HALLWOOD GROUP INC
Form 10-Q
November 14, 2008

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SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-Q

MARK ONE

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

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

FOR THE TRANSITION PERIOD FROM _________ TO _________

For the Period Ended September 30, 2008 **Commission File Number: 1-8303**

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

Delaware	**51-0261339**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)
3710 Rawlins, Suite 1500, Dallas, Texas	**75219**
(Address of principal executive offices)	(Zip Code)

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

Securities Registered Pursuant to Section 12(b) of the Act:

Title of Class	**Name of Each Exchange On Which Registered**
Common Stock ($0.10 par value)	American Stock Exchange

Securities Registered Pursuant to Section 12(g) of the Act:
Title of Class

Series B Redeemable Preferred Stock

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 þ NO o

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. (Check one):

Large accelerated filer o	Accelerated filer o	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company þ

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). YES o NO þ

1,520,666 shares of Common Stock were outstanding at October 31, 2008.

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
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THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(dollars in thousands)
(unaudited)

	September 30, 2008	December 31, 2007
ASSETS		
Current Assets		
Cash and cash equivalents	$ 3,311	$ 7,260
Accounts receivable, net		
Due from factors	17,400	20,340
Trade and other	6,662	5,521
Related parties	162	249
Inventories, net	25,138	25,028
Federal income tax receivable	12,347	12,239
Deferred income tax, net	1,003	971
Prepaids, deposits and other assets	350	928
	66,373	72,536
Noncurrent Assets		
Investments in Hallwood Energy, net		
Property, plant and equipment, net	14,512	14,443
Deferred income tax, net	3,159	3,629
Other assets	135	137
	17,806	18,209
Total Assets	$ 84,179	$ 90,745
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities		
Accounts payable	$ 13,909	$ 13,602
Guarantee obligation additional investment in Hallwood Energy	3,200	
Accrued expenses and other current liabilities	4,876	4,952
State income taxes payable	609	13
Current portion of loans payable	54	158
Payable additional investment in Hallwood Energy		5,000
	22,648	23,725
Noncurrent Liabilities		

Long term portion of loans payable		10,228		17,208
Redeemable preferred stock		1,000		1,000
		11,228		18,208
Total Liabilities		33,876		41,933
Stockholders Equity				
Common stock, issued 2,396,105 shares for both periods; outstanding 1,520,666 shares for both periods		240		240
Additional paid-in capital		56,469		56,469
Retained earnings		7,067		5,576
Treasury stock, 875,439 shares for both periods; at cost		(13,473)		(13,473)
Total Stockholders Equity		50,303		48,812
Total Liabilities and Stockholders Equity	$	84,179	$	90,745

See accompanying notes to condensed consolidated financial statements.

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THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share amounts)
(unaudited)

	Nine Months Ended September 30,	
	2008	**2007**
Revenues		
Textile products sales	$ 126,689	$ 92,949
Expenses		
Textile products cost of sales	94,234	76,296
Administrative and selling expenses	16,726	14,610
	110,960	90,906
Operating income	15,729	2,043
Other Income (Loss)		
Investments in Hallwood Energy		
Equity loss	(12,120)	(13,648)
Interest income		92
Interest expense	(567)	(810)
Interest and other income	72	269
	(12,615)	(14,097)
Income (loss) before income taxes	3,114	(12,054)
Income tax expense (benefit)	1,623	(3,790)
Net Income (Loss)	$ 1,491	$ (8,264)
Net Income (Loss) Per Common Share		
Basic	$ 0.98	$ (5.44)
Diluted	$ 0.98	$ (5.44)
Weighted Average Shares Outstanding		
Basic	1,521	1,518

Diluted	1,523	1,518

See accompanying notes to condensed consolidated financial statements.

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THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share amounts)
(unaudited)

	Three Months Ended September 30,	
	2008	**2007**
Revenues		
Textile products sales	$ 35,568	$ 32,576
Expenses		
Textile products cost of sales	27,715	26,049
Administrative and selling expenses	5,960	5,279
	33,675	31,328
Operating income	1,893	1,248
Other Income (Loss)		
Investments in Hallwood Energy		
Equity loss		(1,272)
Interest expense	(139)	(301)
Interest and other income	30	33
	(109)	(1,540)
Income (loss) before income taxes	1,784	(292)
Income tax expense	529	75
Net Income (Loss)	$ 1,255	$ (367)
Net Income (Loss) Per Common Share		
Basic	$ 0.83	$ (0.24)
Diluted	$ 0.82	$ (0.24)
Weighted Average Shares Outstanding		
Basic	1,521	1,521
Diluted	1,523	1,521

See accompanying notes to condensed consolidated financial statements.

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THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
(in thousands)
(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Net Income (Loss)	$ 1,255	$ (367)	$ 1,491	$ (8,264)
Other Comprehensive Income (Loss)				
Previously realized increase in fair value of marketable securities sold during the period				(55)
Comprehensive Income (Loss)	$ 1,255	$ (367)	$ 1,491	$ (8,319)

See accompanying notes to condensed consolidated financial statements.

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THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS EQUITY
(in thousands)
(unaudited)

	Common Stock		Additional Paid-In	Retained	Treasury Stock		Total Stockholders
	Shares	Par Value	Capital	Earnings	Shares	Cost	Equity
Balance, January 1, 2008	2,396	$ 240	$ 56,469	$ 5,576	875	$ (13,473)	$ 48,812
Net income				1,491			1,491
Balance, September 30, 2008	2,396	$ 240	$ 56,469	$ 7,067	875	$ (13,473)	$ 50,303

See accompanying notes to condensed consolidated financial statements.

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THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

	Nine Months Ended September 30,	
	2008	**2007**
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income (loss)	$ 1,491	$ (8,264)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Equity loss from investments in Hallwood Energy	12,120	13,648
Depreciation and amortization	1,684	1,409
Deferred tax expense (benefit)	438	(4,300)
Excess tax benefits from share-based payment arrangements		(275)
Proceeds from sale of marketable securities		148
Income from investments in marketable securities		(74)
Changes in assets and liabilities:		
(Increase) decrease in accounts receivable	1,886	(4,600)
(Increase) decrease in inventories	(110)	(5,202)
Increase (decrease) in accounts payable	792	2,217
Increase in income taxes receivable/payable	569	1,249
Increase (decrease) in accrued expenses and other current liabilities	(76)	1,688
Net change in other assets and liabilities	499	225
Net cash provided by (used in) operating activities	19,293	(2,131)
CASH FLOWS FROM INVESTING ACTIVITIES		
Investments and loans in Hallwood Energy	(13,919)	(11,093)
Investments in property, plant and equipment, net	(2,239)	(1,005)
Net cash used in investing activities	(16,158)	(12,098)
CASH FLOWS FROM FINANCING ACTIVITIES		
Repayment of other bank borrowings and loans payable	(7,084)	(213)
Proceeds from revolving credit facility, net		6,536
Purchase of common stock for treasury		(439)
Excess tax benefits from share-based payment arrangements		275
Proceeds from exercise of stock options		165
Net cash provided by (used in) financing activities	(7,084)	6,324
DECREASE IN CASH AND CASH EQUIVALENTS	(3,949)	(7,905)

CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	7,260	10,054
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 3,311	$ 2,149

See accompanying notes to condensed consolidated financial statements.

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THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Nine Months Ended September 30, 2008 and 2007
(unaudited)

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

Interim Condensed Consolidated Financial Statements. The interim condensed consolidated financial statements of The Hallwood Group Incorporated and its subsidiaries (the Company) (AMEX: HWG), a Delaware corporation, 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 Form 10-K for the year ended December 31, 2007.

Organization. The Company is a holding company with interests in textile products and energy.

Textile Products. Textile products operations are conducted through the Company s wholly owned subsidiary, Brookwood Companies Incorporated (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 three principal subsidiaries:

Kenyon Industries, Inc. (Kenyon). Kenyon uses the latest technologies and processes in dyeing, finishing, coating and printing of woven synthetic products. At its Rhode Island plant, 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 Incorporated (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 seven layers of textile materials can be processed using both wet and dry lamination techniques.

Strategic Technical Alliance, LLC (STA). STA is part of the Brookwood Marketing division and markets advanced breathable, waterproof laminate and other fabrics primarily for military applications. Continued development of these fabrics for military applications is a key element of Brookwood s business plan. STA s operations are gradually being transferred directly to Brookwood.

Textile products accounts for all of the Company s operating revenues. See Note 3 for additional information on Brookwood.

Energy. Effective December 31, 2005, the Company s remaining energy affiliates, Hallwood Energy II, L.P. (HE II), Hallwood Energy 4, L.P. (HE 4) and Hallwood Exploration, L.P. (Hallwood Exploration), were consolidated into HE 4, which was renamed Hallwood Energy, L.P. (Hallwood Energy). The Company accounted for the former investments using the equity method of accounting. At the consolidation date, Hallwood Energy was principally involved in acquiring oil and gas leases and drilling, gathering and sale of natural gas in the Barnett Shale formation located in Parker, Hood and Tarrant Counties in North Texas, the Barnett Shale and Woodford Shale formations in West Texas, in the Fayetteville Shale formation of Central Eastern Arkansas, and conducting 3-D seismic surveys over optioned land covering a Salt Dome in South Louisiana in order to determine how best to proceed with exploratory activity.

All of the Company s energy activities are conducted through Hallwood Energy. The Company accounts for Hallwood Energy using the equity method of accounting. See Note 4 for additional information on Hallwood Energy.

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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 parent company, The Hallwood Group Incorporated, operates on a traditional fiscal month accounting cycle. The Company s condensed consolidated financial statements as of September 30, 2008 and 2007 include Brookwood s operations through September 27, 2008 and September 29, 2007, respectively. Estimated operating results of Brookwood for the intervening period from September 28, 2008 through September 30, 2008 are provided below (in thousands). As September 30, 2007 was a Sunday, the operating results for 2007 were not effected.

	Amounts in Intervening Period	
	2008	**2007**
Textile products sales	$444	$
Textile products costs of sales	342	
Administrative and selling expenses	54	

New Accounting Pronouncements. In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 157, *Fair Value Measurements* . This Statement defines fair value as used in numerous accounting pronouncements, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosure related to the use of fair value measures in financial statements. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. The adoption of SFAS No. 157 did not have a material impact on the Company s financial position, results of operations or cash flows.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115.* SFAS No. 159 permits entities to choose to measure many financial instruments and certain other items at fair value. The FASB believes the statement will improve financial reporting by providing companies the opportunity to mitigate volatility in reported earnings by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. Use of the statement will expand the use of fair value measurements for accounting for financial instruments. Although the Company has not yet elected to present any financial assets or liabilities at fair value under SFAS No. 159, it may choose to do so in the future.

The Emerging Issues Task Force (EITF) of the FASB ratified EITF Issue 06-11, *Accounting for Income Tax Benefits of Dividends on Share-Based Payment Awards* (EITF 06-11) in June 2007. In a stock-based compensation arrangement, employees may be entitled to dividends during the vesting period for nonvested shares or share units and until the exercise date for stock options. These dividend payments generally can be treated as a deductible compensation expense for income tax purposes, thereby generating an income tax benefit for the employer. At issue was how such a realized benefit should be recognized in the financial statements. The EITF has reached a conclusion that an entity should recognize the realized tax benefit as an increase in additional paid-in capital (APIC) and that the amount recognized in APIC should be included in the pool of excess tax benefits available to absorb tax deficiencies on stock-based payment awards. EITF 06-11 will be effective prospectively for the income tax benefits that result from dividends on equity-classified employee share-based payment awards that are declared in fiscal years beginning after December 15, 2007. The adoption of this EITF did not have a material impact on the Company s financial statements.

On May 9, 2008, the FASB issued SFAS No. 162, *The Hierarchy of Generally Accepted Accounting Principles* . This statement identifies a consistent framework, or hierarchy, for selecting accounting principles to be used in preparing financial statements that are presented in conformity with U.S. generally accepted accounting principles for

nongovernmental entities. It establishes that the GAAP hierarchy should be directed to entities because it is the entity (not the auditor) that is responsible for selecting accounting principles for financial statements that are presented in conformity with GAAP. SFAS No. 162 is effective 60 days following the SEC s approval of the Public Company Accounting Oversight Board auditing amendments to AU Section 411, The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles. Management does not believe that implementation of SFAS No. 162 will have any effect on the Company s consolidated financial statements.

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Nine Months Ended September 30, 2008 and 2007
(unaudited)

Note 2 Inventories

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

	September 30, 2008	December 31, 2007
Raw materials	$ 8,070	$ 8,084
Work in progress	8,049	8,218
Finished goods	10,029	9,475
	26,148	25,777
Less: Obsolescence reserve	(1,010)	(749)
Total	$ 25,138	$ 25,028

Note 3 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.

One of Brookwood s factors announced in March 2008 that it had been negatively impacted by the tightening in the credit markets and was required to draw on its bank credit lines to provide additional liquidity. The factor announced in June 2008 that it acquired additional financing to strengthen its balance sheet and improve and diversify its liquidity and funding. Brookwood is monitoring its factor relationships and developing alternative strategies should economic conditions deteriorate further. As of November 1, 2008, all of Brookwood s factors were complying with payment terms in accordance with factor agreements.

Sales Concentration. Sales to one Brookwood customer, Tennier Industries, Inc. (Tennier), accounted for more than 10% of Brookwood s sales during both the 2008 and 2007 third quarter and nine month periods. Its relationship with Tennier is ongoing. Sales to Tennier, which are included in military sales, were $8,593,000 and $38,573,000 in the 2008 third quarter and nine month periods, respectively, compared to $11,270,000 and $26,840,000 in 2007. Sales to Tennier represented 24.2% and 34.6% of Brookwood s net sales in the 2008 and 2007 third quarters, respectively, and 30.4% and 28.9% in the 2008 and 2007 nine month periods, respectively. Sales to another customer, ORC Industries, Inc. (ORC), accounted for more than 10% of Brookwood s sales in 2008. Its relationship with ORC is ongoing. Sales to ORC, which are included in military sales, were $4,093,000 and $13,375,000 in the 2008 third quarter and nine month periods, respectively, compared to $1,932,000 and $6,162,000 in 2007. Sales to ORC represented 11.5% and 5.9% of Brookwood s net sales in the 2008 and 2007 third quarters, respectively, and 10.6% and 6.6% in the 2008 and 2007 nine month periods, respectively.

Military sales accounted for $21,194,000 and $81,148,000 in the 2008 third quarters and nine month periods, compared to $18,079,000 and $46,626,000 in 2007, respectively. Military sales represented 59.6% and 55.5% of Brookwood s net sales in the 2008 and 2007 third quarters and 64.1% and 50.2% in the 2008 and 2007 nine month periods, respectively.

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,

2008, dividends on the preferred stock were current. Future dividend payments by Brookwood will be attributed first to the preferred stock and thereafter to common stock.

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 ($13,500,000 at September 30, 2008). 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 dividends paid by Brookwood to the Company. However, if the Company s board of directors determines

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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.

Engagement of Financial Advisor. In December 2007, a special committee of the board of directors of the Company engaged a financial advisor to assist it in developing strategic alternatives, including a potential sale, with respect to Brookwood. This initiative was terminated during the 2008 fourth quarter.

Note 4 Investments in Hallwood Energy, L.P.

Investments in Hallwood Energy as of the balance sheet dates were as follows (in thousands):

	As of September 30, 2008		Amount at which carried at		Loss for the nine months ended	
Description	Percent of Class Owned	Cost	September 30, 2008	December 31, 2007	September 30, 2008	September 30, 2007
- Class A limited partner interest	25(a)	$ 50,384	$	$	$	$ (12,374)
- Class C limited partner interest	13	11,084				
- General partner interest	50	13				(2)
- First Convertible Note	17	5,000				
- Second Convertible Note						
Cash investment	96	9,300			(8,920)	
Less: portion invested by third parties		(380)				
Guarantee to invest additional funds		3,200			(3,200)	
Total		$ 78,601	$	$	$ (12,120)	$ (12,376)

(a) 18% after consideration of profit interests

The Company accounts for this investment using the equity method of accounting and records its pro rata share of Hallwood Energy s net income (loss) and partner capital transactions, as appropriate.

