HALLMARK FINANCIAL SERVICES INC
Form 10-Q/A
September 16, 2011
UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q/A
Amendment No. 1

Quarterly report pursuant to Section 13 or 15(d) of the

Securities Exchange Act of 1934

For the quarterly period ended June 30, 2011

Commission file number 001-11252

Hallmark Financial Services, Inc.

(Exact name of registrant as specified in its charter)

Nevada (State or other jurisdiction of Incorporation or organization)	87-0447375 (I.R.S. Employer Identification No.)
777 Main Street, Suite 1000, Fort Worth, Texas (Address of principal executive offices)	76102 (Zip Code)

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

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

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

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o Nox

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: Common Stock, par value $.18 per share – 19,263,457 shares outstanding as of August 8, 2011.

Explanatory Note

Hallmark Financial Services, Inc. is filing this Amendment No. 1 to its Quarterly Report on Form 10-Q for the quarter ended June 30, 2011, originally filed with the Securities and Exchange Commission on August 9, 2011, for the sole purpose of correcting the quarter end date set forth in the certifications pursuant to 18 U.S.C. §1350 included as Exhibits 32(a) and 32(b) of the Form 10-Q. No other changes have been made to the Form 10-Q. This Form 10-Q/A continues to speak as of the original filing date of the Form 10-Q, does not reflect events that may have occurred subsequent to the original filing date, and does not modify or update any related disclosures made in the Form 10-Q.

PART I
FINANCIAL INFORMATION

Item 1. Financial Statements

INDEX TO FINANCIAL STATEMENTS

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

	June 30 2011 (unaudited)	December 31 2010
ASSETS		
Investments:		
Debt securities, available-for-sale, at fair value (cost: $393,497 in 2011 and $383,530 in 2010)	$395,975	$ 388,399
Equity securities, available-for-sale, at fair value (cost: $31,573 in 2011 and $32,469 in 2010)	42,943	44,042
Total investments	438,918	432,441
Cash and cash equivalents	50,885	60,519
Restricted cash	6,346	5,277
Ceded unearned premiums	20,262	25,504
Premiums receivable	57,444	47,337
Accounts receivable	6,020	7,051
Receivable for securities	473	2,215
Reinsurance recoverable	42,726	39,505
Deferred policy acquisition costs	24,047	21,679
Goodwill	43,564	43,564
Intangible assets, net	28,448	30,241
Federal income tax recoverable	13,138	4,093
Prepaid expenses	1,699	1,987
Other assets	13,159	15,207
Total assets	$747,129	$ 736,620
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities:		
Note payable	$2,800	$ 2,800
Subordinated debt securities	56,702	56,702
Reserves for unpaid losses and loss adjustment expenses	278,894	251,677
Unearned premiums	148,205	140,965
Unearned revenue	93	116
Reinsurance balances payable	5,493	3,122
Accrued agent profit sharing	1,277	1,301
Accrued ceding commission payable	4,230	4,231
Pension liability	2,623	2,833
Payable for securities	8,357	2,493
Payable for acquisition	-	14,000
Deferred federal income taxes, net	1,836	3,471
Accounts payable and other accrued expenses	17,005	15,786
Total liabilities	527,515	499,497

Commitments and Contingencies (Note 18)		
Redeemable non-controlling interest	1,223	1,360
Stockholders' equity:		
Common stock, $.18 par value, authorized 33,333,333 shares in 2011 and 2010; issued 20,872,831 in 2011 and 2010	3,757	3,757
Additional paid-in capital	122,292	121,815
Retained earnings	94,567	105,816
Accumulated other comprehensive income	7,843	9,637
Treasury stock (1,418,003 shares in 2011 and 748,662 shares in 2010), at cost	(10,068)	(5,262)
Total stockholders' equity	218,391	235,763
	$747,129	$ 736,620

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

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

	Three Months Ended June 30		Six Months Ended June 30	
	2011	2010	2011	2010
Gross premiums written	$ 91,371	$ 83,180	$ 181,083	$ 165,039
Ceded premiums written	(12,415)	(10,047)	(25,893)	(19,111)
Net premiums written	78,956	73,133	155,190	145,928
Change in unearned premiums	(7,378)	(3,185)	(13,499)	(8,965)
Net premiums earned	71,578	69,948	141,691	136,963
Investment income, net of expenses	3,778	3,276	7,785	6,477
Net realized gains	1,664	1,643	2,783	5,446
Finance charges	1,725	1,771	3,465	3,414
Commission and fees	(243)	(963)	172	(812)
Other income	11	12	25	22
Total revenues	78,513	75,687	155,921	151,510
Losses and loss adjustment expenses	61,920	52,058	125,705	95,156
Other operating expenses	23,788	22,872	46,961	44,354
Interest expense	1,153	1,150	2,311	2,296
Amortization of intangible assets	896	916	1,793	1,832
Total expenses	87,757	76,996	176,770	143,638
Income (loss) before tax	(9,244)	(1,309)	(20,849)	7,872
Income tax (benefit) expense	(9,229)	(953)	(9,622)	1,937
Net (loss) income	(15)	(356)	(11,227)	5,935
Less: Net income attributable to non-controlling interest	8	32	22	37
Net (loss) income attributable to Hallmark Financial Services, Inc.	$ (23)	$ (388)	$ (11,249)	$ 5,898
Net (loss) income per share attributable to Hallmark Financial Services, Inc. common stockholders:				
Basic	$ -	$ (0.02)	$ (0.56)	$ 0.29
Diluted	$ -	$ (0.02)	$ (0.56)	$ 0.29

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of the consolidated financial statements

