholders of the Corporation, and at each election, the persons receiving the greater number of votes, up to the number of directors then to be elected, shall be the persons then elected. The election of directors is subject to any provisions contained in the Certificate of Incorporation, including any provision granting the holders of preferred stock the right to elect directors.

SECTION 3.4 RESIGNATIONS. Any director of the Corporation may resign at any time by giving written notice to the Board or to the Secretary of the Corporation. Any resignation shall take effect at the time specified therein, or, if the time is not specified, it shall take effect immediately upon receipt; and, unless otherwise specified therein, the acceptance of the resignation shall not be necessary to make it effective.

SECTION 3.5 VACANCIES. Except as otherwise provided in the Certificate of Incorporation, any vacancy in the Board, whether because of death, resignation, disqualification, an increase in the number of directors, or any other cause, may be filled by vote of the majority of the remaining directors, although less than a quorum, or by a sole remaining director; provided, however, that whenever the holders of any class or series of shares are entitled to elect one or more directors, any vacancy or newly created directorship of any class or series may be filled by

a majority of the directors elected by that class or series then in office, or by a sole remaining director so elected. Each director chosen to fill a vacancy shall hold office until the director's successor is elected and qualifies or until the director resigns or is removed. No reduction of the authorized number of directors shall have the effect of removing any director prior to the expiration of the director's term of office.

SECTION 3.6 PLACE OF MEETING. The Board or any committee may hold any of its meetings at any place within or without the State of Delaware as the Board or the committee may from time to time by resolution designate or as is designated by the person or persons calling the meeting or in the notice or a waiver of notice of any meeting. Directors may participate in any regular or special meeting of the Board or any committee thereof by means of conference telephone or similar communications equipment pursuant to which all persons participating in the meeting of the Board or the committee can hear each other, and the participation shall constitute presence in person at the meeting.

SECTION 3.7 REGULAR MEETINGS. Regular meetings of the Board may be held at the times as the Board shall from time to time by resolution determine. Except as provided by law, notice of regular meetings need not be given.

SECTION 3.8 SPECIAL MEETINGS. Special meetings of the Board for any purpose or purposes shall be called at any time by the Chairman of the Board and the Chairman of the Board shall call a special meeting at any time upon the written request of two directors. Except as otherwise provided by law or by these Bylaws, written notice of the time and place of special meetings shall be delivered personally or by fax to each director, or sent to each director by mail or by other form of written communication, charges prepaid, addressed to the director at the director's address as it is shown upon the records of the Corporation. In case the notice is mailed or telegraphed, it shall be deposited in the U.S. mail or delivered to the telegraph company at least 72 hours prior to the time of the holding of the meeting. In case the notice is delivered personally or by fax as above provided, it shall be delivered at least 24 hours prior to the time of the holding of the meeting. The mailing, telegraphing, delivery or faxing as above provided shall be due, legal and personal notice to the director. Except where otherwise required by law or by these Bylaws, notice of the purpose of a special meeting need not be given. Notice of any meeting of the Board shall not be required to be given to any director who is present at the meeting, except a director who shall attend the meeting for the express purpose of objecting, at the beginning of the meeting, to the transaction of any business because the meeting is not lawfully called or convened.

SECTION 3.9 QUORUM AND MANNER OF ACTING. Except as otherwise provided in these Bylaws, the Certificate of Incorporation or by applicable law, the presence of a majority of the authorized number of directors shall be required to constitute a quorum for the transaction of business at any meeting of the Board, and all matters shall be decided at any meeting, a quorum being present, by the affirmative votes of a majority of the directors present. A meeting at which a quorum is initially present may continue to transact business notwithstanding the withdrawal of directors, provided any action taken is approved by at least a majority of the required quorum for the meeting. In the absence of a quorum, a majority of directors present at any meeting may

adjourn the same from time to time until a quorum shall be present. Notice of any adjourned meeting need not be given. The directors shall act only as a Board, and the individual directors shall have no power as such.

SECTION 3.10 ACTION BY CONSENT. Any action required or permitted to be taken at any meeting of the Board or of any committee thereof may be taken without a meeting if consent in writing is given thereto by all members of the Board or of the committee, as the case may be, and the consent is filed with the minutes of proceedings of the Board or of the committee.