Hallwood Energy is a privately held independent oil and gas limited partnership and operates as an upstream energy company engaging in the acquisition, development, exploration, production, and sale of hydrocarbons, with a

primary focus on natural gas assets. Hallwood Energy conducts its energy activities from its corporate office located in Dallas, Texas and production offices in Searcy, Arkansas and Lafayette, Louisiana. Hallwood Energy s results of operations are and will be largely dependent on a variety of factors, including, but not limited to fluctuations in natural gas prices; success of its drilling activities; the ability to transport and sell its natural gas; regional and national regulatory matters; and the ability to secure, and price of, goods and services necessary to develop its oil and gas leases; and the ability to raise additional capital.

Hallwood Energy s management has classified its energy investments into three identifiable geographical areas:

West Texas the Barnett Shale and Woodford Shale formations,

Central and Eastern Arkansas primary targets are the Fayetteville Shale and Penn Sand formations, and

South Louisiana various projects on and around the LaPice Salt Dome.

THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
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(unaudited)

Certain of the Company s officers and directors are investors in Hallwood Energy. In addition, as members of management of Hallwood Energy, one director and officer and one officer of the Company hold a profit interest in Hallwood Energy.

In January 2008, the Company loaned $5,000,000 to Hallwood Energy in connection with Hallwood Energy s $30,000,000 First Convertible Note agreement (discussed below).

In May 2008, June 2008 and September 2008, the Company loaned $2,961,000, $2,039,000 and $4,300,000, respectively, (for a total of $9,300,000) pursuant to the Equity Support Agreement in connection with the Talisman Energy Transaction (discussed below).

Equity Losses. The Company s proportionate share of Hallwood Energy s calendar year 2007 loss would have reduced the carrying value of its investment in Hallwood Energy below zero. The general rule for recording equity losses ordinarily indicates that the investor shall discontinue applying the equity method when the investment has been reduced to zero and shall not provide for additional losses, unless the investor provides or commits to provide additional funds to the investee, has guaranteed obligations of the investee, or is otherwise committed to provide further financial support to the investee. Although no guarantee or commitment existed at December 31, 2007, the Company loaned $5,000,000 to Hallwood Energy in January 2008 in connection with Hallwood Energy s $30,000,000 convertible note due January 21, 2011 (the First Convertible Note) to provide capital to continue regular ongoing operations. Accordingly, the Company recorded an additional equity loss in 2007 to the extent of the $5,000,000 loan, as the Company had not determined to what extent, if any, that it would advance additional funds to Hallwood Energy.

In connection with the then ongoing efforts to complete the Talisman Energy Transaction (discussed below), the Company loaned Hallwood Energy $2,961,000 on May 15, 2008. As of that date, the Company s management had indicated that it did not intend to make additional investments in Hallwood Energy, except in connection with Hallwood Energy s obtaining additional funds from external sources. Due to the uncertainties at that time related to the completion of the Talisman Energy Transaction and the Company s additional investment, if any, the Company recorded an equity loss for the 2008 first quarter to the extent of the $2,961,000 loan and reduced the Company s carrying value of its Hallwood Energy investment to zero at March 31, 2008.

As a result of the completion of the Talisman Energy Transaction in June 2008, the Company entered into the Equity Support Agreement with Hallwood Energy which obligated the Company to contribute additional equity or debt capital of $2,039,000 at the completion date (for a total amount of $5,000,000) to Hallwood Energy and guarantee an additional amount of up to $7,500,000 in certain circumstances, both of which were issued under the terms of the Second Convertible Note (discussed below). The Company s commitment to provide additional financial support, resulted in the recording of an equity loss in the 2008 second quarter of $9,159,000, which included accumulated equity losses that had not been previously recorded, as the Company had reduced the carrying value of its investment to zero. The Company s carrying value of its Hallwood Energy investment was zero at June 30, 2008.

The Company loaned $4,300,000 to Hallwood Energy during the 2008 third quarter pursuant to the Equity Support Agreement. The Company had recognized the loss associated with this investment in the 2008 second quarter when the commitment to provide the funds was made. Accordingly, no additional equity loss was recorded in the 2008 third quarter and the Company s carrying value of its Hallwood Energy investment remained at zero as of September 30, 2008. The Company s proportionate share of Hallwood Energy s accumulated losses that have not been recognized as of September 30, 2008 is approximately $3,572,000, based upon a 25% Class A ownership percentage.

Capital Transaction in 2008. As previously disclosed, Hallwood Energy is in the process of seeking additional capital from external sources. In connection with this effort, on June 10, 2008, Hallwood Energy entered into an agreement for the sale and farmout to FEI Shale, L.P. (FEI), a subsidiary of Talisman Energy, Inc., of an undivided interest in up to 33.33% of Hallwood Energy s interest in substantially all its assets for a series of payments of up to $125,000,000 (an initial payment of $60,000,000 and the option to pay up to the additional $65,000,000), and entered

into an agreement to provide consulting services to the purchaser for one year (the Talisman Energy Transaction). FEI prepaid the consulting services agreement which requires two man-weeks per month of service from two senior executives. The revenues from this agreement will be recognized as earned over the course of the twelve month period. In October 2008, FEI elected to make a second payment of $30,000,000 to Hallwood Energy, which results in remaining potential funding from FEI of $35,000,000.

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Under the sale and farmout agreement between Hallwood Energy and FEI, the purchaser made an initial payment of $60,000,000 for an undivided 10% interest in Hallwood Energy s specified oil and gas properties and other assets. For each well for which FEI paid any costs, it will earn an additional interest on the specified properties on which the well is located upon payment of each invoice equal to an additional undivided 23.33% if payment occurs prior to FEI paying a cumulative amount of $90,000,000 under the farmout agreement (the Initial Milestone), or 13.33% if payment occurs after the Initial Milestone. For other oil and gas properties, FEI will earn an undivided 33.33% interest in such properties immediately upon payment of purchase costs paid by FEI under the farmout agreement. With respect to Hallwood Energy s other assets, FEI will immediately earn an additional undivided 10% interest in these other assets upon meeting the Initial Milestone and an additional undivided 13.33% interest in these other assets upon payment of a cumulative amount of $125,000,000 under the farmout agreement. FEI will also earn an undivided 33.33% interest in seismic data for which costs are paid by FEI. Hallwood Energy has agreed to deliver assignments for the interests earned under the farmout agreement and has granted a lien and security interest on 33.33% of its assets in favor of FEI as collateral security for the performance of this agreement.

The parties have agreed to use commercially reasonable efforts to agree upon a budget for each quarterly period during the term of the farmout agreement. Any material variance from the budget requires the prior approval of FEI.

If Hallwood Energy receives an authorization for expenditure from a third-party operator of its properties and either Hallwood Energy or FEI does not wish to include these operations under the farmout agreement, the other party may proceed at its sole risk and expense. If the participating party recoups its costs, the nonparticipating party will become entitled to receive an interest in the well in the amount of 66.67% if Hallwood Energy is the non-participating party, or 33.33% if FEI is the non-participating party.

If Hallwood Energy enters into discussions concerning a sale of a material portion of its assets or a change of control, FEI will have the opportunity to submit a proposal to complete the transaction. If Hallwood Energy and FEI do not enter into a definitive agreement for the transaction, Hallwood Energy may pursue other opportunities if the terms are not less favorable to Hallwood Energy than those proposed by FEI.

The farmout agreement prohibits Hallwood Energy from entering into a change of control agreement unless the lender under the Senior Secured Credit Facility and Junior Credit Facility waives its rights to demand prepayment, and holders of the Convertible Notes waive their rights of redemption upon a change of control or such indebtedness is required to be repaid or redeemed with funds provided or arranged by the party acquiring or merging with Hallwood Energy in the change of control transaction.

In connection with the Talisman Energy Transaction, the Company loaned $2,961,000 to Hallwood Energy on May 15, 2008 on terms similar to the First Convertible Note issued in January 2008. Contemporaneously with the signing of the sale and farmout agreement, the Company entered into an Equity Support Agreement (the Equity Support Agreement) with Hallwood Energy, under which the Company committed 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 loan of $2,961,000 in May 2008 and an additional loan to Hallwood Energy in June 2008 of $2,039,000 (for a total of $5,000,000) are treated as contributions toward the maximum amount. In September 2008, the Company loaned an additional $4,300,000 to Hallwood Energy under the Equity Support Agreement.

Funds advanced to Hallwood Energy pursuant to the Equity Support Agreement are issued under terms of the Second Convertible Note, terms of which are comparable to the First Convertible Note. During June and July 2008, the Company sold $380,000 of the Second Convertible Note to other investors in Hallwood Energy. As of September 30, 2008, $9,300,000 of the Second Convertible Note was outstanding, of which $8,920,000 was held by the Company and $380,000 was held by other Hallwood Energy investors. The remaining commitment amount under the Equity Support Agreement was $3,200,000 at September 30, 2008.

Hallwood Energy continues to seek additional capital from external sources.

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A further description of Hallwood Energy s activities during 2007 and 2008 are provided below.

Loan Financing. In March and April 2007, the Company loaned a total of $9,000,000 to Hallwood Energy, of which $7,000,000 was in the form of demand notes bearing interest at 6% above prime rate, and $2,000,000 was an advance that was repaid four days later with interest. In April 2007, Hallwood Energy made a request for additional capital contributions in the amount of $25,000,000 (the April Call). The Company and Hallwood Energy had agreed that the $7,000,000 of loans would be applied as the Company s portion of the April Call and as such was recorded as a Class C partnership investment. In May 2007, Hallwood Energy repaid $257,000 to the Company, which represented the excess of the $7,000,000 loaned over the Company s share of the capital contribution and related oversubscription.

In April 2007, Hallwood Energy entered into a $100,000,000 loan facility (the Senior Secured Credit Facility) with a new lender (the New Lender), who is an affiliate of one of Hallwood Energy s investors and drew $65,000,000 from the Senior Secured Credit Facility. The proceeds were used to repay the $40,000,000 balance of Hallwood Energy s former credit facility, approximately $9,800,000 for a make-whole fee and approximately $500,000 for incremental interest related to the former credit facility, transaction fees of approximately $200,000 and provide working capital. The Senior Secured Credit Facility is secured by Hallwood Energy s oil and gas leases, matures on February 1, 2010, and bears interest at a rate of the defined LIBOR rate plus 10.75% per annum (increased to LIBOR + 12.75% per annum effective May 1, 2008). An additional 2% of interest is added upon continuance of any defaulting event. The New Lender may demand that Hallwood Energy prepay the outstanding loans in the event of a defined change of control, qualified sale or event of default, including a material adverse event. In conjunction with executing the Senior Secured Credit Facility, the New Lender resigned its position on Hallwood Energy s board of directors and assigned its general partner interest to the remaining members.

The Senior Secured Credit Facility provided that, if Hallwood Energy raised $25,000,000 through an equity call or through debt subordinate to the Senior Secured Credit Facility, the New Lender would match subsequent amounts raised on a dollar for dollar basis up to the remaining $35,000,000 under the Senior Secured Credit Facility through the availability termination date of July 31, 2008. During the 2007 third quarter, Hallwood Energy borrowed an additional $20,000,000 under the Senior Secured Credit and borrowed the remaining $15,000,000 availability in October 2007. Accordingly, the Senior Secured Credit Facility was fully funded with an outstanding balance of $100,000,000 at December 31, 2007.

The Senior Secured Credit Facility contains various financial covenants, including maximum general and administrative expenses and current and proved collateral coverage ratios. In June 2008, the proved collateral coverage ratio test was amended to be effective September 30, 2008, and each quarter thereafter. Non-financial covenants restrict the ability of Hallwood Energy to dispose of assets, incur additional indebtedness, prepay other indebtedness or amend certain debt instruments, pay dividends, create liens on assets, enter into sale and leaseback transactions, make investments, loans or advances, make acquisitions, engage in mergers or consolidations or engage in certain transactions with affiliates, and otherwise restrict certain activities by Hallwood Energy. In October 2007, Hallwood Energy entered into an amendment of the Senior Secured Credit Facility to modify the calculation of the current ratio to include certain capital funding commitments.

The Senior Secured Credit Facility contained a make-whole provision whereby Hallwood Energy is required to pay the New Lender the amount by which the present value of interest and principal from the date of prepayment through January 31, 2009, exceeds the principal amount on the prepayment date. In June 2008, the facility was amended to extend the make-whole provision to January 31, 2010. The New Lender received amended warrants exercisable for 2.5% of the partnership interests at an exercise price of 2.5% of 100% of the amount of the total capital contributed to Hallwood Energy at December 31, 2006.

In January 2008, Hallwood Energy entered into a $30,000,000 convertible subordinated note agreement (the First Convertible Note). The First Convertible Note bears interest which accrues at an annual rate of 16%, which is payable

on a quarterly basis after the completion of a defined equity offering and subject to the prior full payment of borrowings and accrued interest under the Secured Credit Facilities. The First Convertible Note and accrued interest may be converted into Class C interests on a dollar for dollar basis. If no Class C interests are outstanding, the First Convertible Note may be converted into Class A interests or such comparable securities as may be outstanding at the same exchange ratio as the original Class C interests. Principal and unpaid interest are due on the earlier of January 21, 2011, or upon a defined change of control. A change of control redemption may also result in a make-whole provision whereby Hallwood Energy would pay a premium based on the difference between either $48,300,000 or $45,500,000 and the sum of previously made First Convertible Note principal and accrued interest payments. $28,839,000 of the First Convertible Notes had been subscribed for and issued, of which the Company subscribed and purchased $5,000,000 in January 2008.

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In connection with the completion of the Talisman Energy Transaction, the Company entered into an option agreement with the New Lender that grants the New Lender an option to purchase the Company s interest in the First Convertible Note at face value plus accrued interest, exercisable within 90 days commencing with the date of the full and final payment of all obligations and indebtedness owed by Hallwood Energy to the New Lender.

The First Convertible Note lenders also received warrants exercisable at up to $3,750,000 for an equal dollar amount of Class C interests, or such comparable securities as are outstanding at the time of exercise at the same exchange ratio as the original Class C interests. The warrants are exercisable until January 21, 2011.

In May 2008, Hallwood Energy entered into a $12,500,000 convertible subordinated note agreement (the Second Convertible Note), which was underwritten by the Company. The Second Convertible Note was issued in connection with the completion of the Talisman Energy Transaction and the related Equity Support Agreement. The Second Convertible Note contains interest terms, conversion features and repayment terms comparable to the First Convertible Note described previously. As of September 30, 2008, $9,300,000 of the Second Convertible Note was outstanding, of which $8,920,000 was held by the Company and $380,000 was held by other Hallwood Energy investors.

In January 2008, Hallwood Energy entered into the $15,000,000 Junior Credit Facility with the New Lender and drew the full amount of the facility. Proceeds were used to fund working capital requirements and future operational activities. Borrowings under both facilities are secured by Hallwood Energy s oil and gas leases, mature on February 1, 2010, and bear interest at a rate of the defined LIBOR rate plus 10.75% per annum through April 30, 2008, and thereafter increases to 12.75% per annum until loan maturity or prepayment. An additional 2% of interest is added upon continuance of any defaulting event. The New Lender had the right to demand that Hallwood Energy prepay the outstanding loans in the event of a defined change of control, qualified sale or event of default, including a material adverse event, however, such right was restricted in connection with certain amendments to the credit agreements related to the Talisman Energy Transaction. Hallwood Energy remains bound to a deposit control agreement initiated with the Senior Secured Credit Facility.

The Junior Credit Facility contains various financial covenants, materially consistent with the Senior Secured Credit Facility, including maximum general and administrative expenditures and current and proved collateral coverage ratios. The proved collateral coverage ratio covenant was scheduled to become effective June 30, 2008, however, in June 2008 the coverage ratio test was amended to be effective September 30, 2008. Non-financial covenants restrict the ability of Hallwood Energy to dispose of assets, incur additional indebtedness, prepay other indebtedness or amend certain debt instruments, pay dividends, create liens on assets, enter into sale and leaseback transactions, make investments, loans or advances, make acquisitions, engage in mergers or consolidations or engage in certain transactions with affiliates, and otherwise restrict certain Hallwood Energy s activities.

The Junior Credit Facility contains a make-whole provision whereby Hallwood Energy is required to pay the New Lender the amount by which the present value of interest and principal from the date of prepayment through January 31, 2010, exceeds the principal amount on the prepayment date.

In connection with the Junior Credit Facility, the Senior Secured Credit Facility was amended to bear interest at the defined LIBOR rate plus 12.75% per annum beginning May 1, 2008.