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

	Three Months Ended June 30, 2011	Three Months Ended June 30, 2010	Six Months Ended June 30, 2011	Six Months Ended June 30, 2010
Common Stock				
Balance, beginning of period	$ 3,757	$ 3,757	$ 3,757	$ 3,757
Issuance of common stock upon option exercises	-	-	-	-
Balance, end of period	3,757	3,757	3,757	3,757
Additional Paid-In Capital				
Balance, beginning of period	122,074	121,196	121,815	121,016
Accretion of redeemable noncontrolling interest	(3)	(84)	(6)	(162)
Equity based compensation	227	291	489	589
Exercise of stock options	(6)	-	(6)	(40)
Balance, end of period	122,292	121,403	122,292	121,403
Retained Earnings				
Balance, beginning of period	94,590	104,768	105,816	98,482
Net (loss) income attributable to Hallmark Financial Services, Inc.	(23)	(388)	(11,249)	5,898
Balance, end of period	94,567	104,380	94,567	104,380
Accumulated Other Comprehensive Income				
Balance, beginning of period	8,207	11,083	9,637	8,589
Additional minimum pension liability, net of tax	47	37	93	73
Net unrealized holding gains (losses) arising during period	1,253	(2,511)	896	3,750
Reclassification adjustment for losses included in net income	(1,664)	(1,643)	(2,783)	(5,446)
Balance, end of period	7,843	6,966	7,843	6,966
Treasury Stock				
Balance, beginning of period	(5,262)	(5,268)	(5,262)	(5,327)
Acquistion of treasury shares	(4,911)	-	(4,911)	-
Issuance of treasury stock upon option exercises	105	6	105	65
Balance, end of period	(10,068)	(5,262)	(10,068)	(5,262)
Total Stockholders' Equity	$ 218,391	$ 231,244	$ 218,391	$ 231,244
Net (loss) income	$ (15)	$ (356)	$ (11,227)	$ 5,935
Additional minimum pension liability, net of tax	47	37	93	73

Net unrealized holding gains (losses) arising during period	1,253	(2,511)	896	3,750
Reclassification adjustment for gains included in net income	(1,664)	(1,643)	(2,783)	(5,446)
Comprehensive (loss) income	(379)	(4,473)	(13,021)	4,312
Less: Comprehensive income attributable to non-controlling interest	8	32	22	37
Comprehensive (loss) income attributable to Hallmark Financial Services, Inc.	$ (387)	$ (4,505)	$ (13,043)	$ 4,275

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

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

	Six Months Ended June 30	
	2011	2010
Cash flows from operating activities:		
Net (loss) income	$(11,227)	$5,935
Adjustments to reconcile net (loss) income to cash (used) provided by operating activities:		
Depreciation and amortization expense	2,463	2,326
Deferred federal income taxes	(977)	(734)
Realized gains on investments	(2,783)	(5,446)
Change in ceded unearned premiums	5,242	(2,136)
Change in premiums receivable	(10,107)	(7,758)
Change in accounts receivable	1,031	244
Change in deferred policy acquisition costs	(2,368)	(1,944)
Change in unpaid losses and loss adjustment expenses	27,217	29,786
Change in unearned premiums	7,240	11,101
Change in unearned revenue	(23)	(22)
Change in accrued agent profit sharing	(24)	(558)
Change in reinsurance recoverable	(3,221)	(6,141)
Change in reinsurance payable	2,371	(465)
Change in current federal income tax recoverable/payable	(9,045)	(4,508)
Change in accrued ceding commission payable	(1)	(4,365)
Change in all other liabilities	1,009	(1,996)
Change in all other assets	4,195	4,130
Net cash provided by operating activities	10,992	17,449
Cash flows from investing activities:		
Purchases of property and equipment	(1,162)	(841)
Net transfers into restricted cash	(1,069)	(3,825)
Payment for acquisition of subsidiaries	(14,000)	-
Purchases of investment securities	(166,834)	(123,337)
Maturities, sales and redemptions of investment securities	167,410	73,637
Net cash used in investing activities	(15,655)	(54,366)
Cash flows from financing activities:		
Proceeds from exercise of employee stock options	105	25
Purchase of treasury shares	(4,911)	-
Distribution to non-controlling interest	(165)	(144)
Net cash used in financing activities	(4,971)	(119)

Decrease in cash and cash equivalents	(9,634)	(37,036)
Cash and cash equivalents at beginning of period	60,519	112,270
Cash and cash equivalents at end of period	$50,885	$75,234
Supplemental cash flow information:		
Interest paid	$2,309	$2,303
Income taxes paid	$400	$7,179
Supplemental schedule of non-cash investing activities:		
Change in receivable for securities related to investment disposals that settled after the balance sheet date	$1,742	$31
Change in payable for securities related to investment purchases that settled after the balance sheet date	$5,864	$25,601

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

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

1. General

Hallmark Financial Services, Inc. ("Hallmark" and, together with subsidiaries, "we," "us" or "our") is an insurance holding company engaged in the sale of property/casualty insurance products to businesses and individuals. Our business involves marketing, distributing, underwriting and servicing our insurance products, as well as providing other insurance related services.

We pursue our business activities through subsidiaries whose operations are organized into six business units that are supported by our insurance company subsidiaries. Our Standard Commercial business unit handles commercial insurance products and services in the standard market. Our Workers Comp business unit specializes in small and middle market workers compensation business. Our E&S Commercial business unit handles primarily commercial and medical professional liability insurance products and services in the excess and surplus lines market. Our General Aviation business unit handles general aviation insurance products and services. Our Excess & Umbrella business unit offers low and middle market commercial umbrella and excess liability insurance on both an admitted and non-admitted basis focusing primarily on trucking, specialty automobile and non-fleet automobile coverage. Our Personal Lines business unit handles personal insurance products and services. Our insurance company subsidiaries supporting these operating units are American Hallmark Insurance Company of Texas ("AHIC"), Hallmark Insurance Company ("HIC"), Hallmark Specialty Insurance Company ("HSIC"), Hallmark County Mutual Insurance Company ("HCM"), Hallmark National Insurance Company ("HNIC") and Texas Builders Insurance Company ("TBIC").

These six business units are segregated into three reportable industry segments for financial accounting purposes. The Standard Commercial Segment consists of the Standard Commercial business unit and the Workers Comp business unit. The Personal Segment presently consists solely of the Personal Lines business unit and the Specialty Commercial Segment includes the E&S Commercial, General Aviation and Excess & Umbrella business units.

2. Basis of Presentation

Our unaudited consolidated financial statements included herein have been prepared in accordance with U.S. generally accepted accounting principles ("GAAP") and include our accounts and the accounts of our subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation. Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to rules and regulations of the Securities and Exchange Commission ("SEC") for interim financial reporting. These unaudited consolidated financial statements should be read in conjunction with our audited consolidated financial statements for the year ended December 31, 2010 included in our Annual Report on Form 10-K filed with the SEC.

The interim financial data as of June 30, 2011 and 2010 is unaudited. However, in the opinion of management, the interim data includes all adjustments, consisting of normal recurring adjustments, necessary for a fair statement of the results for the interim periods. The results of operations for the period ended June 30, 2011 are not necessarily indicative of the operating results to be expected for the full year.

Redeemable non-controlling interest

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

Income taxes

We file a consolidated federal income tax return. Deferred federal income taxes reflect the future tax consequences of differences between the tax bases of assets and liabilities and their financial reporting amounts at each year end. Deferred taxes are recognized using the liability method, whereby tax rates are applied to cumulative temporary differences based on when and how they are expected to affect the tax return. Deferred tax assets and liabilities are adjusted for tax rate changes in effect for the year in which these temporary differences are expected to be recovered or settled.