SECTION 3.11 COMPENSATION. Directors, whether or not employees of the Corporation or any of its subsidiaries, may receive an annual fee for their services as directors in an amount fixed by resolution of the Board, and, in addition, a fixed fee, with or without expenses of attendance, may be allowed by resolution of the Board for attendance at each meeting, including each meeting of a committee of the Board. The fees may be in the form of cash or other lawful consideration, including stock grants and stock options. Nothing in these Bylaws shall be construed to preclude any director from serving the Corporation in any other capacity as an officer, agent, employee, or otherwise, and receiving compensation therefor.

SECTION 3.12 COMMITTEES. The Board may, by resolution passed by a majority of the whole Board, designate one or more committees, each committee to consist of one or more of the directors of the Corporation. Any committee, to the extent provided in the resolution of the Board and subject to any restrictions or limitations on the delegation of power and authority imposed by applicable law, shall have and may exercise all the powers and authority of the Board in the management of the business and affairs of the Corporation, and may authorize the seal of the Corporation to be affixed to all papers that may require it. Any committee shall keep written minutes of its meetings and report the same to the Board at the next regular meeting of the Board. Unless the Board or these Bylaws shall otherwise prescribe the manner of proceedings of any committee, meetings of committee may be regularly scheduled in advance and may be called at any time by the chairman of the committee or by any two members; otherwise, the provisions of these Bylaws with respect to notice and conduct of meetings of the Board shall govern.

#### ARTICLE IV: OFFICERS

SECTION 4.1 OFFICERS. The officers of the Corporation shall be a Chairman of the Board, a President, one or more Vice Presidents (the number thereof and their respective titles to be determined by the Board), a Secretary, a Treasurer, and any other officers as may be appointed at the discretion of the Board in accordance with the provisions of Section 4.3.

SECTION 4.2 ELECTION. The officers of the Corporation, except any officers that are appointed or elected in accordance with the provisions of Sections 4.3 or 4.5, shall be chosen annually by the Board at its first meeting, and each officer shall hold office until the officer resigns or is removed or otherwise disqualified to serve, or until the officer's successor is elected and qualified.

SECTION 4.3 OTHER OFFICERS. In addition to the officers chosen annually by the Board at its first meeting, the Board also may appoint or elect any other officers as the business of the Corporation may require, each of whom shall have the authority and perform the duties as are provided in these Bylaws or as the Board may from time to time specify, and shall hold office until the officer resigns or is removed or otherwise disqualified to serve, or until the officer's successor is elected and qualified.

SECTION 4.4 REMOVAL AND RESIGNATION. Any officer may be removed, either with or without cause, by resolution of the Board passed by a majority of the directors at the time in office, at any regular or special meeting of the Board, or except in case of an officer chosen by the Board, by any officer upon whom the power of removal may be conferred by the Board.

SECTION 4.5 VACANCIES. A vacancy in any office because of death, resignation, removal, disqualification or any other cause shall be filled in the manner prescribed in these Bylaws for regular appointments to the office.

SECTION 4.6 CHAIRMAN OF THE BOARD. The Chairman of the Board shall, subject to the control of the Board, be the chief executive officer of the Corporation and shall have general supervision, direction and control of the business and affairs of the Corporation and shall have any other powers and duties with respect to the administration of the business and affairs of the Corporation as may from time to time be assigned to the office by the Board or as may be prescribed by these Bylaws.

SECTION 4.7 PRESIDENT. The President shall have the powers and duties with respect to the administration of the business and affairs of the Corporation as may from time to time be assigned to the President by the Board or the Chairman of the Board or as may be prescribed by these Bylaws.

SECTION 4.10 VICE PRESIDENTS. Each Vice President shall have the powers and perform the duties with respect to the administration of the business and affairs of the Corporation as may from time to time be assigned to that Vice President by the Board or the Chairman of the Board or as may be prescribed by these Bylaws. In the absence or disability of the Chairman of the Board and the President, the Vice Presidents in order of their rank as fixed by the Board, or if not ranked, the Vice President designated by the Board, shall perform all of the duties of the Chairman of the Board and the President, and when so acting shall have all the powers of, and be subject to all the restrictions upon, the Chairman of the Board and the President.

SECTION 4.11 SECRETARY.