Hallwood Energy did not meet the current ratio covenant and was in default of the Senior Secured Credit Facility as of December 31, 2007. A second default event related to a commitment agreement by three partners to fund $15,000,000 by November 1, 2007, that was only partially funded. Hallwood Energy received a waiver from the New Lender for both of these default events in January 2008.

Hallwood Energy was not in compliance with the general and administrative expense covenant at March 31, 2008 and the current ratio covenant as of April 30, 2008 required by the Senior Secured Credit Facility and the Junior Credit Facility. Hallwood Energy entered into an amendment of the facilities with the New Lender in June 2008 to waive the defaults and amend various covenants.

At September 30, 2008, Hallwood Energy was not in compliance with the proved collateral coverage ratio under the Senior Credit Facility and the Junior Credit Facility. Accordingly, the interest rate under those facilities is now the defined LIBOR rate plus 14.75% per annum. However, pursuant to the forbearance agreement described below, the New Lender has agreed not to exercise its other remedies under the facilities until at least 91 days after the termination of the farmout agreement.

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In connection with the completion of the Talisman Energy Transaction, Hallwood Energy also agreed to amendments to its credit agreements that, among other things, could result in an increase in interest paid by Hallwood Energy and provides additional covenants. The principal provisions of the amendment and related agreements include the following:

The terms of the make-whole provision of the Senior Secured Credit Facility were extended from January 31, 2009 to January 31, 2010.

Pursuant to a forbearance agreement among Hallwood Energy, FEI, New Lender and others, if Hallwood Energy were in the future to default in certain of its obligations under its credit agreements, the New Lender has agreed not to exercise its remedies under the Senior Secured Credit Facility while the farmout agreement is in effect and for a period of 91 days after the termination of the farmout agreement.

Hallwood Energy shall pay to the New Lender on a monthly basis, the excess net cash flow, as defined, as additional debt service. Such payments, if any, shall be applied first to repay outstanding fees and expenses, second to accrued and unpaid interest and then to unpaid debt principal. The excess net cash flow is defined as operating revenues less operating expenses, certain general and administrative expenses, and other approved expenditures as defined in the agreement. No such payments have been made by Hallwood Energy.

Equity Investments. There are currently three classes of limited partnership interests held in Hallwood Energy:

Class C interests bear a 16% priority return which compounds monthly. The priority return will be accrued and become payable when, as and if declared by the general partner of Hallwood Energy. Hallwood Energy does not anticipate paying any distributions in the foreseeable future. All distributions of defined available cash and defined net proceeds from any sales or other disposition of all or substantially all of the then remaining assets of Hallwood Energy which is entered into in connection with, or which will result in, the liquidation of Hallwood Energy (the Terminating Capital Transaction) must first be used to reduce any unpaid Class C priority return and capital contributions to zero. Unpaid Class C priority return and capital contributions can be converted into Class A interests based on the ratio of Class C contributions to the sum of Class A contributions and the Class C limited partner s Class C partnership interest designated by the Class C limited partner to be converted into Class A partnership interest. The Class C capital contributions were $84,422,000 and unpaid priority returns were $17,321,000 at September 30, 2008.

Class A interests have certain voting rights and with the general partner would receive 100% of the distributions of available cash and net proceeds from Terminating Capital Transactions subsequent to the payment of all unpaid Class C priority return and of all Class C capital contributions until the unrecovered capital accounts of each Class A partner interest is reduced to zero, and thereafter share in all future distributions of available cash and net proceeds from Terminating Capital Transactions with the holders of the Class B interests.

Class B interests represent vested net profit interests awarded to key individuals by Hallwood Energy. At September 30, 2008 and December 31, 2007, outstanding Class B interests had rights to receive 20.0% and 18.6%, respectively, of distributions of defined available cash and net proceeds from Terminating Capital Transactions after the unpaid Class C priority return and capital contributions and the unreturned Class A and general partner capital contributions have been reduced to zero.

In April 2007, Hallwood Energy issued a $25,000,000 Class C equity call to its partners (the April Call) which was fully satisfied. Previously, Hallwood Energy received loans of $7,000,000 each from the Company and an affiliate of the New Lender. These loans were applied to the April Call. In May 2007, Hallwood Energy repaid $257,000 to the

Company, which represented the excess of its $7,000,000 advanced over the Company s share of the capital contribution and related oversubscription.

In April 2007, Hallwood Investments Limited (HIL), a corporation associated with Mr. Anthony J. Gumbiner, the Company s chairman and principal stockholder, and the New Lender each committed to fund one-half of the April Call and potential additional equity or subordinated debt funding calls totaling $55,000,000 by Hallwood Energy, to the extent other investors, including the Company, did not respond to equity calls.

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In May 2007, Hallwood Energy issued a $20,000,000 Class C equity call to its partners (the May Call), which was fully satisfied. The Company s proportionate share of the May Call was $5,091,000. Due to the fact that the Company did not have available sufficient cash, the Company contributed only $2,501,000 towards the May Call. Because of the Company s inability to meet its full equity call requirement, HIL funded $2,591,000 of the May Call that was not funded by the Company. In connection with the funding of this amount, Mr. Gumbiner agreed with a special committee of the board of directors of the Company that he would discuss the terms of this investment in the future.

In August 2007, Hallwood Energy issued a $15,000,000 Class C equity call to its partners (the August Call) which was fully satisfied. The Company s proportionate share of the August Call was $3,683,000. Due to the fact that the Company did not have available sufficient cash, the Company contributed only one-half, or $1,842,000, towards the August Call. Because of the Company s inability to meet its full equity call requirement, HIL funded $1,842,000 of the August Call that was not funded by the Company. In October 2007, the special committee appointed to consider HIL s funding of these capital calls acknowledged the terms of the funding of the capital calls by HIL and determined that, in light of the circumstances, including the Company s present inability to fund any amounts beyond those it had made, no further action was required.

As a result of the receipt of sufficient equity contributions from the April, May and August Calls, the $55,000,000 commitment from HIL and the New Lender was extinguished.

In November 2007, Hallwood Energy issued $15,000,000 of Class C partnership interest to a new equity partner. In addition, HIL, another existing investor in Hallwood Energy, and the New Lender entered into a letter agreement providing for a total of up to $15,000,000 in additional funding. Under the terms of this letter, HIL agreed to advance $7,500,000 and the other investor agreed to advance $3,000,000 to Hallwood Energy no later than November 15, 2007. These advances constituted loans to Hallwood Energy with an interest rate of 16% per annum and a maturity of March 1, 2010. The letter agreement contained a provision that permitted Hallwood Energy to repay the advances at any time without penalty in connection with a recapitalization of Hallwood Energy providing for net proceeds not less than the amount being repaid. If any part of these advances remained outstanding on January 2, 2008, then on that date the outstanding amount would automatically be converted into preferred partnership interests having the same terms as the existing class of preferred partnership interests. In addition, if any portion of the advances was converted into preferred partnership interests on January 2, 2008, then the New Lender agreed to contribute to Hallwood Energy the same proportion of $4,500,000 in exchange for preferred partnership interests. Hallwood Energy also agreed that if any portion of the agreed funding from HIL or the other existing investor was not made, it would be an event of default under the Senior Secured Credit Facility. HIL advanced $7,500,000 in November 2007, although the other investor did not fulfill its commitment. On January 2, 2008, as per the letter agreement, HIL s loan was converted into a Class C interest.

Litigation. In 2006, Hallwood Energy and Hallwood Petroleum (collectively referred to herein as Hallwood) entered into two, two-year contracts with Eagle Drilling, LLC (Eagle Drilling), under which the contractor was to provide drilling rigs and crews to drill wells in Arkansas. On or about August 14, 2006, one of the masts on the rigs provided under the contracts collapsed. Hallwood requested the contractor to provide assurances that the mast on the other rig, and any mast provided to replace the collapsed mast, were safe and met the requirements of the contracts. Eagle Drilling subsequently assigned the contracts to Eagle Domestic Drilling Operations, L.L.C. (Eagle Domestic) on August 25, 2006.

When the contractor refused to provide assurances, Hallwood notified the contractor in September 2006 that the contracts were terminated and it filed suit against Eagle Drilling and Eagle Domestic in Tarrant County, Texas state court (the Hallwood Action) to recover $1,688,000 in funds previously deposited with the contractor under the contracts. Eagle Domestic and its parent then filed for Chapter 11 bankruptcy protection in the United States Bankruptcy Court for the Southern District of Texas, Houston Division (the Texas Bankruptcy Court). After the filing of its bankruptcy case, Eagle Domestic filed an adversary action against Hallwood in the bankruptcy proceeding (the

Eagle Domestic Action) to recover unspecified damages, but purportedly in excess of $50 million based upon disclosures subsequently made during the discovery phase of the case. Hallwood asserted a counterclaim in the Eagle Domestic Action for the return of $1,688,000 in funds previously deposited with the contractor.

In October 2006, Eagle Drilling filed a related lawsuit against Hallwood in Cleveland County, Oklahoma state court (the Eagle Drilling Action) alleging breach of contract damages of approximately $170,000 in connection with certain invoices that were not paid after the collapse of the mast. Eagle Domestic initially joined in the Eagle Drilling Action, alleging other claims, but later dismissed its claims in light of its bankruptcy proceeding in Texas. Eagle Drilling subsequently amended its claims to also include a negligence claim for in excess of $1,050,000 in damages resulting from the collapse of the mast and a tortious breach of contract claim.

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In September 2007, Eagle Drilling filed for Chapter 11 bankruptcy protection in the United States Bankruptcy Court for the Western District of Oklahoma (the Oklahoma Bankruptcy Court). Hallwood then removed the Eagle Drilling Action and its claims against Eagle Drilling in the Hallwood Action to the Oklahoma Bankruptcy Court. In February 2008, the Eagle Drilling Action and the Hallwood Action were consolidated by an agreed order to be tried to a jury in the Oklahoma Bankruptcy Court. No trial date has been scheduled.

In April 2008, Hallwood Energy and Eagle Domestic signed an agreement to settle the Eagle Domestic Action. Hallwood Energy agreed to immediately release any claims it had against Eagle Domestic, pay Eagle Domestic $2,000,000 in cash and issue to Eagle Domestic $2,750,000 in equity of Hallwood Energy or a successor entity, which was accrued by Hallwood Energy at March 31, 2008. Hallwood paid Eagle Domestic $500,000 in July 2008 and the remaining $1,500,000 in October 2008. The parties are in discussions on how to value Hallwood Energy so that the equity component of the settlement can be implemented. The trial previously scheduled in the matter has been continued and no new trial date has been set. Upon receipt of the amounts contemplated by the settlement, the parties and their affiliates will be released from any claims the parties and their affiliates may have against each other on such terms and conditions as are reasonable and customary.

In April 2008, Eagle Drilling filed a motion for leave to amend its complaint in the Oklahoma Bankruptcy Court to allege additional claims for liquidated and actual damages in excess of $22,900,000 in connection with Hallwood s alleged breach of the drilling contracts, as well as unspecified damages for tortious interference with contracts and business relations, defamation and business disparagement. Hallwood opposed Eagle Drilling s motion insofar as Eagle Drilling sought to add the $22,900,000 breach of contract/liquidated damages claims on the basis that Eagle Drilling had assigned the underlying drilling contracts to Eagle Domestic and thus did not have standing to pursue those claims. The Oklahoma Bankruptcy Court has not yet ruled on Eagle Drilling s motion to amend its complaint.

As a result of Eagle Drilling s attempt to sue on the same claims asserted by Eagle Domestic in the Eagle Domestic Action, Eagle Domestic filed a motion in the Texas Bankruptcy Court that sought to compel Eagle Drilling to show cause why it should not be held in contempt for its efforts to assert those claims. Hallwood joined in that motion. After conducting an evidentiary hearing in June 2008, the Texas Bankruptcy Court issued an order and related opinion on September 24, 2008 wherein it held that the claims for liquidated damages arising from the alleged breach of the drilling contracts did not belong to Eagle Drilling, but rather to Eagle Domestic. Among other things, the Texas Bankruptcy Court found that the drilling contracts terminated after Eagle Drilling s assignment of the contracts to Eagle Domestic on August 25, 2006. The Texas Bankruptcy Court also barred Eagle Drilling from prosecuting any claims against Hallwood in the Oklahoma Bankruptcy Court or any other court where the basis of the claim was that the drilling contracts were terminated prior to Eagle Drilling s assignment of the contracts to Eagle Domestic on August 25, 2006 or that Hallwood owed money for any accounts receivable created after August 25, 2006. Eagle Drilling has appealed the Texas Bankruptcy Court s order.

In response to various motions filed by the parties in the Eagle Drilling bankruptcy proceeding, the Oklahoma Bankruptcy Court appointed an expert witness to examine the merits of the parties claims and to report to the court on potential fraudulent transfers that may have been made by Eagle Drilling to or for the benefit of Eagle Drilling s insiders and affiliates. On September 19, 2008, the court-appointed expert filed his report and identified potential avoidable transfers made by the Eagle Drilling to its insiders and affiliates. The expert also reported that the merits of the parties claim against each other rest upon numerous factual determinations, but that Hallwood has a valid claim against Eagle Drilling if Hallwood was not responsible for the collapse. This finding was in response to Eagle Drilling s contention that Hallwood had released Eagle Drilling via the settlement with Eagle Domestic. The expert also noted the Texas Bankruptcy Court s forthcoming ruling could have a major impact on the viability of Eagle Drilling s $22,900,000 breach of contract/liquidated damages claims against Hallwood. On October 24, 2008, the Oklahoma Bankruptcy Court asked the expert to supplement his report to take into account the entry of the Texas Bankruptcy Court s order and to further investigate other potentially avoidable transfers.

Earlier, on August 7, 2008, Eagle Drilling filed a motion to vacate the agreed order that consolidated the Hallwood Action and the Eagle Drilling Action before the Oklahoma Bankruptcy Court and to remand those actions back to the state courts in which they were originally filed. Hallwood filed an opposition to that motion on August 22, 2008. On October 21, 2008, the Debtor filed with the Oklahoma Bankruptcy Court a motion for dismissal of the Eagle Drilling bankruptcy proceeding. On November 5, 2008, Hallwood filed an objection to that motion and subsequently filed a motion to convert the Eagle Drilling

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bankruptcy proceeding to a chapter 7 proceeding, or alternatively, to appoint a chapter 11 trustee. No hearings have been set on any of these motions.

On November 7, 2008, the expert issued his supplemental report wherein he reported that Eagle Drilling has no claim against Hallwood for termination of the drilling contracts based on the Texas Bankruptcy Court s order. The expert also stated the potentially avoidable transactions should be further investigated by means of a fraudulent transfer action filed by Eagle Drilling or, if Eagle Drilling refuses to do so, by an independent third party. Finally, the expert reported that he did not believe Eagle Drilling, as the debtor in possession, had been acting in the best interests of the debtor and its creditors.

Hallwood Energy and Hallwood Petroleum are currently unable to determine the impact that the above-referenced bankruptcy cases and associated litigation may have on its results of operations or its financial position.

On October 27, 2008, Cimarex Energy Co. filed *Cimarex Energy Co. v. Hallwood Energy, L.P.* in the 298th Judicial District Court in Dallas County, Texas. Cimarex contends that Hallwood Energy has failed to pay approximately $3.7 million purportedly due under a Participation Agreement between parties related to the Boudreaux #1 Well in Lafayette Parish, Louisiana. Hallwood Energy has not yet filed its answer and intends to vigorously defend the claim.

Going Concern. In addition to the Talisman Energy Transaction, Hallwood Energy is continuing to seek additional capital, however, there is no assurance that any such transaction will be completed. If FEI does not elect to fund a substantial portion of the remaining $35,000,000 contemplated under the farmout agreement or if Hallwood Energy is unable to obtain additional funds, there is substantial doubt about Hallwood Energy s ability to continue as a going concern.