Use of Estimates in the Preparation of the Financial Statements

Our preparation of financial statements in conformity with GAAP requires us to make estimates and assumptions that affect our reported amounts of assets and liabilities and our disclosure of contingent assets and liabilities at the date of our consolidated financial statements, as well as our reported amounts of revenues and expenses during the reporting period. Refer to “Critical Accounting Estimates and Judgments” under Item 7 of our Annual Report on Form 10-K for the year ended December 31, 2010 for information on accounting policies that we consider critical in preparing our consolidated financial statements. Actual results could differ materially from those estimates.

Fair Value of Financial Instruments

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

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

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

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

Notes Payable: The carrying value of our bank credit facility of $2.8 million approximates the fair value based on the current interest rate.

Subordinated Debt Securities: Our trust preferred securities have a carried value of $56.7 million and a fair value of $55.7 million as of June 30, 2011. The fair value of our trust preferred securities is based on discounted cash flows using a current yield to maturity of 8.0% based on similar issues to discount future cash flows.

For reinsurance recoverable, federal income tax payable and receivable, other assets and other liabilities, the carrying amounts approximate fair value because of the short maturity of such financial instruments.

Variable Interest Entities

On June 21, 2005, we formed Hallmark Statutory Trust I ("Trust I"), an unconsolidated trust subsidiary, for the sole purpose of issuing $30.0 million in trust preferred securities. Trust I used the proceeds from the sale of these securities and our initial capital contribution to purchase $30.9 million of subordinated debt securities from Hallmark. The debt securities are the sole assets of Trust I, and the payments under the debt securities are the sole revenues of Trust I.

On August 23, 2007, we formed Hallmark Statutory Trust II ("Trust II"), an unconsolidated trust subsidiary, for the sole purpose of issuing $25.0 million in trust preferred securities. Trust II used the proceeds from the sale of these securities and our initial capital contribution to purchase $25.8 million of subordinated debt securities from Hallmark. The debt securities are the sole assets of Trust II, and the payments under the debt securities are the sole revenues of Trust II.

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

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

Adoption of New Accounting Pronouncements

In January 2010, the Financial Accounting Standards Board ("FASB") updated Accounting Standards Codification ("ASC") Topic 820, "Fair Value Measurements and Disclosures" ("ASC 820") to require additional disclosures about fair value measurements regarding transfers between fair value categories, as well as purchases, sales, issuances and settlements related to fair value measurements of financial instruments with non-observable inputs. This update was effective for interim and annual periods beginning after December 15, 2009, except for disclosures about purchases, sales, issuances and settlements of financial instruments with non-observable inputs, which are effective for years beginning after December 15, 2010. The adoption of ASC 820 did not have a material impact on our financial position or results of operations but did require additional disclosures.

In January 2010, we adopted new guidance issued by the FASB providing that a company should include a VIE in its consolidated accounts if the company is the primary beneficiary of the VIE. A company is considered the primary beneficiary of a VIE if it has both of the following characteristics: (a) the power to direct the activities of the VIE that most significantly impact the VIE's economic performance; and (b) the obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE. Ongoing reassessment of whether a company is the primary beneficiary of a VIE is required. The new guidance replaces the quantitative-based approach previously required for determining which company, if any, has a controlling financial interest in a VIE. The adoption of this guidance did not have a material impact on our financial position or results of operations.

In July 2010, the FASB issued Accounting Standards Update (ASU) 2010-20, which requires additional disclosures about the credit quality of financing receivables and allowances for credit losses. The additional requirements include disclosure of the nature of credit risks inherent in financing receivables, how credit risk is analyzed and assessed when determining the allowance for credit losses, and the reasons for the change in the allowance for credit losses. The disclosures are effective for us for interim and annual reporting periods ending on or after December 15, 2010. The adoption of ASU 2010-20 did not have a material impact on our financial position or results of operations.

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

Accounting Pronouncements Not Yet Adopted

In October 2010, the FASB issued new guidance related to the accounting for costs associated with acquiring or renewing insurance contracts. The guidance identifies those costs relating to the successful acquisition of new or renewal insurance contracts which are to be capitalized. The guidance will be effective for us for the year beginning January 1, 2012 and may be applied prospectively or retrospectively. We are in the process of assessing the effect that the implementation of the new guidance will have on our financial position and results of operations. The amount of acquisition costs we would defer under the new guidance may be less than the amount deferred under our current accounting practice.

3. Business Combinations

We account for business combinations using the purchase method of accounting pursuant to ASC Topic 805, "Business Combinations." The cost of an acquired entity is allocated to the assets acquired (including identified intangible assets) and liabilities assumed based on their estimated fair values. The excess of the cost of an acquired entity over the net of the amounts assigned to assets acquired and liabilities assumed is an asset referred to as "Goodwill". Indirect and general expenses related to business combinations are expensed as incurred. Prior to 2009 indirect and general expenses were capitalized.

Effective August 29, 2008, we acquired 80% of the issued and outstanding membership interests in the subsidiaries now comprising our Excess & Umbrella business unit for consideration of $15.0 million. In connection with the acquisition, we executed an operating agreement for each subsidiary. The operating agreements grant us the right to purchase the remaining 20% membership interests in the subsidiaries and grant to an affiliate of the seller the right to require us to purchase such remaining membership interests (the "Put/Call Option"). The Put/Call Option becomes exercisable by either us or the affiliate of the seller upon the earlier of August 29, 2012, the termination of the employment of the seller by the Excess & Umbrella business unit or a change of control of Hallmark. If the Put/Call Option is exercised, we will have the right or obligation to purchase the remaining 20% membership interests in the Excess & Umbrella business unit for an amount equal to nine times the average Pre-Tax Income (as defined in the operating agreements) for the previous 12 fiscal quarters. We estimate the ultimate redemption value of the Put/Call Option to be $1.4 million at June 30, 2011.

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

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

4. Fair Value

ASC 820 defines fair value, establishes a consistent framework for measuring fair value and expands disclosure requirements about fair value measurements. ASC 820, among other things, requires us to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. In addition, ASC 820 precludes the use of block discounts when measuring the fair value of instruments traded in an active market, which were previously applied to large holdings of publicly traded equity securities.