(A) The Secretary shall keep, or cause to be kept, at the principal office of the Corporation, or any other place as the Board may order, a book of minutes of all meetings of directors and stockholders, with the time and place of holding, whether regular or special, and if special, how authorized and the notice given, the names of those present at meetings of directors, the number of shares present or represented at meetings of stockholders, and the proceedings thereof.

(B) The Secretary shall keep, or cause to be kept, at the principal office of the Corporation's transfer agent, a share register, or a duplicate share register, showing the name of each stockholder, the number of shares of each class held by the stockholder, the number and date of certificates issued for shares, and the number and date of cancellation of every certificate surrendered for cancellation.

(C) The Secretary shall give, or cause to be given, notice of all meetings of stockholders and of the Board required by these Bylaws or by law to be given, and shall keep the seal of the Corporation in safe custody and shall affix and attest the seal to all documents to be executed on behalf of the Corporation under its seal, and shall have any other powers and perform any other duties as may be prescribed by these Bylaws or assigned by the Board, the Chairman of the Board or any officer of the Corporation to whom the Secretary may report. If for any reason the Secretary shall fail to give notice of any special meeting of the Board called by one or more of the persons identified in Section 3.8 , then any of those persons may give notice of any special meeting.

SECTION 4.12 TREASURER. The Treasurer shall receive, deposit and disburse funds belonging to the Corporation, and perform all duties that pertain to the office and that are required by the Board.

ARTICLE V: CONTRACTS, CHECKS, DRAFTS,  
BANK ACCOUNTS, ETC.

SECTION 5.1 EXECUTION OF CONTRACTS. The Board, except as these Bylaws otherwise provide, may authorize any officer or officers, or agent or agents, to enter into any contract or execute any instrument in the name of and on behalf of the Corporation, and the authority may be general or confined to specific instances; and unless so authorized by the Board or by these Bylaws, no officer, agent or employee shall have any power or authority to bind the Corporation by any contract or engagement or to pledge its credit or to render it liable for any purpose or in any amount.

SECTION 5.2 CHECKS, DRAFTS, ETC. All checks, drafts or other orders for payment of money, notes or other evidence of indebtedness, issued in the name of or payable to the Corporation, shall be signed or endorsed by those persons and in the manner as, from time to time, shall be determined by resolution of the Board. Each officer, assistant, agent or attorney shall give a bond, if any, as the Board may require.

SECTION 5.3 DEPOSITS. All funds of the Corporation not otherwise employed shall be deposited from time to time to the credit of the Corporation in any banks, trust companies or other depositories as the Board may select, or as may be selected by any officer or officers, assistant or assistants, agent or agents, or attorney or attorneys of the Corporation to whom the power shall have been delegated by the Board. For the purpose of deposit and for the purpose of collection for the account of the Corporation, the Chairman of the Board, the President, any Vice President, the Secretary and the Treasurer (or any other officer or officers, assistant or assistants, agent or agents, or attorney or attorneys of the Corporation who shall from time to time be

determined by the Board) may endorse, assign and deliver checks, drafts and other orders for the payment of money which are payable to the order of the Corporation.

SECTION 5.4 GENERAL AND SPECIAL BANK ACCOUNTS. The Board may from time to time authorize the opening and keeping of general and special bank accounts with any banks, trust companies or other depositories as the Board may select or as may be selected by any officer or officers, assistant or assistants, agent or agents, or attorney or attorneys of the Corporation to whom the power is delegated by the Board. The Board may make any special rules and regulations with respect to the bank accounts, not inconsistent with the provisions of these Bylaws, as it may deem expedient.