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The following table sets forth summarized financial data for Hallwood Energy, L.P. (in thousands):

	September 30, 2008	December 31, 2007
Balance Sheet Data		
Cash and cash equivalents	$ 24,007	$ 2,372
Restricted cash	927	
Oil and gas properties, net	116,657	107,248
Total assets	148,772	115,678
Notes payable (including make-whole fee)	158,925	101,990
Total liabilities	195,937	146,516
Partners capital (deficiency)	(47,165)	(30,838)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Statement of Operations Data				
Revenues				
Natural gas and oil sales	$ 2,038	$ 1,667	$ 13,853	$ 1,667
Facility income	177	183	966	183
	2,215	1,850	14,819	1,850
Expenses				
Impairment of oil and gas properties	3,742		3,742	31,680
General and administrative expenses	825	1,771	7,247	5,120
Depreciation and depletion	2,701	959	6,631	1,081
Operating expenses	898	715	2,947	804
Litigation settlement	7		4,770	
	8,173	3,445	25,337	38,685
Operating (loss)	(5,958)	(1,595)	(10,518)	(36,835)
Other Income and Expense				
Interest expense	858	(3,711)	(16,793)	(17,913)
Interest and other income (loss)	3,162	(38)	3,485	146
	4,020	(3,749)	(13,308)	(17,767)
Net (Loss)	$ (1,938)	$ (5,344)	$ (23,826)	$ (54,602)

Impairment. In accordance with the full cost accounting methodology, Hallwood Energy performs a ceiling test at each quarter s end. As a result of this test at September 30, 2008, Hallwood Energy recognized an impairment of its oil and gas properties of $3,742,000. The impairment was primarily due to a significant decline in natural gas prices from the prior quarter and the transfer of unevaluated leasehold cost associated with the unsuccessful drilling program in South Louisiana to the full cost pool. Hallwood Energy s evaluation and its ability to develop its unevaluated properties could lead to future impairments.

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Note 5 Loans Payable

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

	September 30, 2008	December 31, 2007
Working capital revolving credit facility, interest at Libor +1.25% - 1.75% or Prime, due January 2010	$ 10,228	$ 17,181
Equipment term loans, interest at various rates, due at various dates through April 2009	54	185
Total	10,282	17,366
Current portion	(54)	(158)
Noncurrent portion	$ 10,228	$ 17,208

Working Capital Revolving Credit Facility. The Company s Brookwood subsidiary has a revolving credit facility in an amount up to $25,000,000 (increased from $22,000,000 in December 2007) with Key Bank National Association (the Working Capital Revolving Credit Facility). Borrowings are collateralized by accounts receivable, certain finished goods inventory, machinery and equipment and all of the issued and outstanding capital stock of Brookwood and its subsidiaries. The facility bears interest at Brookwood s option of Prime, or Libor plus 1.25% - 1.75% (variable depending on compliance ratios) and contains various covenants. The interest rate was a blended rate of 4.95% and 6.73% at September 30, 2008 and December 31, 2007, respectively. The outstanding balance was $10,228,000 at September 30, 2008 and Brookwood had $14,772,000 of borrowing availability under this facility.

Equipment Term Loans. Brookwood has a revolving equipment credit facility in an amount up to $3,000,000 with Key Bank. Interest rates for the equipment term loans varied between 4.23% and 8.20% with a blended rate of 5.01% and 6.53% at September 30, 2008 and December 31, 2007, respectively. The outstanding balance was $54,000 at September 30, 2008 and Brookwood had $2,946,000 of borrowing availability under this facility.

Loan Covenants. The Working Capital Revolving Credit Facility provides for a maximum total debt to tangible net worth ratio and a covenant that Brookwood shall maintain a quarterly minimum net income of not less than one dollar. Cash dividends and tax sharing payments to the Company are contingent upon Brookwood s compliance with the covenants contained in the Working Capital Revolving Credit Facility. As of the end of all interim periods in 2008 and 2007 and as of December 31, 2007, Brookwood was in compliance with its loan covenants, although a waiver regarding a pro forma (inclusive of projected dividend) total debt to tangible net worth ratio for the 2007 third quarter was granted to allow a $1,500,000 dividend payment in November 2007 and an amendment to the Working Capital Revolving Credit Facility was entered into in June 2008 to allow a $4,800,000 dividend payment in June 2008, which restricts calendar 2008 total dividends from Brookwood to $9,300,000.

Restricted Net Assets. Cash dividends and tax sharing payments by Brookwood to the Company are contingent upon compliance with the loan covenants. This limitation on the transferability of assets constitutes a restriction of Brookwood s net assets, which were $33,035,000 and $29,180,000 as of September 30, 2008 and December 31, 2007, respectively.

Note 6 Stockholders Equity

Stock Options. The Company established the 1995 Stock Option Plan for The Hallwood Group Incorporated which authorized the granting of nonqualified stock options to employees, directors and consultants of the Company. The 1995 Plan authorized options to purchase up to 244,800 shares of common stock of the Company. The exercise prices of all options granted were at the fair market value of the Company s stock on the date of grant, had an expiration date of ten years from date of grant and were fully vested on the date of grant.

At September 30, 2008, there were 4,500 fully vested outstanding options that expire in May 2010. The 1995 Stock Option Plan terminated on June 27, 2005. Options issued prior to the termination were not affected; however, no new options can be issued under the 1995 Plan.

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In January 2007, one officer of the Company exercised options to purchase 2,250 shares of the Company s common stock that were scheduled to expire in February 2007. The officer paid the exercise price and related tax withholding requirement by exchanging an equivalent number of common shares valued at the fair market value of the common stock at the date of exercise. The net result of the exercise and exchange was the issuance of 1,273 shares from treasury at an average carrying value of $14.97 per share.

In June 2007, two officers of the Company exercised options to purchase a total of 7,500 shares of the Company s common stock that were scheduled to expire in September 2007. The officers paid the exercise price and related tax withholding requirement by exchanging an equivalent number of common shares valued at the fair market value of the common stock at the date of exercise. The net result of the exercises and exchanges was the issuance of 3,955 shares from treasury at an average carrying value of $15.08 per share.

There was no option activity for the nine months ended September 30, 2008 and status of outstanding options are as follows:

	Number of Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value
Outstanding, January 1, 2008	4,500	$ 10.31		
Granted				
Exercised				
Forfeited				
Outstanding, September 30, 2008	4,500	$ 10.31	1.67	$ 246,000
Options exercisable and vested at September 30, 2008	4,500		1.67	$ 246,000

The aggregate intrinsic value in the table above represents the total pre-tax intrinsic value (the difference between the Company s closing stock price on the last trading day of the 2008 third quarter ($65.00 per share) and the exercise price, multiplied by the number of options).

Note 7 Income Taxes

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Federal				
Deferred	$ 317	$ (168)	$ 438	$ (4,259)

Current	(109)		(109)	
Sub-total	208	(168)	329	(4,259)
State				
Deferred				(43)
Current	321	243	1,294	512
Sub-total	321	243	1,294	469
Total	$ 529	$ 75	$ 1,623	$ (3,790)

The net deferred tax asset was $4,162,000 and $4,600,000 at September 30, 2008 and December 31, 2007, respectively. The deferred tax asset at September 30, 2008 was comprised of $1,261,000 attributable to temporary differences that, upon reversal, can be utilized to offset income from operations, $2,142,000 attributable to a net operating loss carryforward from 2007, and $759,000 of

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alternative minimum credits. The December 31, 2007 amount was attributable to temporary differences of $1,720,000, a net operating loss carryforward of $2,036,000 and $844,000 of alternative minimum tax credits. The effective federal tax rate in both periods was 34%. State taxes are determined based upon taxable income apportioned to those states in which the Company does business at their respective tax rates.

The federal income tax receivable, attributable to the carryback of its 2007 taxable loss, was $12,347,000 and $12,239,000 at September 30, 2008 and December 31, 2007, respectively. The Company filed a carryback of its 2007 taxable loss in September 2008 and received the refund in October 2008 of $12,347,000.

Note 8 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, 2008	2007
Change in payable additional investment in Hallwood Energy	$ 3,201	$
Accrued capital expenditures in accounts payable Amount at period end	$ 37	$ 523
Previously realized increase in fair value of marketable securities sold during the period	$	$ (55)
Income tax effect from exercise of stock options:		
Income taxes payable	$	$ 275
Additional paid-in capital		(275)
	$	$
***Supplemental disclosures of cash payments*:**		
Income taxes paid (refunded)	$ 634	$ (713)
Interest paid	567	833

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Note 9 Computation of Income (Loss) Per Common Share

The following table reconciles weighted average shares outstanding from basic to diluted methods (in thousands):

Description	Three Months Ended September 30, 2008	Three Months Ended September 30, 2007	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007
Weighted Average Shares Outstanding				
Basic	1,521	1,521	1,521	1,518
Potential shares from assumed exercise of stock options	5		5	
Potential repurchase of shares from stock option proceeds	(3)		(3)	
Diluted	1,523	1,521	1,523	1,518
Net Income (Loss)				
Basic and diluted	$ 1,255	$ (367)	$ 1,491	$ (8,264)

Due to the losses in the 2007 periods, potential shares from assumed exercise of stock options in the amounts of 3,000 and 6,000 shares for the three month and nine month periods in 2007, respectively, were antidilutive. No shares were excluded from the calculation of diluted earnings per share for the three months and nine months ended September 30, 2008.

Note 10 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 and for travel and related expenses to and from the Company s United States office.

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

	Three Months Ended September 30, 2008	Three Months Ended September 30, 2007	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007
Consulting fees	$ 249	$ 249	$ 747	$ 747
Office space and administrative services	80	53	232	127
Travel expenses	11	20	47	36
Total	$ 340	$ 322	$ 1,026	$ 910

In addition, HIL and Mr. Gumbiner perform 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.

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HIL shares common offices, facilities and certain staff in its Dallas office with the Company. The Company pays certain common general and administrative expenses and charges HIL an overhead reimbursement fee for its allocable share of the expenses. For the three months ended September 30, 2008 and 2007, HIL reimbursed the Company $38,000 and $41,000, respectively, for such expenses. For the nine months ended September 30, 2008 and 2007, HIL reimbursed the Company $118,000 and $116,000, respectively.

In April 2007, HIL committed to fund one-half of potential additional equity or subordinated debt funding calls by Hallwood Energy totaling $55,000,000, or $27,500,000, to the extent other investors, including the Company, did not respond to a call. In June 2007, HIL funded that portion of the Company s share of the May Call that the Company did not fund in the amount of $2,591,000 and contributed, along with the Hallwood Energy s lender, an additional amount in August 2007 to fully satisfy the May Call, to the extent other Hallwood Energy investors did not respond to the May Call. In September 2007, HIL funded that portion of the Company s share of the August Call in the amount of $1,842,000 that the Company did not fund and contributed an additional amount, along with the lender, in September 2007 to fully satisfy the August Call, to the extent other Hallwood Energy investors did not respond to the August Call. In September 2007, the $55,000,000 commitment from HIL and the lender expired as a result of the receipt of sufficient equity contributions from the April Call, May Call and August Call.

In November 2007, HIL committed to fund $7,500,000 of additional equity to Hallwood Energy no later than November 15, 2007. HIL funded the full $7,500,000 in November under this agreement, with Hallwood Energy executing a promissory note bearing interest at 16% per annum. On January 2, 2008, as per the commitment agreement, the outstanding amount was automatically converted into Hallwood Energy Class C partnership interest.

In January 2008, HIL loaned $5,000,000 to Hallwood Energy in connection with Hallwood Energy s $30,000,000 First Convertible Note. Terms of the First Convertible Note agreement are discussed in the section entitled Investments in Hallwood Energy . As of October 31, 2008, HIL and one of its affiliated entities have invested $19,156,000 in Hallwood Energy.

Hallwood Energy. Hallwood Energy shares common offices, facilities and certain staff in its Dallas office with the Company. Hallwood Energy reimburses the Company for its allocable share of the expenses and certain direct energy-related expenses. For the three months ended September 30, 2008 and 2007, Hallwood Energy reimbursed the Company $113,000 and $77,000 for such expenses, respectively. For the nine months ended September 30, 2008 and 2007, Hallwood Energy reimbursed the Company $317,000 and $203,000, respectively.

Note 11 C Litigation, Contingencies and Commitments

Litigation. From time to time, the Company, 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. In the Company s opinion, no litigation in which the Company, subsidiaries or affiliates is a party is likely to have a material adverse effect on its financial condition, results of operation or cash flows.

On July 31, 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 pertaining to internally-coated webs: U.S. Patent No. 5,418,051; 5,856,245; 5,869,172; 6,071,602 and 6,129,978. On October 3, 2007, the U.S. District Court dismissed The Hallwood Group Incorporated from the lawsuit. Brookwood timely answered the lawsuit. Nextec recently sought leave of court to add two additional patents to the lawsuit: U.S. Patent No. 5,954,902 and 6,289,841. The Court granted leave to Nextec, and Nextec filed its amended complaint September 19, 2008. The case is currently in the discovery phase. Brookwood intends to vigorously defend all claims.

Hallwood Energy. As a significant investor in Hallwood Energy, the Company may be impacted by litigation involving Hallwood Energy. Refer to Note 4 for a further description of certain litigation involving Hallwood Energy.

Environmental Contingencies. A number of jurisdictions in which the Company operates 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 business to date, it is possible that such considerations may have a significant and adverse impact in the future. The Company actively monitors its

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environmental compliance and while certain issues arise from time to time, management is not presently aware of any compliance issues which will significantly impact the financial position, operations or cash flows of the Company.

In August 2005, the Rhode Island Department of Health (RIDOH) issued a compliance order to Kenyon, alleging that Kenyon is a non-community water system and ordering Kenyon to comply with the RIDOH program for public water supply systems. Kenyon contested the compliance order and an administrative hearing was held in November 2005. No decision has been rendered by RIDOH. However, by letter dated July 23, 2008, the United States Environmental Protection Agency (EPA) advised Kenyon that it is the EPA s position that the Kenyon facility is a Public Water System and is subject to the regulations of the Safe Drinking Water Act . Kenyon is currently reviewing the actions necessary to comply with the aforementioned regulations. Compliance will require revamping the plant s water supply system which will require an anticipated minimum cost of $100,000.

In August 2005, Kenyon received a Notice of Alleged Violation from The Rhode Island Department of Environmental Management (RIDEM) that alleged that Kenyon had failed to comply timely with a requirement to test the destruction efficiency of a thermal oxidizer at its Kenyon plant. The notice further alleged that when the test was conducted, the equipment did not operate at the required efficiency. Since that time, Kenyon upgraded and retested the equipment and demonstrated compliance with the destruction efficiency requirement. RIDEM requested additional information regarding the testing and Kenyon s remedial actions, which Kenyon provided.

In February 2007, RIDEM issued a formal Notice of Violation (NOV) on the above matter, seeking a $14,000 fine. Kenyon requested an informal hearing to dispute the allegations in the NOV and the fine. An informal hearing was held in March 2007 and a Consent Agreement was executed. A $9,500 fine was remitted to RIDEM to close this matter.

In June 2007, RIDEM issued a NOV to Kenyon, alleging that Kenyon violated certain provisions of its wastewater discharge permit and seeking an administrative penalty of $79,000. Kenyon filed an Answer and Request for Hearing in which it disputed certain allegations in the NOV and the amount of the penalty. An informal meeting was held with RIDEM in August 2007. Following settlement negotiations, a Consent Agreement was executed which required payment of a $5,000 fine and agreement by Kenyon to perform two Supplemental Environmental Projects (SEPs) at a total cost of $161,000. As of October 31, 2008, one SEP had been completed, and engineering plans for the second SEP were being modified to secure RIDEM approval. If RIDEM issues a timely approval and weather conditions allow, the second SEP will be completed within 120 days of receipt of the approval, as required by the Consent Agreement. However, if there is a delay in the receipt of the approval, weather conditions may make it necessary for the second SEP to be completed in the Spring of 2009.

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Note 12 Segments and Related Information

The following represents the Company s reportable segment operations for the three months and nine months ended September 30, 2008 and 2007, respectively (in thousands):

	Textile Products	Energy	Other	Consolidated
Three months ended September 30, 2008				
Total revenue from external sources	$ 35,568			$ 35,568
Operating income (loss)	$ 3,401	$	$ (1,508)	$ 1,893
Other income (loss), net	(139)		30	(109)
Income (loss) before income taxes	$ 3,262	$	$ (1,478)	$ 1,784
Three months ended September 30, 2007				
Total revenue from external sources	$ 32,576			$ 32,576
Operating income (loss)	$ 2,622	$	$ (1,374)	$ 1,248
Other income (loss), net	(301)	(1,272)	33	(1,540)
Income (loss) before income taxes	$ 2,321	$ (1,272)	$ (1,341)	$ (292)
Nine months ended September 30, 2008				
Total revenue from external sources	$ 126,689			$ 126,689
Operating income (loss)	$ 19,542	$	$ (3,813)	$ 15,729
Other income (loss), net	(567)	(12,120)	72	(12,615)
Income (loss) before income taxes	$ 18,975	$ (12,120)	$ (3,741)	$ 3,114
Nine months ended September 30, 2007				
Total revenue from external sources	$ 92,949			$ 92,949
Operating income (loss)	$ 5,773	$	$ (3,730)	$ 2,043
Other income (loss), net	(810)	(13,556)	269	(14,097)
Income (loss) before income taxes	$ 4,963	$ (13,556)	$ (3,461)	$ (12,054)

No differences have occurred in the basis or methodologies used in the preparation of this interim segment information from those used in the December 31, 2007 annual report. The total assets for the Company s operating segments have not materially changed since the December 31, 2007 annual report.