We determine the fair value of our financial instruments based on the fair value hierarchy established in ASC 820. In accordance with ASC 820, we utilize the following fair value hierarchy:

- Level 1: quoted prices in active markets for identical assets;
- Level 2: inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, inputs of identical assets for less active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the instrument; and
- Level 3: inputs to the valuation methodology that are unobservable for the asset or liability.

This hierarchy requires the use of observable market data when available.

Under ASC 820, we determine fair value based on the price that would be received for an asset or paid to transfer a liability in an orderly transaction between market participants on the measurement date. It is our policy to maximize the use of observable inputs and minimize the use of unobservable inputs when developing fair value measurements, in accordance with the fair value hierarchy described above. Fair value measurements for assets and liabilities where there exists limited or no observable market data are calculated based upon our pricing policy, the economic and competitive environment, the characteristics of the asset or liability and other factors as appropriate. These estimated fair values may not be realized upon actual sale or immediate settlement of the asset or liability.

Where quoted prices are available on active exchanges for identical instruments, investment securities are classified within Level 1 of the valuation hierarchy. Level 1 investment securities include common and preferred stock.

Level 2 investment securities include corporate bonds, collateralized corporate bank loans, municipal bonds, and U.S. Treasury securities for which quoted prices are not available on active exchanges for identical instruments. We use a third party pricing service to determine fair values for each Level 2 investment security in all asset classes. Since quoted prices in active markets for identical assets are not available, these prices are determined using observable market information such as quotes from less active markets and/or quoted prices of securities with similar characteristics, among other things. We have reviewed the processes used by the pricing service and have determined that they result in fair values consistent with the requirements of ASC 820 for Level 2 investment securities.

In cases where there is limited activity or less transparency around inputs to the valuation, investment securities are classified within Level 3 of the valuation hierarchy. Level 3 investments are valued based on the best available data in order to approximate fair value. This data may be internally developed and consider risk premiums that a market participant would require. Investment securities classified within Level 3 include other less liquid investment securities.

The following table presents for each of the fair value hierarchy levels, our assets that are measured at fair value on a recurring basis at June 30, 2011 (in thousands):

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Unobservable Inputs (Level 3)	Total
U.S. Treasury securities and obligations of U.S. Government	$ -	$ 23,155	$ -	$ 23,155
Corporate bonds	-	72,947	-	72,947
Collateralized corporate bank loans	-	107,910	1,305	109,215
Municipal bonds	-	170,496	19,457	189,953
Mortgage-backed	-	705	-	705
Total debt securities	-	375,213	20,762	395,975
Financial services	18,048	-	-	18,048
All other	24,895	-	-	24,895
Total equity securities	42,943	-	-	42,943
Total debt and equity securities	$ 42,943	$ 375,213	$ 20,762	$ 438,918

Due to significant unobservable inputs into the valuation model for certain municipal bonds and a collateralized corporate bank loan in illiquid markets, we classified these investments as level 3 in the fair value hierarchy. We used an income approach in order to derive an estimated fair value of the municipal bonds classified as Level 3, which included inputs such as expected holding period, benchmark swap rate, benchmark discount rate and a discount rate premium for illiquidity. The fair value of the collateralized corporate bank loan classified as level 3 is based on discounted cash flows using current yield to maturity of 10.4%, which is based on the relevant spread over LIBOR for this particular loan to discount future cash flows.

The following table summarizes the changes in fair value for all financial assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) during the six months ended June 30, 2011 (in thousands):

Beginning balance as of January 1, 2011	$21,981
Settlements	(224)
Total realized/unrealized gains included in net income	-
Net losses included in other comprehensive income	(995)
Transfers into Level 3	-
Transfers out of Level 3	-
Ending balance as of June 30, 2011	$20,762

5. Investments

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

Debt Investments: We assess whether we intend to sell, or it is more likely than not that we will be required to sell, a fixed maturity investment before recovery of its amortized cost basis less any current period credit losses. For fixed maturity investments that are considered other-than-temporarily impaired and that we do not intend to sell and will not be required to sell, we separate the amount of the impairment into the amount that is credit related (credit loss component) and the amount due to all other factors. The credit loss component is recognized in earnings and is the difference between the investment's amortized cost basis and the present value of its expected future cash flows. The remaining difference between the investment's fair value and the present value of future expected cash flows is recognized in other comprehensive income.

Equity Investments: Some of the factors considered in evaluating whether a decline in fair value for an equity investment is other-than-temporary include: (1) our ability and intent to retain the investment for a period of time sufficient to allow for an anticipated recovery in value; (2) the recoverability of cost; (3) the length of time and extent to which the fair value has been less than cost; and (4) the financial condition and near-term and long-term prospects for the issuer, including the relevant industry conditions and trends, and implications of rating agency actions and offering prices. When it is determined that an equity investment is other-than-temporarily impaired, the security is written down to fair value, and the amount of the impairment is included in earnings as a realized investment loss. The fair value then becomes the new cost basis of the investment, and any subsequent recoveries in fair value are recognized at disposition. We recognize a realized loss when impairment is deemed to be other-than-temporary even if a decision to sell an equity investment has not been made. When we decide to sell a temporarily impaired available-for-sale equity investment and we do not expect the fair value of the equity investment to fully recover prior to the expected time of sale, the investment is deemed to be other-than-temporarily impaired in the period in which the decision to sell is made.

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

	Three Months Ended June 30		Six Months Ended June 30	
	2011	2010	2011	2010
U.S. Treasury securities and obligations of U.S. Government	$ -	$ -	$ 14	$ -
Corporate bonds	271	-	271	2,078
Collateralized corporate bank loans	206	74	640	1,290
Municipal bonds	66	24	(1)	(72)
Mortgage-backed	-	-	-	-
Equity securities-financial services	51	1,201	789	1,767
Equity securities-all other	1,070	344	1,070	383
Gain on investments	1,664	1,643	2,783	5,446
Other-than-temporary impairments	-	-	-	-
Net realized gains	$ 1,664	$ 1,643	$ 2,783	$ 5,446

We realized gross gains on investments of $1.7 million and $1.6 million during the three months ended June 30, 2011 and 2010, respectively and $2.9 million and $5.5 million for the six months ended June 30, 2011 and 2010, respectively. We realized gross losses on investments of $43 thousand and $11 thousand for the three months ended June 30, 2011 and 2010. We realized gross losses on investments of $0.1 million for the six months ended both June 30, 2011 and 2010. We recorded proceeds from the sale of investment securities of $82.9 million and $26.5 million during the three months ended June 30, 2011 and 2010, respectively, and $165.7 million and $73.6 million for the six months ended June 30, 2011 and 2010, respectively. Realized investment gains and losses are recognized in operations on the specific identification method.