#### ARTICLE VI: SHARES AND THEIR TRANSFER

##### SECTION 6.1 CERTIFICATES FOR STOCK.

(A) Every owner of stock of the Corporation shall be entitled to have a certificate or certificates, to be in the form the Board shall prescribe, certifying the number and class or series of shares of the stock of the Corporation owned by the owner. The certificates representing shares of stock shall be numbered in the order in which they are issued and shall be signed in the name of the Corporation by the Chairman of the Board, the President or any Vice President, and by the Secretary, any Assistant Secretary or the Treasurer. Any or all of the signatures on the certificates may be a facsimile. In case any officer, transfer agent or registrar who has signed, or whose facsimile signature has been placed upon, any certificate, shall have ceased to be an officer, transfer agent or registrar before the certificate is issued, the certificate may nevertheless be issued by the Corporation with the same effect as though the person who signed the certificate, or whose facsimile signature is placed thereupon, were the officer, transfer agent or registrar at the date of issue. A record shall be kept of the names of the persons, firms or corporations owning the stock represented by the certificates, the number and class or series of shares represented by the certificates, and the dates of the certificates, and in case of cancellation, the respective dates of cancellation. Every certificate surrendered to the Corporation for exchange or transfer shall be canceled, and no new certificate or certificates shall be issued in exchange for any existing certificate until the existing certificate shall have been so canceled, except in cases provided for in Section 6.4 .

(B) Until the earliest of July 31, 2009, such date as the Corporation shall no longer have any unutilized Carryforwards or such date after which Section 382 of the Code is repealed or so substantially modified such that, in the opinion of counsel to the Corporation, the restrictions on transfer described in Paragraph (1)(c) of Article Fourth of the Corporation's Certificate of Incorporation are no longer necessary to accomplish their intended purpose, all certificates representing shares of Common Stock shall conspicuously bear the following legend:

"THE SHARES REPRESENTED BY THIS CERTIFICATE ARE SUBJECT TO CERTAIN RESTRICTIONS ON TRANSFERS SET FORTH IN ARTICLE FOURTH OF THE CORPORATION'S CERTIFICATE OF INCORPORATION, THE TEXT OF WHICH IS SUMMARIZED ON THE REVERSE SIDE OF THIS

CERTIFICATE. ANY ATTEMPT TO ACQUIRE COMMON STOCK OF THE CORPORATION IN VIOLATION OF SUCH RESTRICTIONS SHALL BE NULL AND VOID AND MAY RESULT IN FINANCIAL LOSS TO THE PERSON OR ENTITY ATTEMPTING SUCH ACQUISITION."

SECTION 6.2 TRANSFERS OF STOCK. Transfers of shares of stock of the Corporation shall be made only on the books of the Corporation at the direction of the registered holder of the shares, or by the holder's attorney authorized by a power of attorney duly executed and filed with the Secretary, or with a transfer clerk or a transfer agent appointed as provided in Section 6.3, and upon surrender of the certificate or certificates for the shares properly endorsed and the payment of all taxes due. The person in whose name shares of stock stand on the books of the Corporation shall be deemed the owner thereof for all purposes as regards the Corporation. Whenever any transfer of shares shall be made for collateral security, and not absolutely, that fact shall be so expressed in the entry of transfer if, when the certificate or certificates shall be presented to the Corporation for transfer, both the transferor and the transferee request the Corporation to do so.

SECTION 6.3 REGULATIONS. The Board may make any rules and regulations as it may deem expedient, not inconsistent with these Bylaws, concerning the issue, transfer and registration of certificates for shares of the stock of the Corporation. It may appoint, or authorize any officer or officers to appoint, one or more transfer clerks or one or more transfer agents and one or more registrars, and may require all certificates for stock to bear the signature or signatures of any of them.

SECTION 6.4 LOST, STOLEN, DESTROYED, AND MUTILATED CERTIFICATES. In any case of loss, theft, destruction, or mutilation of any certificate of stock, another may be issued in its place upon proof of loss, theft, destruction, or mutilation and upon the giving of a bond of indemnity to the Corporation in any form and in any sum as the Board or any officer may direct; provided, however, that a new certificate may be issued without requiring any bond when, in the judgment of the Board or any officer, it is proper so to do.

SECTION 6.5 FIXING DATE FOR DETERMINATION OF STOCKHOLDERS OF RECORD. In order that the Corporation may determine the stockholders entitled to notice of or to vote at any meeting of stockholders or any adjournment thereof, or entitled to receive payment of any dividend or other distribution or allotment of any rights, or entitled to exercise any rights in respect of any other change, conversion or exchange of stock or for the purpose of any other lawful action other than to consent to corporate action in writing without a meeting, the Board may fix, in advance, a record date, which shall not be more than 60 nor less than 10 days before the date of the meeting, nor more than 60 days prior to any other action. If in any case involving the determination of stockholders for any purpose other than notice of or voting at a meeting of stockholders the Board shall not fix a record date, then the record date for determining stockholders for that purpose shall be the close of business on the day on which the Board shall adopt the resolution relating thereto. A determination of stockholders entitled to notice of or to vote at a meeting of stockholders shall apply to any adjournment of the meeting; provided, however, that the Board may fix a new record date for the adjourned meeting.