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Overview

General. The Company is a holding company with interests in textiles and energy.

Textile Products. In 2007 and 2008, 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, cost and availability of supplies, Brookwood s response to competition, its ability to generate new markets and products and the effect of global trade regulation. Although the Company s textile activities have generated positive cash flow in recent years, there is no assurance that this trend will continue.

While Brookwood has enjoyed substantial growth in its military business, there is no assurance this trend will continue. Brookwood s sales to the customers from whom it derives its military business have been more 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 $21,194,000 and $81,148,000 for the 2008 third quarter and nine month periods, respectively, were 17.2% and 74.0% higher than the comparable periods in 2007 of $18,079,000 and $46,626,000.

The military had limited orders in 2006 and the 2007 first quarter for existing products and adopted revised specifications for new products to replace the products for which Brookwood s customers have been suppliers. However, the U.S. government released orders in the remaining 2007 quarters and into 2008 that include Brookwood s products, which resulted in a substantial increase in 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. 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 escalating energy costs, coupled with a varying product mix, have continued to cause fluctuations in Brookwood s margins, a trend that appears likely to 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 been developing 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 U.S. textile industry has been and continues to be negatively impacted by existing worldwide trade practices, including the North American Free Trade Agreement (NAFTA), anti-dumping and duty enforcement activities by the U.S. Government and by the value of the U.S. dollar in relation to other currencies. The establishment of the World Trade Organization (WTO) in 1995 has resulted in the phase out of quotas on textiles and apparel, effective January 1, 2005. Notwithstanding quota elimination, China s accession agreement for membership in the WTO provides that WTO member countries (including the United States, Canada and European countries) may re-impose quotas on specific categories of products in the event it is determined that imports from China have surged and are threatening to create a market disruption for such categories of products. During 2005, the United States and China agreed to a new quota arrangement, which will impose quotas on certain textile products through the end of 2008. In addition, the European Union also agreed with China on a new textile arrangement, which imposed quotas through the end of 2007. The European Union and China have announced that they will jointly monitor the volume of trade in a number of

highly sensitive product categories during 2008. The United States may also unilaterally impose additional duties in response to a particular product being imported (from China or other countries) in such increased quantities as to cause (or threaten) serious damage to the relevant domestic industry (generally known as anti-dumping actions). In addition, China has imposed an export tax on all textile products manufactured in China; Brookwood does not believe this tax will have a material impact on its business.

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Under NAFTA there are no textile and apparel quotas between the U. S. and either Mexico or Canada for products that meet certain origin criteria. Tariffs among the three countries are either already zero or are being phased out. Also, the WTO recently phased out textile and apparel quotas.

The U.S. has also approved the Central American Free Trade Agreement (CAFTA) with several Central American countries (Costa Rica, the Dominican Republic, El Salvador, Guatemala, Honduras and Nicaragua). Under CAFTA, textile and apparel originating from CAFTA countries will be duty and quota-free, provided that yarn formed in the United States or other CAFTA countries is used to produce the fabric. In addition, the United States recently implemented bilateral free trade agreements with Bahrain, Chile, Israel, Jordan, Morocco and Singapore. Although these actions have the effect of exposing Brookwood s market to the lower price structures of the other countries and, therefore, continuing to increase competitive pressures, management is not able to predict their specific impact.

The textile products business is not interdependent with the Company s other business operations. The Company does not guarantee the Brookwood bank facilities and is not obligated to contribute additional capital.

Engagement of Financial Advisor. In December 2007, a special committee of the board of directors of the Company engaged a financial advisor to assist it in developing strategic alternatives, including a potential sale, with respect to Brookwood. This initiative was terminated during the 2008 fourth quarter.

Energy. Hallwood Energy is a privately held independent oil and gas limited partnership and operates as an upstream energy company engaging in the acquisition, development, exploration, production, and sale of hydrocarbons, with a primary focus on natural gas assets. Hallwood Energy conducts its energy activities from its corporate office located in Dallas, Texas and production offices in Searcy, Arkansas and Lafayette, Louisiana. Hallwood Energy s results of operations are and will be largely dependent on a variety of factors, including, but not limited to fluctuations in natural gas prices; success of its drilling activities; the ability to transport and sell its natural gas; regional and national regulatory matters; and the ability to secure, and price of, goods and services necessary to develop its oil and gas leases. As of September 30, 2008, the Company owned approximately 22% of the blended Class A and Class C limited partner interests (18% after consideration of profit interests) of Hallwood Energy. In addition, the Company owned approximately 39% of the convertible notes issued by Hallwood Energy.

In June 2008, Hallwood Energy entered into an agreement for the sale and farmout to FEI Shale, L.P. (FEI), a subsidiary of Talisman Energy, Inc. of an undivided interest in up to 33.33% of Hallwood Energy s interest in substantially all its assets for a series of payments of up to $125,000,000 (an initial payment of $60,000,000 and the option to pay up to an additional $65,000,000), and entered into an agreement to provide consulting services to the purchaser for one year (the Talisman Energy Transaction). In October 2008, FEI elected to make a second payment of $30,000,000 to Hallwood Energy, which results in remaining potential funding from FEI of $35,000,000.

Refer also to the section Investments in Hallwood Energy for a further description of the Company s energy activities.

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 2008 third quarter of $1,255,000, compared to a net loss of $367,000 in 2007. Revenue for the 2008 third quarter was $35,568,000, compared to $32,576,000 in 2007.

Net income for the 2008 nine month period was $1,491,000, compared to a net loss of $8,264,000 in 2007. Revenue for the 2008 nine month period was $126,689,000, compared to $92,949,000 in 2007.

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Revenues

Textile products sales of $35,568,000 increased by $2,992,000, or 9.2%, in the 2008 third quarter, compared to $32,576,000 in 2007. Sales for the nine month period increased by $33,740,000, or 36.3%, to $126,689,000, compared to $92,949,000 in 2007. The increases in the 2008 periods were principally due to an increase of sales of specialty fabric to U.S. military contractors, as a result of increased orders from the military to Brookwood s customers. Military sales accounted for $21,194,000 and $81,148,000 in the 2008 third quarter and nine month periods, respectively, compared to $18,079,000 and $46,626,000 in 2007. The military sales represented 59.6% and 55.5% of Brookwood s net sales in the 2008 and 2007 third quarters, respectively, and 64.1% and 50.2% in the 2008 and 2007 nine month periods, respectively.

Sales to one customer, Tennier Industries, Inc. (Tennier) accounted for more than 10% of Brookwood s net sales during both the 2008 and 2007 three month and nine month periods. Its relationship with Tennier is ongoing. Sales to Tennier, which are included in military sales, were $8,593,000 and $38,573,000 in the 2008 third quarter and nine month periods, respectively, compared to $11,270,000 and $26,840,000 in 2007. Sales to Tennier represented 24.2% and 34.6% of Brookwood s net sales in the 2008 and 2007 quarters, respectively, and 30.4% and 28.9% in the 2008 and 2007 nine month periods, respectively. Sales to another customer, ORC Industries, Inc. (ORC) accounted for more than 10% of Brookwood s sales in 2008. Its relationship with ORC is ongoing. Sales to ORC, which are included in military sales, were $4,093,000 and $13,375,000 in the 2008 third quarter and nine month periods, respectively, compared to $1,932,000 and $6,162,000 in 2007. Sales to ORC represented 11.5% and 5.9% of Brookwood s net sales in the 2008 and 2007 third quarters, respectively, and 10.6% and 6.6% in the 2008 and 2007 nine month periods, respectively.

Expenses

Textile products cost of sales of $27,715,000 for the 2008 third quarter increased by $1,666,000, or 6.4%, compared to $26,049,000 in 2007. For the nine month period, textile products cost of sales of $94,234,000 for 2008 increased by $17,938,000, or 23.5%, compared to $76,296,000 in 2007. The 2008 increases principally resulted from material and labor costs associated with the higher sales volume, changes in product mix and utility costs, which increased 68% and 59% in the 2008 third quarter and nine month periods compared to the 2007 periods. Cost of sales includes all costs associated with the manufacturing process, including but not limited to, materials, labor, utilities, 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 and associated manufacturer s rebates. 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 increased gross profit margin for the 2008 third quarter, 22.1% versus 20.0%, and for the 2008 nine month period, 25.6% versus 17.9%, principally resulted from higher sales volume, changes in product mix and manufacturing efficiencies such as reductions to material working loss.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	**2007**	**2008**	**2007**
Textile products	$ 4,452	$ 3,905	$ 12,913	$ 10,880
Corporate	1,508	1,374	3,813	3,730
Total	$ 5,960	$ 5,279	$ 16,726	$ 14,610

Textile products administrative and selling expenses of $4,452,000 for the 2008 third quarter increased by $547,000, or 14.0%, from 2007. For the nine months, selling and administrative expenses increased by $2,033,000, or 18.7%, compared to 2007. The increase for the 2008 third quarter from the 2007 quarter was primarily attributable to an increase of $200,000 of employee related expenses (e.g. salaries and benefits) related to the higher sales volume, as well as in support of increased compliance requirements for Sarbanes-Oxley and environmental matters, $173,000 for provision of doubtful accounts and an increase of $276,000 for legal and professional fees, partially offset by a $60,000 reduction in commissions. The increase for the 2008 nine month period was primarily attributable to an increase of $1,308,000 of employee related expenses related to higher sales volume, as well as in support of increased compliance requirements for Sarbanes-Oxley and environmental matters, $174,000 of increased factor commissions,

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$104,000 for provision of doubtful accounts and an increase of $566,000 for legal and professional fees, partially offset by $128,000 of one-time 2007 first quarter relocation expenses related to Brookwood Laminating s move to Connecticut. The textile products administrative and selling expenses included items such as payroll, professional fees, sales commissions, marketing, rent, insurance, travel and royalties. Brookwood conducts research and development activities related to the exploration, development and production of innovative products and technologies. Research and development costs were approximately $210,000 and $121,000 for the 2008 and 2007 third quarters, respectively and $668,000 and $448,000 in the 2008 and 2007 nine month periods, respectively.

Corporate administrative expenses increased $134,000, or 9.7%, for the 2008 third quarter, compared to 2007. For the nine months, corporate expenses increased $83,000, or 2.2%, compared to 2007. The increase for the 2008 third quarter was principally attributable to higher professional fees of $141,000, including costs related to the special committee s activities in considering the Company s investment in Hallwood Energy and strategic alternatives with respect to Brookwood, partially offset by a decrease in Sarbanes-Oxley costs of $40,000. The increase for the 2008 nine month period was principally attributable to higher professional fees of $176,000 and higher office space and administrative service costs for HIL of $105,000, partially offset by reduced Sarbanes-Oxley costs of $201,000.

Other Income (Loss)

Equity income (loss) from the Company s investments in Hallwood Energy, attributable to the Company s share of loss in Hallwood Energy, was zero in the 2008 third quarter, compared to a loss of $1,272,000 in 2007. The equity loss for the 2008 nine month period was $12,120,000, compared to a loss of $13,648,000 in 2007. In the 2008 third quarter, Hallwood Energy reported a loss of $1,938,000, which included an impairment of its oil and gas properties of $3,742,000, interest expense of $858,000 (including an offset of $6,374,000 attributable to the make-whole fee) and other income of $3,227,000, which principally relates to the contract services agreement with Talisman. In the 2007 third quarter, Hallwood Energy reported a loss of $5,344,000, which included interest expense of $3,711,000 (including $190,000 attributed to the make-whole fee. The make-whole fees were included in interest expense. The Company recorded the equity losses in the 2008 periods to the extent of loans it made to Hallwood Energy in 2008 of $8,920,000 and a guarantee to invest additional funds up to $3,200,000 and reduced the carrying value of its investment in Hallwood Energy to zero. For the 2008 nine month period, Hallwood Energy reported a loss of $23,826,000, compared to loss of $54,602,000 for the 2007 nine month period. As of September 30, 2008, the Company s proportionate share of Hallwood Energy s accumulated losses that have not been recognized is approximately $3,572,000, based upon a 25% Class A ownership percentage.

The Company earned interest income of $-0- and $92,000 for the 2007 third quarter and nine month periods, respectively, which was accrued but not paid in cash on loans it made to Hallwood Energy in the period from March to May 2007.

Interest expense was $139,000 and $567,000 in the 2008 third quarter and nine month periods, respectively, compared to $301,000 and $810,000 in the 2007 periods. Interest expense principally relates to Brookwood s Key Bank revolving credit facility. The decreases in interest expense were due to lower interest rates and lower principal balances.

Interest and other income was $30,000 and $72,000 in the 2008 third quarter and nine month periods, respectively, compared to $33,000 and $269,000 in the 2007 periods. The 2008 decreases were principally due to a gain in the amount of $74,000 from the sale of a marketable security sold in March 2007, and reduced interest income earned on lower balances of cash and cash equivalents.

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Income Taxes

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Federal				
Deferred	$ 317	$ (168)	$ 438	$ (4,259)
Current	(109)		(109)	
Sub-total	208	(168)	329	(4,259)
State				
Deferred				(43)
Current	321	243	1,294	512
Sub-total	321	243	1,294	469
Total	$ 529	$ 75	$ 1,623	$ (3,790)

At September 30, 2008, the deferred tax asset was attributable to temporary differences, that upon reversal, could be utilized to offset income from operations, a net operating loss carryforward and alternative minimum tax credits. The effective federal tax rate in both periods was 34%, while state taxes are determined based upon taxable income apportioned to those states in which the Company does business at their respective tax rates.

Investments in Hallwood Energy

At September 30, 2008, the Company had invested $61,481,000 in Hallwood Energy, which represented approximately 22% of the blended Class A and Class C limited partner interests (18% after consideration of profit interests) of Hallwood Energy and, in addition, the Company loaned Hallwood Energy $13,920,000 in the form of convertible notes. The Company accounts for this investment using the equity method of accounting and records its pro rata share of Hallwood Energy s net income (loss) and partner capital transactions as appropriate.

Hallwood Energy is a privately held independent oil and gas limited partnership and operates as an upstream energy company engaging in the acquisition, development, exploration, production, and sale of hydrocarbons, with a primary focus on natural gas assets. Hallwood Energy conducts its energy activities from its corporate office located in Dallas, Texas and production offices in Searcy, Arkansas and Lafayette, Louisiana. Hallwood Energy s results of operations are and will be largely dependent on a variety of factors, including, but not limited to fluctuations in natural gas prices; success of its drilling activities; the ability to transport and sell its natural gas; regional and national regulatory matters; and the ability to secure, and price of, goods and services necessary to develop its oil and gas leases; and the ability to raise additional capital.

Hallwood Energy s management has classified its energy investments into three identifiable geographical areas:

West Texas the Barnett Shale and Woodford Shale formations,

Central and Eastern Arkansas primary targets are the Fayetteville Shale and Penn Sand formations, and

South Louisiana various projects on and around the LaPice Salt Dome.

Certain of the Company s officers and directors are investors in Hallwood Energy. In addition, as members of management of Hallwood Energy, one director and officer and one officer of the Company hold a profit interest in Hallwood Energy.

In January 2008, the Company loaned $5,000,000 to Hallwood Energy as part of a $30,000,000 convertible subordinated note agreement (discussed below).

In May 2008, June 2008 and September 2008, the Company loaned $2,961,000, $2,039,000 and $4,300,000, respectively, (for a total of $9,300,000) pursuant to the Equity Support Agreement in connection with the Talisman Energy Transaction (discussed below).

The Company s proportionate share of Hallwood Energy s calendar year 2007 loss would have reduced the carrying value of its investment in Hallwood Energy below zero. The general rule for recording equity losses ordinarily indicates that the investor shall discontinue applying the equity method when the investment has been reduced to zero and shall not provide for additional

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losses unless the investor provides or commits to provide additional funds in the investee, has guaranteed obligations of the investee, or is otherwise committed to provide further financial support to the investee. Although no guarantee or commitment existed at December 31, 2007, the Company loaned $5,000,000 to Hallwood Energy in January 2008 in connection with Hallwood Energy s issuance of up to $30,000,000 of convertible subordinated note due January 21, 2011 (the First Convertible Note) to provide capital to continue regular ongoing operations. Accordingly, the Company recorded an additional equity loss in 2007 to the extent of the $5,000,000 loan, as the Company had not determined to what extent, if any, that it would advance additional funds to Hallwood Energy.