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

As of June 30, 2011	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Treasury securities and obligations of U.S. Government	$ 23,098	$ 57	$ -	$ 23,155
Corporate bonds	70,647	3,079	(779)	72,947
Collateralized corporate bank loans	108,861	534	(180)	109,215
Municipal bonds	190,231	2,929	(3,207)	189,953
Mortgage-backed	660	45	-	705
Total debt securities	393,497	6,644	(4,166)	395,975
Financial services	14,522	3,860	(334)	18,048
All other	17,051	7,885	(41)	24,895
Total equity securities	31,573	11,745	(375)	42,943
Total debt and equity securities	$ 425,070	$ 18,389	$ (4,541)	$ 438,918
As of December 31, 2010				
U.S. Treasury securities and obligations of U.S. Government	$ 39,767	$ 36	$ -	$ 39,803
Corporate bonds	82,956	3,465	(844)	85,577
Collateralized corporate bank loans	106,723	1,685	(95)	108,313
Municipal bonds	153,334	2,421	(1,842)	153,913
Mortgage-backed	750	43	-	793
Total debt securities	383,530	7,650	(2,781)	388,399
Financial services	15,385	5,770	(270)	20,885
All other	17,084	6,196	(123)	23,157
Total equity securities	32,469	11,966	(393)	44,042
Total debt and equity securities	$ 415,999	$ 19,616	$ (3,174)	$ 432,441

The following schedules summarize the gross unrealized losses showing the length of time that investments have been continuously in an unrealized loss position as of June 30, 2011 and December 31, 2010 (in thousands):

	As of June 30, 2011					
	12 months or less		Longer than 12 months		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. Treasury securities and obligations of U.S. Government	$ -	$ -	$ -	$ -	$ -	$ -
Corporate bonds	3,472	(17)	2,400	(762)	5,872	(779)
Collateralized corporate bank loans	35,384	(176)	19	(4)	35,403	(180)
Municipal bonds	38,571	(534)	38,815	(2,673)	77,386	(3,207)
Mortgage-backed	-	-	-	-	-	-
Total debt securities	77,427	(727)	41,234	(3,439)	118,661	(4,166)
Financial services	2,363	(239)	746	(95)	3,109	(334)
All other	1,950	(41)	-	-	1,950	(41)
Total equity securities	4,313	(280)	746	(95)	5,059	(375)
Total debt and equity securities	$ 81,740	$ (1,007)	$ 41,980	$ (3,534)	$ 123,720	$ (4,541)

	As of December 31, 2010					
	12 months or less		Longer than 12 months		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. Treasury securities and obligations of U.S. Government	$ -	$ -	$ -	$ -	$ -	$ -
Corporate bonds	8,036	(13)	2,342	(831)	10,378	(844)
Collateralized corporate bank loans	17,370	(90)	19	(5)	17,389	(95)
Municipal bonds	24,755	(248)	46,591	(1,594)	71,346	(1,842)
Mortgage-backed	-	-	-	-	-	-
Total debt securities	50,161	(351)	48,952	(2,430)	99,113	(2,781)
Financial services	1,234	(270)	-	-	1,234	(270)
All other	625	(123)	-	-	625	(123)
Equity securities	1,859	(393)	-	-	1,859	(393)
Total debt and equity securities	$ 52,020	$ (744)	$ 48,952	$ (2,430)	$ 100,972	$ (3,174)

At June 30, 2011, the gross unrealized losses more than twelve months old were attributable to 25 debt security positions. At December 31, 2010, the gross unrealized losses more than twelve months old were attributable to 31 debt security positions. We consider these losses as a temporary decline in value as they are predominately on bonds that we do not intend to sell and do not believe we will be required to sell prior to recovery of our amortized cost basis. We see no other indications that the decline in values of these securities is other-than-temporary.

Based on evidence gathered through our normal credit evaluation process, we presently expect that all debt securities held in our investment portfolio will be paid in accordance with their contractual terms. Nonetheless, it is at least reasonably possible that the performance of certain issuers of these debt securities will be worse than currently expected resulting in additional future write-downs within our portfolio of debt securities.

Also, as a result of the challenging market conditions, we expect the volatility in the valuation of our equity securities to continue in the foreseeable future. This volatility may lead to additional impairments on our equity securities portfolio or changes regarding retention strategies for certain equity securities.

The amortized cost and estimated fair value of debt securities at June 30, 2011 by contractual maturity are as follows. Expected maturities may differ from contractual maturities because certain borrowers may have the right to call or prepay obligations with or without penalties.

	Amortized Cost	Fair Value
	(in thousands)	
Due in one year or less	$ 55,262	$ 55,864
Due after one year through five years	154,545	158,273
Due after five years through ten years	137,861	137,283
Due after ten years	45,169	43,850
Mortgage-backed	660	705
	$ 393,497	$ 395,975

6. Pledged Investments

We have pledged certain of our securities for the benefit of various state insurance departments and reinsurers. These securities are included with our available-for-sale debt securities because we have the ability to trade these securities. We retain the interest earned on these securities. These securities had a carrying value of $32.1 million and $33.4 million at June 30, 2011 and December 31, 2010, respectively.

7. Reserves for Unpaid Losses and Loss Adjustment Expenses

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

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

We recorded $4.3 million and $6.5 million of unfavorable prior years' loss development during the three and six months ended June 30, 2010, respectively. The unfavorable prior years development during the six months ended June 30, 2010 was comprised of $0.7 million of unfavorable development in our Personal Lines business primarily attributable to geographic expansion; $2.3 million of unfavorable development in our E&S Commercial business unit related primarily to general liability claims and increased volatility in large liability losses; $3.3 million of unfavorable development in our Standard Commercial business unit primarily attributable to our commercial property and general liability lines of business; $0.1 million of unfavorable development in our General Aviation business unit related to our liability lines of business; and $0.1 million of unfavorable development in our Excess & Umbrella business unit.

For the purpose of estimating the reserves for unpaid losses and LAE during the six months ended June 30, 2011, past experience was adjusted for the rapid emergence of additional Florida claims development. While we believe the reserves for unpaid losses and LAE are adequate, given our limited historical experience within the state, there is a reasonable possibility that this recent claims experience could be an indication of an unfavorable trend that may require additional reserves for unpaid losses and LAE. We have estimated the increase in reserves attributable to recent Florida claim experience to be $9.5 million for the six months ended June 30, 2011based on an estimated range of possible adverse development of $8.5 million to $11.1 million.