#### ARTICLE VII: INDEMNIFICATION

SECTION 7.1 SCOPE OF INDEMNIFICATION. The Corporation shall indemnify to the full extent permitted by the laws of Delaware as from time to time in effect, the persons described in Section 145 of the Delaware General Corporation Law, or other provisions of the laws of Delaware relating to the indemnification of officers, directors, employees and agents, as from time to time in effect. The foregoing shall not be construed to limit the powers of the Board to provide any other rights of indemnity which it may deem appropriate.

SECTION 7.2 ADVANCES. The Corporation shall advance the expenses of any Director or officer incurred in defending any action, suit or proceeding, or appeal therefrom, whether civil, criminal, administrative, investigative or otherwise, in advance of the final disposition of any action, suit or proceeding by determination of the Board that the advance is appropriate; provided the Corporation receive an undertaking by or on behalf of the Director or officer involved to repay the amount unless it is ultimately determined that the person is entitled to be indemnified by the Corporation. The expenses incurred by officers, employees and agents may be so paid upon any terms and conditions the Board deems appropriate.

#### ARTICLE VIII: MISCELLANEOUS

SECTION 8.1 SEAL. The Board shall adopt a corporate seal, which shall be in the form of a circle and shall bear the name of the Corporation and words showing that the Corporation was incorporated in the State of Delaware.

SECTION 8.2 WAIVER OF NOTICES. Whenever notice is required to be given by these Bylaws or the Certificate of Incorporation or by law, the person entitled to the notice may waive the notice in writing, either before or after the time stated therein, and the waiver shall be deemed equivalent to notice.

SECTION 8.3 AMENDMENTS. Except as otherwise provided in these Bylaws or in the Certificate of Incorporation, these Bylaws or any of them may be altered, amended, repealed or rescinded and new Bylaws may be adopted by the Board or by the stockholders at any annual or special meeting of stockholders, provided that notice of the proposed alteration, amendment, repeal, rescission or adoption is given in the notice of the meeting.

SECTION 8.4 REPRESENTATION OF OTHER CORPORATIONS. The Chairman of the Board, President, any Vice President, the Secretary or the Treasurer of the Corporation is authorized to vote, represent and exercise on behalf of the Corporation all rights incident to any and all shares or ownership interests of any other corporation or corporations, partnership or limited liability company standing in the name of the Corporation. The authority granted to the officers to vote or represent on behalf of the Corporation any and all shares held by the Corporation in any other corporation or corporations may be exercised either by the officers in person or by any person authorized so to do by proxy or power of attorney duly executed by the officers.



**Certification by Chief Executive Officer  
Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002**

I, Anthony J. Gumbiner, certify that:

1. I have reviewed this quarterly report on Form 10-Q of The Hallwood Group Incorporated;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a – 15(e) and 15d – 15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a – 15(f) and 15d – 15(f)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities particularly during the period in which this report is being prepared;
  - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 14, 2011

/s/ Anthony J. Gumbiner  
By: Anthony J. Gumbiner  
Title: Chief Executive Officer

**Certification by Chief Financial Officer  
Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002**

I, Richard Kelley, certify that:

1. I have reviewed this quarterly report on Form 10-Q of The Hallwood Group Incorporated;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a – 15(e) and 15d – 15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a – 15(f) and 15d – 15(f)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities particularly during the period in which this report is being prepared;
  - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 14, 2011

/s/ Richard Kelley  
By: Richard Kelley  
Title: Chief Financial Officer

**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**

**Exhibit 32.1**

**Certification Pursuant to 18 U.S.C. Section 1350, as Adopted  
Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002**

In connection with the filing of the quarterly report on Form 10-Q for the quarter ended September 30, 2011 (the "Report") by The Hallwood Group Incorporated (the "Company"), each of the undersigned hereby certifies that:

1. The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: November 14, 2011

/s/ Anthony J. Gumbiner  
Anthony J. Gumbiner  
Chief Executive Officer

Dated: November 14, 2011

/s/ Richard Kelley  
Richard Kelley  
Chief Financial Officer