In connection with the then ongoing efforts to complete the Talisman Energy Transaction, the Company loaned Hallwood Energy $2,961,000 on May 15, 2008. As of that date, the Company s management had indicated that it did not intend to make additional investments in Hallwood Energy, except in connection with Hallwood Energy s obtaining additional funds from external sources. Due to the uncertainties at that time related to the completion of the Talisman Energy Transaction and the Company s additional investment, if any, the Company recorded an equity loss for the 2008 first quarter to the extent of the $2,961,000 loan. The Company s carrying value of its Hallwood Energy investment was zero at March 31, 2008.

As a result of the completion of the Talisman Energy Transaction in June 2008, the Company entered into the Equity Support Agreement with Hallwood Energy which obligated the Company to contribute additional equity or debt capital of $2,039,000 (for a total of $5,000,000) at the completion date to Hallwood Energy and guarantee an additional amount of up to $7,500,000 in certain circumstances, both of which were to be issued under the terms of the Second Convertible Note (discussed below). The Company s commitment to provide additional financial support, resulted in the recording of an equity loss in the 2008 second quarter of $9,159,000, which included accumulated equity losses that had not been previously recorded as the Company reduced the carrying value of its investment to zero. The Company s carrying value of its Hallwood Energy investment was zero at September 30, 2008.

Capital Transaction in 2008. On June 10, 2008, Hallwood Energy entered into an agreement for the sale and farmout to FEI Shale, L.P. (FEI), a subsidiary of Talisman Energy, Inc. of an undivided interest in up to 33.33% of Hallwood Energy s interest in substantially all its assets for a series of payments of up to $125,000,000 (an initial payment of $60,000,000 and the option to pay up to an additional $65,000,000), and entered into an agreement to provide consulting services to the purchaser for one year (the Talisman Energy Transaction). FEI prepaid the consulting services agreement which requires two man-weeks per month of service from two senior executives. The revenues from this agreement will be recognized as earned over the course of the twelve month period. In October 2008, FEI elected to make a second payment of $30,000,000 to Hallwood Energy, which results in remaining potential funding from FEI of $35,000,000.

Under the sale and farmout agreement between Hallwood Energy and FEI, the purchaser made an initial payment of $60,000,000 for an undivided 10% interest in Hallwood Energy s specified oil and gas properties and other assets. For each well for which FEI paid any costs, it will earn an additional interest on the specified properties on which the well is located upon payment of each invoice equal to an additional undivided 23.33% if payment occurs prior to FEI paying a cumulative amount of $90,000,000 under the farmout agreement (the Initial Milestone), or 13.33% if payment occurs after the Initial Milestone. For other oil and gas properties, FEI will earn an undivided 33.33% interest in such properties immediately upon payment of purchase costs paid by FEI under the farmout agreement. With respect to Hallwood Energy s other assets, FEI will immediately earn an additional undivided 10% interest in these other assets upon meeting the Initial Milestone and an additional undivided 13.33% interest in these other assets upon payment of a cumulative amount of $125,000,000 under the farmout agreement. FEI will also earn an undivided 33.33% interest in seismic data for which costs are paid by FEI. Hallwood Energy has agreed to deliver assignments for the interests earned under the farmout agreement and has granted a lien and security interest on 33.33% of its assets in favor of FEI as collateral security for the performance of this agreement.

The parties have agreed to use commercially reasonable efforts to agree upon a budget for each quarterly period during the term of the farmout agreement. Any material variance from the budget requires the prior approval of FEI.

If Hallwood Energy receives an authorization for expenditure from a third-party operator of its properties and either Hallwood Energy or FEI does not wish to include these operations under the farmout agreement, the other party may proceed at its sole risk and expense. If the participating party recoups its costs, the nonparticipating party will become entitled to receive an interest in the well in the amount of 66.67% if Hallwood Energy is the non-participating party, or 33.33% if FEI is the non-participating party.

If Hallwood Energy enters into discussions concerning a sale of a material portion of its assets or a change of control, FEI will have the opportunity to submit a proposal to complete the transaction. If Hallwood Energy and FEI do not enter into a definitive

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agreement for the transaction, Hallwood Energy may pursue other opportunities if the terms are not less favorable to Hallwood Energy than those proposed by FEI.

The farmout agreement prohibits Hallwood Energy from entering into a change of control agreement unless the lender under the Senior Secured Credit Facility and Junior Credit Facility waives its rights to demand prepayment, and holders of the Convertible Notes waive their rights of redemption upon a change of control or such indebtedness is required to be repaid or redeemed with funds provided or arranged by the party acquiring or merging with Hallwood Energy in the change of control transaction.

In connection with the Talisman Energy Transaction, the Company loaned $2,961,000 to Hallwood Energy on May 15, 2008. Contemporaneously with the signing of the sale and farmout agreement, the Company entered into an Equity Support Agreement (the Equity Support Agreement) with Hallwood Energy, under which the Company committed 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 loan of $2,961,000 in May 2008 and an additional loan to Hallwood Energy in June 2008 of $2,039,000 (for a total of $5,000,000) are treated as contributions toward the maximum amount. In September 2008, the Company loaned an additional $4,300,000 to Hallwood Energy under the Equity Support Agreement.

Funds advanced to Hallwood Energy pursuant to the Equity Support Agreement are issued under terms of the Second Convertible Note (discussed below), which are comparable to the First Convertible Note. During June and July 2008, the Company sold $380,000 of the Second Convertible Notes to other investors in Hallwood Energy. As of September 30, 2008, $9,300,000 of the Second Convertible Notes were outstanding, of which $8,920,000 was held by the Company and $380,000 was held by other Hallwood Energy investors. The remaining commitment amount by the Company under the Equity Support Agreement was $3,200,000, at September 30, 2008.

Hallwood Energy continues to seek additional capital from external sources.

A description of Hallwood Energy s activities during 2007 and 2008 are provided below.

Loan Financing. In March and April 2007, the Company loaned a total of $9,000,000 to Hallwood Energy, of which $7,000,000 was in the form of demand notes bearing interest at 6% above prime rate, and $2,000,000 was an advance that was repaid four days later with interest. In April 2007, Hallwood Energy made a request for additional capital contributions in the amount of $25,000,000 (the April Call). The Company and Hallwood Energy had agreed that the $7,000,000 of loans would be applied as the Company s portion of the April Call and as such was recorded as a Class C partnership investment. In May 2007, Hallwood Energy repaid $257,000 to the Company, which represented the excess of the $7,000,000 loaned over the Company s share of the capital contribution and related oversubscription.

In April 2007, Hallwood Energy entered into a $100,000,000 loan facility (the Senior Secured Credit Facility) with a new lender (the New Lender), who is an affiliate of one of Hallwood Energy s investors and drew $65,000,000 from the Senior Secured Credit Facility. The proceeds were used to repay the $40,000,000 balance of Hallwood Energy s former credit facility, approximately $9,800,000 for a make-whole fee and approximately $500,000 for incremental interest related to Former Credit Facility, transaction fees of approximately $200,000 and provide working capital. The Senior Secured Credit Facility is secured by Hallwood Energy s oil and gas leases, matures on February 1, 2010, and bears interest at a rate of the defined LIBOR rate plus 10.75% per annum (increased to LIBOR + 12.75% per annum effective May 1, 2008). An additional 2% of interest is added upon continuance of any defaulting event. The New Lender may demand that Hallwood Energy prepay the outstanding loans in the event of a defined change of control, qualified sale or event of default, including a material adverse event. In conjunction with executing the Senior Secured Credit Facility, the New Lender resigned its position on Hallwood Energy s board of directors and assigned its general partner interest to the remaining members.

The Senior Secured Credit Facility provided that, if Hallwood Energy raised $25,000,000 through an equity call or through debt subordinate to the Senior Secured Credit Facility, the New Lender would match subsequent amounts

raised on a dollar for dollar basis up to the remaining $35,000,000 under the Senior Secured Credit Facility through the availability termination date of July 31, 2008. During the 2007 third quarter, Hallwood Energy borrowed an additional $20,000,000 under the Senior Secured Credit and borrowed the remaining $15,000,000 availability in October 2007. Accordingly, the Senior Secured Credit Facility was fully funded with an outstanding balance of $100,000,000 at December 31, 2007.

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The Senior Secured Credit Facility contains various financial covenants, including maximum general and administrative expenses and current and proved collateral coverage ratios. In June 2008, the proved collateral coverage ratio test was amended to be effective September 30, 2008, and each quarter thereafter. Non-financial covenants restrict the ability of Hallwood Energy to dispose of assets, incur additional indebtedness, prepay other indebtedness or amend certain debt instruments, pay dividends, create liens on assets, enter into sale and leaseback transactions, make investments, loans or advances, make acquisitions, engage in mergers or consolidations or engage in certain transactions with affiliates, and otherwise restrict certain activities by Hallwood Energy. In October 2007, Hallwood Energy entered into an amendment of the Senior Secured Credit Facility to modify the calculation of the current ratio to include certain capital funding commitments.

The Senior Secured Credit Facility contained a make-whole provision whereby Hallwood Energy is required to pay the New Lender the amount by which the present value of interest and principal from the date of prepayment through January 31, 2009, exceeds the principal amount on the prepayment date. In June 2008, the facility was amended to extend the make-whole provision to January 31, 2010. The New Lender received amended warrant terms exercisable for 2.5% of the partnership interests at an exercise price of 2.5% of 100% of the amount of the total capital contributed to Hallwood Energy at December 31, 2006.

In January 2008, Hallwood Energy entered into a $30,000,000 convertible subordinated note agreement (the First Convertible Note). The First Convertible Note bears interest which accrues at an annual rate of 16%, which is payable on a quarterly basis after the completion of a defined equity offering and subject to the prior full payment of borrowings and accrued interest under the secured credit facilities. The First Convertible Note and accrued interest may be converted into Class C interests on a dollar for dollar basis. If no Class C interests are outstanding, the Convertible Note may be converted into Class A interests or such comparable securities as may be outstanding at the same exchange ratio as the original Class C interests. Principal and unpaid interest are due on the earlier of January 21, 2011, or upon a defined change of control. A change of control redemption may also result in a make-whole provision whereby Hallwood Energy would pay a premium based on the difference between either $48,300,000 or $45,500,000 and the sum of previously made First Convertible Note principal and accrued interest payments. As of June 30, 2008, $28,839,000 of the First Convertible Notes had been subscribed for and issued. The Company subscribed for $5,000,000 of the First Convertible Note and provided the funds to Hallwood Energy in January 2008.

The First Convertible Note lenders also received a warrant exercisable at up to $3,750,000 for an equal dollar amount of Class C interests, or such comparable securities as are outstanding at the time of exercise at the same exchange ratio as the original Class C interests. The warrant is exercisable until January 21, 2011.

In connection with the completion of the Talisman Energy Transaction, the Company entered into an option agreement with the New Lender that grants the new lender an option to purchase the Company s interest in the First Convertible Note at face value plus accrued interest, exercisable within 90 days commencing with the date of the full and final payment of all obligations and indebtedness owed by Hallwood Energy to the New Lender

In May 2008, Hallwood Energy entered into a $12,500,000 convertible subordinated note agreement (the Second Convertible Note), which was underwritten by the Company. The Second Convertible Note was issued in connection with the completion of the Talisman Energy Transaction and the related Equity Support Agreement for $12,500,000. The Second Convertible Note contains interest terms, conversion features and repayment terms comparable to the First Convertible Note described previously. As of September 30, 2008, $9,300,000 of the Second Convertible Note had been issued, of which $8,920,000 was held by the Company and $380,000 was held by other Hallwood Energy investors. The remaining commitment amount under the Equity Support Agreement was $3,200,000 at September 30, 2008.

In January 2008, Hallwood Energy entered into the $15,000,000 Junior Credit Facility with the Senior Secured Credit Facility s New Lender and drew the full $15,000,000 available. The proceeds were used to fund working capital requirements and future operational activities. Borrowings under both facilities are secured by Hallwood Energy s oil

and gas leases, mature on February 1, 2010, and bear interest at a rate of the defined LIBOR rate plus 10.75% per annum through April 30, 2008, and thereafter increases to 12.75% per annum until loan maturity or prepayment. An additional 2% of interest is added upon continuance of any defaulting event. The New Lender may demand that Hallwood Energy prepay the outstanding loans in the event of a defined change of control, qualified sale or event of default, including a material adverse event. Hallwood Energy remains bound to a deposit control agreement initiated with the Senior Secured Credit Facility.

The Junior Credit Facility contains various financial covenants, materially consistent with the Senior Secured Credit Facility, including maximum general and administrative expenditures and current and proved collateral coverage ratios. The proved collateral coverage ratio covenant was scheduled to become effective June 30, 2008, however, in June 2008 the coverage ratio test

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was amended to be effective September 30, 2008. Non-financial covenants restrict the ability of Hallwood Energy to dispose of assets, incur additional indebtedness, prepay other indebtedness or amend certain debt instruments, pay dividends, create liens on assets, enter into sale and leaseback transactions, make investments, loans or advances, make acquisitions, engage in mergers or consolidations or engage in certain transactions with affiliates, and otherwise restrict certain Hallwood Energy s activities.

The Junior Credit Facility contains a make-whole provision whereby Hallwood Energy is required to pay the New Lender the amount by which the present value of interest and principal from the date of prepayment through January 31, 2010, exceeds the principal amount on the prepayment date.

In connection with the Junior Credit Facility, the Senior Secured Credit Facility was amended to bear and interest at the defined LIBOR rate plus 12.75% per annum beginning May 1, 2008.

Hallwood Energy did not meet the current ratio covenant and was in default of the Senior Secured Credit Facility as of December 31, 2007. A second default event related to a commitment agreement by three partners to fund $15,000,000 by November 1, 2007, that was only partially funded. Hallwood Energy received a waiver from the New Lender for both of these default events in January 2008.

Hallwood Energy was not in compliance with the general and administrative expense covenant at March 31, 2008 and the current ratio covenant as of April 30, 2008 required by the Senior Secured Credit Facility and Junior Credit Facility. Hallwood Energy entered into an amendment of the facilities with the New Lender in June 2008 to waive the defaults and amend various covenants.

At September 30, 2008, Hallwood Energy was not in compliance with the proved collateral coverage ratio under the Senior Credit Facility and the Junior Credit Facility. Accordingly, the interest rate under those facilities is now the defined LIBOR rate plus 14.75% per annum. However, pursuant to the forbearance agreement described below, the New Lender has agreed not to exercise its other remedies under the facilities until at least 91 days after the termination of the farmout agreement.

In connection with the completion of the Talisman Energy Transaction, Hallwood Energy also agreed to amendments to its credit agreements that, among other things, could result in an increase in interest paid by Hallwood Energy and provides additional covenants. The principal provisions of the amendment and related agreements include the following:

The terms of the make-whole provision of the Senior Secured Credit Facility were extended from January 31,2009 to January 31, 2010.

Pursuant to a forbearance agreement among Hallwood Energy, FEI, New Lender and others, if Hallwood Energy were in the future to default in certain of its obligations under its credit agreements, the New Lender has agreed not to exercise its remedies under the Senior Secured Credit Facility while the farmout agreement is in effect and for a period of 91 days after the termination of the farmout agreement.

Hallwood Energy shall pay to the New Lender on a monthly basis, the excess net cash flow, as defined, as additional debt service. Such payments, if any, shall be applied first to repay outstanding fees and expenses, second to accrued and unpaid interest and then to unpaid debt principal. The excess net cash flow is defined as operating revenues less operating expenses, certain general and administrative expenses, and other approved expenditures as defined in the agreement.