8. Share-Based Payment Arrangements

Our 2005 Long Term Incentive Plan ("2005 LTIP") is a stock compensation plan for key employees and non-employee directors that was approved by the shareholders on May 26, 2005. There are 2,000,000 shares authorized for issuance under the 2005 LTIP. As of June 30, 2011, there were incentive stock options to purchase 1,301,666 shares of our common stock outstanding, non-qualified stock options to purchase 305,000 shares of our common stock outstanding and 377,501 shares reserved for future issuance under the 2005 LTIP. The exercise price of all such outstanding stock options is equal to the fair market value of our common stock on the date of grant.

Incentive stock options granted under the 2005 LTIP prior to 2009 vest 10%, 20%, 30% and 40% on the first, second, third and fourth anniversary dates of the grant, respectively, and terminate five to ten years from the date of grant. Incentive stock options granted in 2009 and one grant of 5,000 incentive stock options in 2011 vest in equal annual increments on each of the first seven anniversary dates and terminate ten years from the date of grant. One grant of 25,000 incentive stock options in 2010 and one grant of 10,000 incentive stock options in 2011 vest in equal annual increments on each of the first three anniversary dates and terminate ten years from the date of grant. Non-qualified stock options granted under the 2005 LTIP generally vest 100% six months after the date of grant and terminate ten years from the date of grant. One grant of 200,000 non-qualified stock options in 2009 vests in equal annual increments on each of the first seven anniversary dates and terminates ten years from the date of grant.

A summary of the status of our stock options as of and changes during the six months ended June 30, 2011 is presented below:

	Number of Shares	Average Exercise Price	Contractual Term (Years)	Intrinsic Value ($000)
Outstanding at January 1, 2011	1,627,500	$ 9.66		
Granted	15,000	$ 8.34		
Exercised	(15,000)	$ 6.61		
Forfeited or expired	(20,834)	$ 4.13		
Outstanding at June 30, 2011	1,606,666	$ 9.75	6.6	$ 791
Exercisable at June 30, 2011	1,084,858	$ 10.70	6.2	$ 309

The following table details the intrinsic value of options exercised, total cost of share-based payments charged against income before income tax benefit and the amount of related income tax benefit recognized in income for the periods indicated (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2011	2010	2011	2010
Intrinsic value of options exercised	$ 4	$ 3	$ 4	$ 47
Cost of share-based payments (non-cash)	$ 228	$ 291	$ 490	$ 589
Income tax benefit of share-based payments recognized in income	$ 7	$ 7	$ 15	$ 15

As of June 30, 2011 there was $1.5 million of total unrecognized compensation cost related to non-vested share-based compensation arrangements granted under our plans, of which $0.3 million is expected to be recognized during the remainder of 2011, $0.4 million is expected to be recognized in 2012, $0.3 million is expected to be recognized in 2013, $0.2 million is expected to be recognized each year from 2014 through 2015 and $0.1 million is expected to be recognized in 2016.

The fair value of each stock option granted is estimated on the date of grant using the Black-Scholes option pricing model. Expected volatilities are based on the historical volatility of Hallmark's and similar companies' common stock for a period equal to the expected term. The risk-free interest rates for periods within the contractual term of the options are based on rates for U.S. Treasury Notes with maturity dates corresponding to the options' expected lives on the dates of grant. Expected term is determined based on the simplified method as we do not have sufficient historical exercise data to provide a basis for estimating the expected term.

The following table details the weighted average grant date fair value and related assumptions for the periods indicated.

	Three Months Ended June 30, 2011	Three Months Ended June 30, 2010	Six Months Ended June 30, 2011	Six Months Ended June 30, 2010
Grant date fair value per share	$ 3.50	$ 3.62	$ 3.50	$ 3.62
Expected term (in years)	6.3	6.0	6.3	6.0
Expected volatility	38.0 %	35.0 %	38.0 %	35.0 %
Risk free interest rate	2.6 %	3.2 %	2.6 %	3.2 %

9. Segment Information

The following is business segment information for the three and six months ended June 30, 2011 and 2010 (in thousands):

	Three Months Ended June 30, 2011	Three Months Ended June 30, 2010	Six Months Ended June 30, 2011	Six Months Ended June 30, 2010
Revenues:				
Standard Commercial Segment	$ 16,241	$ 17,265	$ 33,668	$ 35,299
Specialty Commercial Segment	34,476	32,124	67,619	64,611
Personal Segment	25,869	24,754	50,919	45,968
Corporate	1,927	1,544	3,715	5,632
Consolidated	$ 78,513	$ 75,687	$ 155,921	$ 151,510
Pre-tax income (loss), net of non-controlling interest:				
Standard Commercial Segment	$ (4,753)	$ (1,870)	$ (5,133)	$ (2,809)
Specialty Commercial Segment	873	967	4,331	7,314
Personal Segment	(4,596)	1,132	(17,810)	3,782
Corporate	(776)	(1,570)	(2,259)	(452)
Consolidated	$ (9,252)	$ (1,341)	$ (20,871)	$ 7,835

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

Assets		June 30, 2011		December 31, 2010
Standard Commercial Segment	$	124,794	$	118,818
Specialty Commercial Segment		349,407		330,843
Personal Segment		226,089		204,660
Corporate		46,839		82,299
	$	747,129	$	736,620

10. Reinsurance

We reinsure a portion of the risk we underwrite in order to control the exposure to losses and to protect capital resources. We cede to reinsurers a portion of these risks and pay premiums based upon the risk and exposure of the policies subject to such reinsurance. Ceded reinsurance involves credit risk and is generally subject to aggregate loss limits. Although the reinsurer is liable to us to the extent of the reinsurance ceded, we are ultimately liable as the direct insurer on all risks reinsured. Reinsurance recoverables are reported after allowances for uncollectible amounts. We monitor the financial condition of reinsurers on an ongoing basis and review our reinsurance arrangements periodically. Reinsurers are selected based on their financial condition, business practices and the price of their product offerings.

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

	Three Months Ended June 30,				Six Months Ended June 30,			
	2011		2010		2011		2010	
Ceded earned premiums	$	15,359	$	9,432	$	32,151	$	17,257
Reinsurance recoveries	$	6,933	$	6,842	$	19,483	$	10,578

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

- Property catastrophe. Our property catastrophe reinsurance reduces the financial impact a catastrophe could have on our commercial and personal property insurance lines. Catastrophes might include multiple claims and policyholders. Catastrophes include hurricanes, windstorms, earthquakes, hailstorms, explosions, severe winter weather and fires. Our property catastrophe reinsurance is excess-of-loss reinsurance, which provides us reinsurance coverage for losses in excess of an agreed-upon amount. We utilize catastrophe models to assist in determining appropriate retention and limits to purchase. The terms of our property catastrophe reinsurance are:

  o We retain the first $3.0 million of property catastrophe losses; and

- o Our reinsurers reimburse us 100% for any loss in excess of our $3.0 million retention up to $30.0 million for each catastrophic occurrence, subject to an aggregate limit of $54.0 million.