Equity Investments. There are currently three classes of limited partnership interests held in Hallwood Energy:

Class C interests bear a 16% priority return which compounds monthly. The priority return will be accrued and become payable when, as and if declared by the general partner of Hallwood Energy. Hallwood Energy does not anticipate paying any distributions in the foreseeable future. All distributions of defined available cash and defined net proceeds from any sales or other disposition of all or substantially all of the then remaining assets of Hallwood Energy which is entered into in connection with, or which will result in, the liquidation of

Hallwood Energy (the Terminating Capital Transaction) must first be used to reduce any unpaid Class C priority return and capital contributions to zero. Unpaid Class C priority return and capital contributions can be converted into Class A interests based on the ratio of Class C contributions to the sum of Class A contributions and the Class C limited partner s Class C partnership interest designated by the Class C limited partner to be converted into Class A partnership interest. The Class C capital contributions were $84,422,000 and unpaid priority returns $17,321,000 at September 30, 2008.

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Class A interests have certain voting rights and with the general partner would receive 100% of the distributions of available cash and net proceeds from Terminating Capital Transactions subsequent to the payment of all unpaid Class C priority return and of all Class C capital contributions until the unrecovered capital accounts of each Class A partner interest is reduced to zero, and thereafter share in all future distributions of available cash and net proceeds from Terminating Capital Transactions with the holders of the Class B interests.

Class B interests represent vested net profit interests awarded to key individuals by Hallwood Energy. At September 30, 2008 and December 31, 2007, outstanding Class B interests had rights to receive 20.0% and 18.6%, respectively, of distributions of defined available cash and net proceeds from Terminating Capital Transactions after the unpaid Class C priority return and capital contributions and the unreturned Class A and general partner capital contributions have been reduced to zero.

In April 2007, Hallwood Energy issued a $25,000,000 Class C equity call to its partners (the April Call) which was fully satisfied. Previously, Hallwood Energy received loans of $7,000,000 each from the Company and an affiliate of the New Lender. These loans were applied to the April Call. In May 2007, Hallwood Energy repaid $257,000 to the Company, which represented the excess of its $7,000,000 advanced over the Company s share of the capital contribution and related oversubscription.

In April 2007, Hallwood Investments Limited (HIL), a corporation associated with Mr. Anthony J. Gumbiner, the Company s chairman and principal stockholder, and the New Lender each committed to fund one-half of the April Call and potential additional equity or subordinated debt funding calls totaling $55,000,000 by Hallwood Energy, to the extent other investors, including the Company, did not respond to equity calls.

In May 2007, Hallwood Energy issued a $20,000,000 Class C equity call to its partners (the May Call), which was fully satisfied. The Company s proportionate share of the May Call was $5,091,000. Due to the fact that the Company did not have available sufficient cash, the Company contributed only $2,501,000 towards the May Call. Because of the Company s inability to meet its full equity call requirement, HIL funded $2,591,000 of the May Call that was not funded by the Company. In connection with the funding of this amount, Mr. Gumbiner agreed with a special committee of the board of directors of the Company that he would discuss the terms of this investment in the future.

In August 2007, Hallwood Energy issued a $15,000,000 Class C equity call to its partners (the August Call) which was fully satisfied. The Company s proportionate share of the August Call was $3,683,000. Due to the fact that the Company did not have available sufficient cash, the Company contributed only one-half, or $1,842,000, towards the August Call. Because of the Company s inability to meet its full equity call requirement, HIL funded $1,842,000 of the August Call that was not funded by the Company. In October 2007, the special committee appointed to consider HIL s funding of these capital calls acknowledged the terms of the funding of the capital calls by HIL and determined that, in light of the circumstances, including the Company s present inability to fund any amounts beyond those it had made, no further action was required.

As a result of the receipt of sufficient equity contributions from the April, May and August Calls, the $55,000,000 commitment from HIL and the New Lender was extinguished.

In November 2007, Hallwood Energy issued $15,000,000 of Class C partnership interest to a new equity partner. In addition, HIL, another existing investor in Hallwood Energy, and the New Lender entered into a letter agreement providing for a total of up to $15,000,000 in additional funding. Under the terms of this letter, HIL agreed to advance $7,500,000 and the other investor agreed to advance $3,000,000 to Hallwood Energy no later than November 15, 2007. These advances constituted loans to Hallwood Energy with an interest rate of 16% per annum and a maturity of March 1, 2010. The letter agreement contained a provision that permitted Hallwood Energy to repay the advances at any time without penalty in connection with a recapitalization of Hallwood Energy providing for net proceeds not less than the amount being repaid. If any part of these advances remained outstanding on January 2, 2008, then on that date the outstanding amount would automatically be converted into preferred partnership interests having the same terms as the existing class of preferred partnership interests. In addition, if any portion of the advances was converted into

preferred partnership interests on January 2, 2008, then the New Lender agreed to contribute to Hallwood Energy the same proportion of $4,500,000 in exchange for preferred partnership interests. Hallwood Energy also agreed that if any portion of the agreed funding from HIL or the other existing investor was not made, it would be an event of default under the Senior Secured Credit Facility. HIL advanced $7,500,000 in November 2007, although the other investor did not fulfill its commitment. On January 2, 2008, as per the letter agreement, HIL s loan was converted into a Class C interest.

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Litigation. In 2006, Hallwood Energy and Hallwood Petroleum (collectively referred to herein as Hallwood) entered into two, two-year contracts with Eagle Drilling, LLC (Eagle Drilling), under which the contractor was to provide drilling rigs and crews to drill wells in Arkansas. On or about August 14, 2006, one of the masts on the rigs provided under the contracts collapsed. Hallwood requested the contractor to provide assurances that the mast on the other rig, and any mast provided to replace the collapsed mast, were safe and met the requirements of the contracts. Eagle Drilling subsequently assigned the contracts to Eagle Domestic Drilling Operations, L.L.C. (Eagle Domestic) on August 25, 2006.

When the contractor refused to provide assurances, Hallwood notified the contractor in September 2006 that the contracts were terminated and it filed suit against Eagle Drilling and Eagle Domestic in Tarrant County, Texas state court (the Hallwood Action) to recover $1,688,000 in funds previously deposited with the contractor under the contracts. Eagle Domestic and its parent then filed for Chapter 11 bankruptcy protection in the United States Bankruptcy Court for the Southern District of Texas, Houston Division (the Texas Bankruptcy Court). After the filing of its bankruptcy case, Eagle Domestic filed an adversary action against Hallwood in the bankruptcy proceeding (the Eagle Domestic Action) to recover unspecified damages, but purportedly in excess of $50 million based upon disclosures subsequently made during the discovery phase of the case. Hallwood asserted a counterclaim in the Eagle Domestic Action for the return of $1,688,000 in funds previously deposited with the contractor.

In October 2006, Eagle Drilling filed a related lawsuit against Hallwood in Cleveland County, Oklahoma state court (the Eagle Drilling Action) alleging breach of contract damages of approximately $170,000 in connection with certain invoices that were not paid after the collapse of the mast. Eagle Domestic initially joined in the Eagle Drilling Action, alleging other claims, but later dismissed its claims in light of its bankruptcy proceeding in Texas. Eagle Drilling subsequently amended its claims to also include a negligence claim for in excess of $1,050,000 in damages resulting from the collapse of the mast and a tortious breach of contract claim.

In September 2007, Eagle Drilling filed for Chapter 11 bankruptcy protection in the United States Bankruptcy Court for the Western District of Oklahoma (the Oklahoma Bankruptcy Court). Hallwood then removed the Eagle Drilling Action and its claims against Eagle Drilling in the Hallwood Action to the Oklahoma Bankruptcy Court. In February 2008, the Eagle Drilling Action and the Hallwood Action were consolidated by an agreed order to be tried to a jury in the Oklahoma Bankruptcy Court. No trial date has been scheduled.

In April 2008, Hallwood Energy and Eagle Domestic signed an agreement to settle the Eagle Domestic Action. Hallwood Energy agreed to immediately release any claims it had against Eagle Domestic, pay Eagle Domestic $2,000,000 in cash and issue to Eagle Domestic $2,750,000 in equity of Hallwood Energy or a successor entity, which was accrued by Hallwood Energy at March 31, 2008. Hallwood paid Eagle Domestic $500,000 in July 2008 and the remaining $1,500,000 in October 2008. The parties are in discussions on how to value Hallwood Energy so that the equity component of the settlement can be implemented. The trial previously scheduled in the matter has been continued and no new trial date has been set. Upon receipt of the amounts contemplated by the settlement, the parties and their affiliates will be released from any claims the parties and their affiliates may have against each other on such terms and conditions as are reasonable and customary.

In April 2008, Eagle Drilling filed a motion for leave to amend its complaint in the Oklahoma Bankruptcy Court to allege additional claims for liquidated and actual damages in excess of $22,900,000 in connection with Hallwood s alleged breach of the drilling contracts, as well as unspecified damages for tortious interference with contracts and business relations, defamation and business disparagement. Hallwood opposed Eagle Drilling s motion insofar as Eagle Drilling sought to add the $22,900,000 breach of contract/liquidated damages claims on the basis that Eagle Drilling had assigned the underlying drilling contracts to Eagle Domestic and thus did not have standing to pursue those claims. The Oklahoma Bankruptcy Court has not yet ruled on Eagle Drilling s motion to amend its complaint.

As a result of Eagle Drilling s attempt to sue on the same claims asserted by Eagle Domestic in the Eagle Domestic Action, Eagle Domestic filed a motion in the Texas Bankruptcy Court that sought to compel Eagle Drilling to show cause why it should not be held in contempt for its efforts to assert those claims. Hallwood joined in that motion. After

conducting an evidentiary hearing in June 2008, the Texas Bankruptcy Court issued an order and related opinion on September 24, 2008 wherein it held that the claims for liquidated damages arising from the alleged breach of the drilling contracts did not belong to Eagle Drilling, but rather to Eagle Domestic. Among other things, the Texas Bankruptcy Court found that the drilling contracts terminated after Eagle Drilling s assignment of the contracts to Eagle Domestic on August 25, 2006. The Texas Bankruptcy Court also barred Eagle Drilling from prosecuting any claims against Hallwood in the Oklahoma Bankruptcy Court or any other court where the basis of the claim was that the drilling contracts were terminated prior to Eagle Drilling s assignment of the contracts to Eagle Domestic on

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August 25, 2006 or that Hallwood owed money for any accounts receivable created after August 25, 2006. Eagle Drilling has appealed the Texas Bankruptcy Court s order.

In response to various motions filed by the parties in the Eagle Drilling bankruptcy proceeding, the Oklahoma Bankruptcy Court appointed an expert witness to examine the merits of the parties claims and to report to the court on potential fraudulent transfers that may have been made by Eagle Drilling to or for the benefit of Eagle Drilling s insiders and affiliates. On September 19, 2008, the court-appointed expert filed his report and identified potential avoidable transfers made by the Eagle Drilling to its insiders and affiliates. The expert also reported that the merits of the parties claim against each other rest upon numerous factual determinations, but that Hallwood has a valid claim against Eagle Drilling if Hallwood was not responsible for the collapse. This finding was in response to Eagle Drilling s contention that Hallwood had released Eagle Drilling via the settlement with Eagle Domestic. The expert also noted the Texas Bankruptcy Court s forthcoming ruling could have a major impact on the viability of Eagle Drilling s $22,900,000 breach of contract/liquidated damages claims against Hallwood. On October 24, 2008, the Oklahoma Bankruptcy Court asked the expert to supplement his report to take into account the entry of the Texas Bankruptcy Court s order and to further investigate other potentially avoidable transfers.

Earlier, on August 7, 2008, Eagle Drilling filed a motion to vacate the agreed order that consolidated the Hallwood Action and the Eagle Drilling Action before the Oklahoma Bankruptcy Court and to remand those actions back to the state courts in which they were originally filed. Hallwood filed an opposition to that motion on August 22, 2008. On October 21, 2008, the Debtor filed with the Oklahoma Bankruptcy Court a motion for dismissal of the Eagle Drilling bankruptcy proceeding. On November 5, 2008, Hallwood filed an objection to that motion and subsequently filed a motion to convert the Eagle Drilling bankruptcy proceeding to a chapter 7 proceeding, or alternatively, to appoint a chapter 11 trustee. No hearings have been set on any of these motions.

On November 7, 2008, the expert issued his supplemental report wherein he reported that Eagle Drilling has no claim against Hallwood for termination of the drilling contracts based on the Texas Bankruptcy Court s order. The expert also stated the potentially avoidable transactions should be further investigated by means of a fraudulent transfer action filed by Eagle Drilling or, if Eagle Drilling refuses to do so, by an independent third party. Finally, the expert reported that he did not believe Eagle Drilling, as the debtor in possession, had been acting in the best interests of the debtor and its creditors.

Hallwood Energy and Hallwood Petroleum are currently unable to determine the impact that the above-referenced bankruptcy cases and associated litigation may have on its results of operations or its financial position.

On October 27, 2008, Cimarex Energy Co. filed *Cimarex Energy Co. v. Hallwood Energy, L.P.* in the 298th Judicial District Court in Dallas County, Texas. Cimarex contends that Hallwood Energy has failed to pay approximately $3.7 million purportedly due under a Participation Agreement between parties related to the Boudreaux #1 Well in Lafayette Parish, Louisiana. Hallwood Energy has not yet filed its answer and intends to vigorously defend the claim.

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The following table reflects the status of Hallwood Energy s oil and gas investments as of November 1, 2008:

Description	Central and Eastern Arkansas	South Louisiana	West Texas (a)	Total
Principal focus	Fayetteville Shale and Penn Sand	Salt Dome	Barnett and Woodford Shale	
Initial funding	3rd Quarter 2005	1st Quarter 2004	3rd Quarter 2004	
Company investment				$75,611(b)
Company ownership percentage (c)				22%/18%
Net acres held (d)	262,200	(e)	17,314	
Operator	Hallwood Energy/ Others	Hallwood Energy	Chesapeake/ Hallwood Energy	
Well type: (f)				
Horizontal / directional	42	6	5	53
Vertical	21		5	26
Well status:				
Producing	36		5	41
Drilling	10		3	13
Successful / waiting pipeline				
Evaluating/completing	4		1	5
Unsuccessful	13	6	1	20
Net production (Mcf/day)	966 (g)		797	1,763

a) Hallwood Energy owns an approximate 32% working interest in the Chesapeake-operated properties. Hallwood Energy is now operating/drilling certain wells with approximately 66% working interest.

b) Represents $40,961,000 in 2005, $9,427,000 in 2006, $11,093,000 in 2007, $5,000,000 in January 2008,

$2,961,000 in May 2008, $1,869,000 in June 2008 and $4,300,000 in September 2008.

c) Before and after consideration of profit interests held by management of Hallwood Energy.

d) Net acres held is the sum of the total number of acres in which Hallwood Energy owns a working interest multiplied by Hallwood Energy s fractional working interest.

e) Hallwood Energy holds leases on approximately 2,000 acres. Farmouts are being sought for the remaining prospects.

f) Hallwood Energy also participates in non-operated wells in Arkansas and Louisiana. All wells are natural gas wells. Represents the gross number of wells in which Hallwood Energy holds a working interest, including co-owner operated wells in which Hallwood Energy has a minority interest.

g) The Dismang well, producing at 4,800 mcf/d at the time, will

be shut in from
July 2008 through
December 2008 due
to over production of
its allowable rate.

A description of activities in each area is provided below. Forward looking information is from current estimates by the management of Hallwood Energy, based on existing and anticipated conditions and assume Hallwood Energy is successful in securing additional capital as discussed below.

Central and Eastern Arkansas

Hallwood Energy is reviewing its properties in Arkansas in light of the results to date and current economic conditions, including prices received. Although a majority of the gross number of wells in which Hallwood Energy has participated in Arkansas have been productive, these productive wells are generally those that have been operated by third parties in which Hallwood Energy has a minority interest, are not currently economic, or are Penn Sand wells for which Hallwood Energy is assessing the potentially available locations. Therefore, Hallwood Energy is assessing its operations in Arkansas.

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South Louisiana

Hallwood Energy does not intend to expend additional amounts to further explore this area, and is seeking potential partners that would farm in or otherwise participate in the remaining prospects in the area.

West Texas

Chesapeake has drilled to total depth on five wells. Four of these wells are currently producing and selling gas and one well is waiting on completion. The 2008 budget calls a total of eight or nine gross wells in West Texas. Hallwood Energy is the operator for 2 wells.

Critical Accounting Policies

There have been no changes to the critical accounting policies identified and set forth in the Company s Form 10-K for the year ended December 31, 2007.

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 and for travel and related expenses to and from the Company s United States office.

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,	
	2008	2007	2008	2007
Consulting fees	$ 249	$ 249	$ 747	$ 747
Office space and administrative services	80	53	232	127
Travel expenses	11	20	47	36
Total	$ 340	$ 322	$ 1,026	$ 910

In addition, HIL and Mr. Gumbiner perform 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 shares common offices, facilities and certain staff in its Dallas office with the Company. The Company pays certain common general and administrative expenses and charges HIL an overhead reimbursement fee for its allocable share of the expenses. For the three months ended September 30, 2008 and 2007, HIL reimbursed the Company $38,000 and $41,000, respectively, for such expenses. For the nine months ended September 30, 2008 and 2007, HIL reimbursed the Company $118,000 and $116,000, respectively.

In April 2007, HIL committed to fund one-half of potential additional equity or subordinated debt funding calls totaling $55,000,000, or $27,500,000, by Hallwood Energy, to the extent other investors, including the Company, did not respond to a call. In June 2007, HIL funded that portion of the Company s share of the May Call that the Company

did not fund in the amount of $2,591,000 and contributed, along with the Hallwood Energy s lender, an additional amount in August 2007 to fully satisfy the May Call, to the extent other Hallwood Energy investors did not respond to the May Call. In September 2007, HIL funded that

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portion of the Company s share of the August Call in the amount of $1,842,000 that the Company did not fund and contributed an additional amount, along with the lender, in September 2007 to fully satisfy the August Call, to the extent other Hallwood Energy investors did not respond to the August Call. In September 2007, the $55,000,000 commitment from HIL and the lender expired as a result of the receipt of sufficient equity contributions from the April Call, May Call and August Call.

In November 2007, HIL committed to fund $7,500,000 of additional equity to Hallwood Energy no later than November 15, 2007. HIL funded the full $7,500,000 in November under this agreement, with Hallwood Energy executing a promissory note bearing interest at 16% per annum. On January 2, 2008, as per the commitment agreement, the outstanding amount was automatically converted into Hallwood Energy Class C partnership interest.

In January 2008, HIL loaned $5,000,000 to Hallwood Energy in connection with the $30,000,000 First Convertible Note issue. The terms of the Convertible Note agreement are discussed in the section entitled Investments in Hallwood Energy . As of November 1, 2008, HIL and one of its affiliated entities have invested $19,156,000 in Hallwood Energy.

Hallwood Energy. Hallwood Energy shares common offices, facilities and certain staff in its Dallas office with the Company. Hallwood Energy reimburses the Company for its allocable share of the expenses and certain direct energy-related expenses. For the three months ended September 30, 2008 and 2007, Hallwood Energy reimbursed the Company $113,000 and $77,000 for such expenses, respectively. For the nine months ended September 30, 2008 and 2007, Hallwood Energy reimbursed the Company $317,000 and $203,000, respectively.

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, 2008 (in thousands):

	Payments Due During the Year Ending December 31,						
	2008*	**2009**	**2010**	**2011**	**2012**	**Thereafter**	**Total**
Contractual Obligations							
Long term debt	$ 27	$ 27	$ 10,228	$	$	$	$ 10,282
Redeemable preferred stock			1,000				1,000
Operating leases	292	1,080	758	357	371	1,361	4,219
Total	$ 319	$ 1,107	$ 11,986	$ 357	$ 371	$ 1,361	$ 15,501

* For the three months ending December 31, 2008.

Interest costs associated with the Company s debt, which principally 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 contractual repayment of the term loan debt and a renewal of the revolving credit facilities at their loan balances as of September 30, 2008, are $127,000 for the nine months ending December 31, 2008 and $506,000 for each the years ending December 31, 2009 through December 31, 2012, 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 ($13,500,000 at September 30, 2008). 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. 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

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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.

Hallwood Energy. The Company s Hallwood Energy affiliate has various contractual obligations and commercial commitments. At September 30, 2008, such obligations and commitments included $115,000,000 for long-term debt, $37,322,000 of convertible debt, $23,719,000 for interest, $6,652,000 for long-term rig commitments, $2,750,000 for settlement of litigation and $60,000 for operating leases.

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:

		Quarters Ended			
Description	Requirement	September 30, 2008	June 30, 2008	March 31, 2008	December 31, 2007
Total debt to tangible net worth	must be less than ratio of 1.50	1.00	1.13	1.31	1.32
Net income	must exceed $1.00	Yes	Yes	Yes	Yes

Brookwood was in compliance with its loan covenants under the Working Capital Revolving Credit Facility for the first three quarters in 2008 and for all interim periods in 2007, although a waiver regarding a pro forma (inclusive of projected dividend) total debt to tangible net worth ratio for the 2007 third quarter was granted to allow a $1,500,000 dividend payment in November 2007 and an amendment to the Working Capital Revolving Credit Facility was entered into in June 2008 to allow a $4,800,000 dividend payment in June 2008, which restricts calendar 2008 total dividends from Brookwood to $9,300,000.

Cash dividends and tax sharing payments by Brookwood to the Company are contingent upon compliance with the Key Bank loan covenants. This limitation on the transferability of assets constitutes a restriction of Brookwood s net assets, which were $33,035,000 and $29,180,000 as of September 30, 2008 and December 31, 2007, respectively.

Hallwood Energy. The principal ratios and covenants required to be maintained by Hallwood Energy under its Senior Secured Credit Facility, as amended in June 2008, are provided below:

General and administrative costs, excluding certain legal fees, can not exceed $1,700,000 for any quarter, beginning the earlier of the end of the first fiscal quarter after the completion or termination of FEI s funding obligations under the farmout agreement or June 30, 2009

Current ratio must exceed 1.00 to 1.00 each quarter, beginning June 30, 2007

Proved collateral coverage ratio (including cash) must exceed 0.75 to 1.00, beginning September 30, 2008 and increases over time

Non-financial covenants restrict the ability of Hallwood Energy to dispose of assets, incur additional indebtedness, prepay other indebtedness or amend certain debt instruments, pay dividends, create liens on assets, enter into sale and leaseback transactions, make investments, loans or advances, make acquisitions, engage in mergers or consolidations or engage in certain transactions with affiliates, and otherwise restrict certain activities by Hallwood Energy. The new lender may demand that Hallwood Energy prepay the outstanding loan, including the make-whole fee, in the event of

a defined change of control, qualified sale or event of default, including a material adverse event.

Hallwood Energy was not in compliance with the Senior Secured Credit Facility as of December 31, 2007 in regards to meeting the current ratio test of 1:1. A second default event related to a commitment agreement by three of Hallwood Energy s partners to fund $15,000,000 by November 1, 2007 that was only partially funded. The lender waived these defaults in January 2008 and amended the loan agreement for the Senior Secured Credit Facility, which established the next current ratio test at April 30, 2008.

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In January 2008, Hallwood Energy entered into the Junior Credit Facility and borrowed the full $15,000,000 available under the facility. The Junior Credit Facility contains various financial covenants materially consistent with the Senior Secured Credit Facility.

Hallwood Energy was not in compliance with the general and administrative expense covenant at March 31, 2008 and the current ratio covenant as of April 30, 2008 required by the Senior Secured Credit Facility and Junior Credit Facility and had entered into discussions with the New Lender to waive the current default and amend by extending this covenant test into a future period. Hallwood Energy entered into an amendment of the facilities with the New Lender in June 2008 to waive the defaults and amend various covenants.

At September 30, 2008, Hallwood Energy was not in compliance with the proved collateral coverage ratio under the Senior Credit Facility and the Junior Credit Facility. Accordingly, the interest rate under those facilities is now the defined LIBOR rate plus 14.75% per annum. However, pursuant to the forbearance agreement described below, the New Lender has agreed not to exercise its other remedies under the facilities until at least 91 days after the termination of the farmout agreement.

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Liquidity and Capital Resources

General. The Company principally operates in the textile products and energy business segments. The Company s cash position decreased by $3,949,000 during the 2008 nine month period to $3,311,000 as of September 30, 2008. The principal source of cash was $19,293,000 from operating activities. The primary uses of cash were $13,919,000 for additional investments and loans in Hallwood Energy, $2,239,000 for property, plant and equipment and repayment of $7,084,000 in bank borrowings.

Textiles. The Company s textile products segment generates funds from the dyeing, laminating and finishing of fabrics and their sale to customers in the consumer, industrial, medical and military markets. Brookwood maintains a $25,000,000 working capital revolving credit facility and a $3,000,000 equipment facility with Key Bank. The facilities have a maturity date of January 2010. At September 30, 2008, Brookwood had approximately $14,772,000 of unused borrowing capacity on its working capital revolving line of credit facility and $2,946,000 on its equipment credit facility.

Brookwood paid cash dividends to the Company of $7,800,000 through September 30, 2008 and $6,000,000 for all of 2007. In addition, Brookwood made payments to the Company of $5,640,000 through September 30, 2008 and $1,591,000 for all of 2007 under its tax sharing agreement. Future cash dividends and tax sharing payments are contingent upon Brookwood s continued compliance with the covenants contained in the Key Bank credit facility. Brookwood was in compliance with the covenants as of September 30, 2008, June 30, 2008 and March 31, 2008 and for all periods in 2007 although a waiver regarding a pro forma (inclusive of projected dividend) total debt to tangible net worth ratio for the 2007 third quarter was granted to allow a $1,500,000 dividend payment in November 2007 and an amendment to the Working Capital Revolving Credit Facility was entered into in June 2008 to allow a $4,800,000 dividend payment in June 2008, which restricts the total dividends for 2008 from Brookwood to $9,300,000. There were no significant additional capital requirements as of September 30, 2008.

Energy. During 2008, 2007, 2006 and 2005, the Company invested $13,920,000, $11,093,000, $9,427,000 and $40,961,000, respectively in Hallwood Energy, as part of a total equity and debt funding to Hallwood Energy of $75,401,000.

In January 2008, Hallwood Energy entered into the $30,000,000 Convertible Note agreement, of which $28,839,000 of the convertible subordinated notes had been subscribed for and issued. In addition, Hallwood Energy entered into the $15,000,000 Junior Credit Facility in January 2008 and drew the full $15,000,000 available.

Hallwood Energy was not in compliance with the Senior Secured Credit Facility as of December 31, 2007 in regards to meeting the current ratio test of 1:1. A second default event related to a commitment agreement by three of Hallwood Energy s partners to fund $15,000,000 by November 1, 2007 that was only partially funded. The lender waived these defaults in January 2008 and amended the loan agreement for the Senior Secured Credit Facility, which established the next current ratio test at April 30, 2008.

Hallwood Energy was not in compliance with the general and administrative expense covenant at March 31, 2008 and the current ratio covenant as of April 30, 2008 required by the Senior Secured Credit Facility and the Junior Credit Facility and had entered into discussions with the New Lender to waive the default and amend by extending this covenant test into a future period. Hallwood Energy entered into an amendment of the facilities with the New Lender in June 2008 to waive the defaults and amend various covenants.

On June 10, 2008, Hallwood Energy completed the Talisman Energy Transaction for the sale and farmout to a subsidiary of Talisman Energy, Inc. of an undivided interest in up to 33.33% of Hallwood Energy s interest in substantially all its assets for a series of payments of up to $125,000,000 (an initial payment of $60,000,000 and options to pay an additional $65,000,000) and entered into an agreement to provide consulting services to the purchaser for one year.

In connection with the Talisman Energy Transaction, the Company loaned $2,961,000 to Hallwood Energy on May 15, 2008 on terms similar to the First Convertible Note issued in January 2008. Contemporaneously with the signing of the sale and farmout agreement, the Company entered into the Equity Support Agreement with Hallwood

Energy. The Company committed 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 loan of $2,961,000 in May 2008 and an additional loan to Hallwood Energy on June 10, 2008 of $2,039,000 (for a total of $5,000,000) are treated as contributions toward the maximum amount. In September 2008, the Company loaned an additional $4,300,000 to Hallwood Energy under the Equity Support Agreement. The remaining commitment amount by the Company under the Equity Support Agreement was $3,200,000, at September 30, 2008.

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In connection with entering into these agreements, Hallwood Energy also agreed to amendments to its existing credit agreements that, among other things, could result in an increase in interest paid by Hallwood Energy and provides additional covenants. Hallwood Energy anticipates that the payments by the purchaser under the sale and farmout agreement will likely pay substantially all Hallwood Energy s capital costs and the majority of its general and administrative expenses, as long as those payments continue to be made. However, Hallwood Energy s remaining expenses will likely exceed its revenues for the remainder of 2008. Therefore it is likely that the Company will be required to contribute additional funds to Hallwood Energy pursuant to the Equity Support Agreement during 2008. To the extent the Company does not make future capital contributions in proportion to its interest in Hallwood Energy, its percentage ownership interest will be reduced. The actual level of Hallwood Energy s capital requirements during 2008 and thereafter will depend on a number of factors that cannot be determined at this time, including future gas prices, costs of field operations, the ability to successfully identify and acquire prospective properties and drill and complete wells, access to gathering and transportation infrastructure, and the availability of alternative sources of capital, such as loans from third parties or equity contributions from new investors.

In addition to the Talisman Energy Transaction, Hallwood Energy is continuing to seek additional capital, however, there is no assurance that any such transaction will be completed. If FEI does not elect to fund a substantial portion of the remaining $35,000,000 contemplated under the farmout agreement or if Hallwood Energy is unable to obtain additional funds, there is substantial doubt about Hallwood Energy s ability to continue as a going concern.

Future Liquidity. The Company s ability to generate cash flow from operations will depend on its future performance and its ability to successfully implement business and growth strategies. The Company s performance will also be affected by prevailing economic conditions. Many of these factors are beyond the Company s control. Considering its current cash position, its anticipated cash flow from operations and income tax refund of approximately $12,347,000 received in October 2008, the Company believes it has sufficient funds to meet its liquidity needs, including any contribution to Hallwood Energy required under the Equity Support Agreement. Hallwood Energy has not requested that the Company contribute any funds pursuant to the Equity Support Agreement. Furthermore, Hallwood Energy has not requested the Company to contribute, and therefore the Company has not considered whether it would contribute, any funds in excess of those contemplated by the Equity Support Agreement. If Hallwood Energy were to request funding of any amounts other than pursuant to the Equity Support Agreement (remaining commitment amount was $3,200,000 at September 30, 2008), the Company would consider the request in light of the circumstances and conditions of the Company and Hallwood Energy at the time.

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

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 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 Form 10-K for the year ended December 31, 2007 in the section entitled Business Competition, Risks and Other 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.

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Item 4. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures. It is the conclusion of the Company s principal executive officer and principal financial officer that the Company s disclosure controls and procedures (as defined in Exchange Act rules 13a-15(e) and 15d-15(e)), based on their evaluation of these controls and procedures as of the end of the period covered by this Form 10-Q, are effective at the reasonable assurance level in ensuring that information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission s rules and forms, and that information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the Company s management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure. Management necessarily applied its judgment in assessing the costs and benefits of such controls and procedures, which, by their nature, can provide only reasonable assurance regarding management s control objectives. The design of any system of controls and procedures is based in part upon certain assumptions about the likelihood of future events. There can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions, regardless of how remote.

In August 2003, the Company s independent registered public accounting firm provided written communications to management and the audit committee on the need to improve the financial closing process at the Brookwood subsidiary. In April 2004, the Company received a further written communication from the independent registered public accounting firm to management and the audit committee on the continued need to improve the Brookwood financial closing process. In March 2005, April 2006, May 2007 and May 2008, the Company received communications from its independent registered public accounting firm that further improvements in the financial systems and processes at its Brookwood subsidiary are still required. With the addition of new staff, Brookwood s management believes it has made substantial progress both in the timeliness and accuracy of the closing process. Brookwood has implemented a new order processing, manufacturing cost and inventory control system and it has updated its general ledger system, which is integrating various accounting processes. The new systems will further aid in accelerating and automating the financial closing process.

Changes in Internal Controls over Financial Reporting. There were no changes in the Company s internal controls over financial reporting that occurred during the last fiscal quarter that have materially affected, or are reasonably likely to materially affect, these controls.

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PART II OTHER INFORMATION

Item

1	Legal Proceedings Reference is made to Note 11 to the Company s condensed consolidated financial statements included within this Form 10-Q.	
1A	Risk Factors	N/A
2	Unregistered Sales of Equity Securities and Use of Proceeds	None
3	Defaults upon Senior Securities	None
4	Submission of Matters to a Vote of Security Holders	None
5	Other Information	None
6	Exhibits	

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.

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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, 2008

By: /s/ Melvin J. Melle
Melvin J. Melle, Vice President
(Duly Authorized Officer and
Principal Financial and
Accounting Officer)

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INDEX TO EXHIBITS

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