- • Commercial property. Our commercial property reinsurance is excess-of-loss coverage intended to reduce the financial impact a single-event or catastrophic loss may have on our results. The terms of our commercial property reinsurance are:

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

  - o Our reinsurers reimburse us for the next $5.0 million for each commercial property risk, and $10.0 million for all commercial property risk involved in any one occurrence, in all cases subject to an aggregate limit of $30.0 million for all commercial property losses occurring during the treaty period; and

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

- • Commercial casualty. Our commercial casualty reinsurance is excess-of-loss coverage intended to reduce the financial impact a single-event loss may have on our results. The terms of our commercial casualty reinsurance are:

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

  - o Our reinsurers reimburse us for the next $5.0 million for each commercial liability risk.

- • Aviation. We purchase reinsurance specific to the aviation risks underwritten by our General Aviation business unit. This reinsurance provides aircraft hull and liability coverage and airport liability coverage on a per occurrence basis on the following terms:

  - o We retain the first $1.0 million of each aircraft hull or liability loss or airport liability loss; and

  - o Our reinsurers reimburse us for the next $5.5 million of each combined aircraft hull and liability loss and for the next $4.0 million of each airport liability loss.

- • Excess & Umbrella. Currently, we purchase proportional reinsurance where we retain 20% of each risk and cede the remaining 80% to reinsurers. In states where we are not yet licensed to offer a non-admitted product, we utilize a fronting arrangement pursuant to which we assume all of the risk and then retrocede a portion of that risk under the same proportional reinsurance treaty. Through June 30, 2009, our Excess & Umbrella business unit wrote policies pursuant to a general agency agreement with an unaffiliated carrier and we assumed 35% of the risk from that carrier.

- • E&S Commercial. Currently, we purchase proportional reinsurance on our medical professional liability risks where we retain 40% of each risk and cede the remaining 60% to reinsurers. In states where we are not yet licensed to offer a non-admitted product, we utilize a fronting arrangement pursuant to which we assume all of the risk and then retrocede a portion of that risk under the same proportional reinsurance treaty.

- Hallmark County Mutual. HCM is used to front certain lines of business in our Specialty Commercial and Personal Segments in Texas where we previously produced policies for third party county mutual insurance companies and reinsured 100% for a fronting fee. In addition, HCM is used to front business produced by unaffiliated third parties. HCM does not retain any business.

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

11. Note Payable

On January 27, 2006, we borrowed $15.0 million under our revolving credit facility to fund the cash required to close the acquisition of the subsidiaries comprising our E&S Commercial business unit. As of June 30, 2011, the balance on the revolving note was $2.8 million, which currently bears interest at 2.75% per annum. (See Note 13, “Credit Facilities.”)

12. Subordinated Debt Securities

On June 21, 2005, we entered into a trust preferred securities transaction pursuant to which we issued $30.9 million aggregate principal amount of subordinated debt securities due in 2035. To effect the transaction, we formed Trust I as a Delaware statutory trust. Trust I issued $30.0 million of preferred securities to investors and $0.9 million of common securities to us. Trust I used the proceeds from these issuances to purchase the subordinated debt securities. Our Trust I subordinated debt securities bear an initial interest rate of 7.725% until June 15, 2015, at which time interest will adjust quarterly to the three-month LIBOR rate plus 3.25 percentage points. Trust I pays dividends on its preferred securities at the same rate. Under the terms of our Trust I subordinated debt securities, we pay interest only each quarter and the principal of the note at maturity. The subordinated debt securities are uncollaterized and do not require maintenance of minimum financial covenants. As of June 30, 2011, the balance of our Trust I subordinated debt was $30.9 million.

On August 23, 2007, we entered into a trust preferred securities transaction pursuant to which we issued $25.8 million aggregate principal amount of subordinated debt securities due in 2037. To effect the transaction, we formed Trust II as a Delaware statutory trust. Trust II issued $25.0 million of preferred securities to investors and $0.8 million of common securities to us. Trust II used the proceeds from these issuances to purchase the subordinated debt securities. Our Trust II subordinated debt securities bear an initial interest rate of 8.28% until September 15, 2017, at which time interest will adjust quarterly to the three-month LIBOR rate plus 2.90 percentage points. Trust II pays dividends on its preferred securities at the same rate. Under the terms of our Trust II subordinated debt securities, we pay interest only each quarter and the principal of the note at maturity. The subordinated debt securities are uncollaterized and do not require maintenance of minimum financial covenants. As of June 30, 2011, the balance of our Trust II subordinated debt was $25.8 million.

13. Credit Facilities

Our First Restated Credit Agreement with The Frost National Bank dated January 27, 2006 was most recently amended effective March 21, 2011 to increase the revolving commitment to $15.0 million from $5.0 million. This amendment further revised various affirmative and negative covenants. We pay interest on the outstanding balance at our election at a rate of the prime rate or LIBOR plus 2.5%. We pay an annual fee of 0.25% of the average daily unused balance of the credit facility. We pay letter of credit fees at the rate of 1.00% per annum. Our obligations under the revolving credit facility are secured by a security interest in the capital stock of all of our subsidiaries, guarantees of all of our subsidiaries and the pledge of all of our non-insurance company assets. The revolving credit facility contains covenants that, among other things, require us to maintain certain financial and operating ratios and restrict certain distributions, transactions and organizational changes. As of June 30, 2011, we were in compliance with or had obtained waivers of all of our covenants. As of June 30, 2011, we had $2.8 million outstanding under this facility.

14. Deferred Policy Acquisition Costs

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2011	2010	2011	2010
Deferred	$ (13,269)	$ (11,842)	$ (28,828)	$ (27,697)
Amortized	12,165	11,304	26,460	25,753
Net	$ (1,104)	$ (538)	$ (2,368)	$ (1,944)

15. Earnings per Share

The following table sets forth basic and diluted weighted average shares outstanding for the periods indicated (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2011	2010	2011	2010
Weighted average shares - basic	20,033	20,124	20,078	20,122
Effect of dilutive securities	7	132	14	52
Weighted average shares - assuming dilution	20,040	20,256	20,092	20,174

For the three months and six months ended June 30, 2011, 939,166 shares of common stock potentially issuable upon the exercise of employee stock options were excluded from the weighted average number of shares outstanding on a diluted basis because the effect of such options would be anti-dilutive. For the three months and six months ended June 30, 2010, 899,166 shares of common stock potentially issuable upon the exercise of employee stock options were excluded from the weighted average number of shares outstanding on a diluted basis because the effect of such options would be anti-dilutive.

16. Net Periodic Pension Cost

The following table details the net periodic pension cost incurred by period (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2011	2010	2011	2010
Interest cost	$ 153	$ 163	$ 305	$ 325
Amortization of net loss	71	56	143	112
Expected return on plan assets	(147)	(137)	(295)	(273)
Net periodic pension cost	$ 77	$ 82	$ 153	$ 164

We contributed $126 thousand and $220 thousand to our frozen defined benefit cash balance plan (“Cash Balance Plan”) during the three and six months ended June 30, 2011. We contributed $94 thousand to the Cash Balance Plan during the three and six months ended June 30, 2010. Refer to Note 14 to the consolidated financial statements in our Annual Report on Form 10-K for the year ended December 31, 2010 for more discussion of our retirement plans.

17. Income Taxes

Our effective income tax rate for the six months ended June 30, 2011 was 46.2%, which varied from the statutory income tax rate primarily as a result of the tax benefit from our tax exempt income increasing the tax benefit from our pre-tax loss. Our effective income tax rate for the six months ended June 30, 2010 was 24.6%, which varied from the statutory income tax rate utilized primarily due to the increase in the tax exempt income relative to lower pre-tax income and the recognition of a tax benefit related to the disposal of certain securities.

18. Commitments and Contingencies

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

We disagree with the Comptroller and intend to vigorously fight their assertion that TGA is liable for the surplus lines premium taxes. At this stage, we cannot predict the course of any proceedings, the timing of any rulings or other significant events relating to such surplus lines tax audit. Given these limitations and the inherent difficulty of projecting the outcome of regulatory disputes, we are presently unable to reasonably estimate the possible loss or legal costs that are likely to arise out of the surplus lines tax audit or any future proceedings relating to this matter.

We are engaged in other legal proceedings in the ordinary course of business, none of which, either individually or in the aggregate, are believed likely to have a material adverse effect on our consolidated financial position or results of operations, in the opinion of management. The various legal proceedings to which we are a party are routine in nature and incidental to our business.

19. Subsequent Events

On July 1, 2011 AHIC, a wholly-owned subsidiary of the Company, completed the acquisition of TBIC Holding Corporation, Inc. (“TBIC Holding”). TBIC Holding has two wholly-owned subsidiaries, Texas Builders Insurance Company (“TBIC”) and TBIC Risk Management, Inc. (“TBICRM”). TBIC is a Texas domiciled workers’ compensation insurance carrier. TBICRM provides risk management services to customers of TBIC.

AHIC acquired TBIC Holding for initial consideration of $1.6 million paid in cash on July 1, 2011, from working capital. The base purchase price is subject to certain post-closing adjustments. In addition, a holdback purchase price of up to $0.4 million may become payable following four full calendar quarters after closing and a contingent purchase price of up to $3.0 million may become payable following 16 full calendar quarters after closing, in each case based upon a formula contained in the acquisition agreement.

The terms of our property catastrophe reinsurance were amended effective July 1, 2011. We now retain the first $6.0 million of property catastrophe losses and our reinsurers reimburse us 100% for any loss in excess of our $6.0 million retention up to $34.0 million for each catastrophic occurrence, subject to an aggregate limit of $54.0 million.

On July 6, 2011 the Company borrowed $1.25 million under our credit facility with The Frost National Bank. The proceeds were used to repurchase the Company’s common stock under the Company’s stock buy back program.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

The following discussion should be read together with our consolidated financial statements and the notes thereto. This discussion contains forward-looking statements. Please see "Risks Associated with Forward-Looking Statements in this Form 10-Q" for a discussion of some of the uncertainties, risks and assumptions associated with these statements.

Introduction

Hallmark Financial Services, Inc. ("Hallmark" and, together with subsidiaries, "we," "us" or "our") is an insurance holding company that, through its subsidiaries, engages in the sale of property/casualty insurance products to businesses and individuals. Our business involves marketing, distributing, underwriting and servicing commercial insurance, personal insurance and general aviation insurance, as well as providing other insurance related services. Our business is geographically concentrated in the south central and northwest regions of the United States, except for our General Aviation and Excess & Umbrella business which is written on a national basis. We pursue our business activities through subsidiaries whose operations are organized into six business units, which are supported by our insurance company subsidiaries.

Our non-carrier insurance activities are segregated by business units into the following reportable segments:

- Standard Commercial Segment. Our Standard Commercial Segment includes the standard lines commercial property/casualty insurance products and services handled by our Standard Commercial business unit and the workers compensation insurance products handled by our Workers Comp business unit.

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

- Personal Segment. Our Personal Segment includes the non-standard personal automobile insurance, low value dwelling/homeowners, renters, motorcycle and business auto insurance products and services handled by our Personal Lines business unit.

The retained premium produced by our business units is supported by the following insurance company subsidiaries:

- American Hallmark Insurance Company of Texas ("AHIC") presently retains a portion of the risks on the commercial property/casualty and workers compensation policies marketed within the Standard Commercial Segment, retains a portion of the risks on personal policies marketed within the Personal Segment and retains a portion of the risks on the commercial, medical professional liability, aviation and satellite launch property/casualty policies marketed within the Specialty Commercial Segment.

- Hallmark Specialty Insurance Company ("HSIC") presently retains a portion of the risks on the commercial property/casualty and medical professional liability policies marketed within the Specialty Commercial Segment.

- Hallmark Insurance Company ("HIC") presently retains a portion of the risks on both the personal policies marketed within the Personal Segment and the commercial and aviation property/casualty products marketed within the Specialty Commercial Segment.

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

- Hallmark County Mutual Insurance Company ("HCM") control and management is maintained through our wholly owned subsidiary CYR Insurance Management Company ("CYR"). CYR has as its primary asset a management agreement with HCM, which provides for CYR to have management and control of HCM. HCM is used to front certain lines of business in our Specialty Commercial and Personal Segments in Texas. HCM does not retain any business.

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

AHIC, HSIC, HIC, HNIC have entered into a pooling arrangement pursuant to which AHIC retains 32.5% of our total net premiums written by all of our business units, HIC retains 34.4% of our total net premiums written, HSIC retains 27.6% of our total net premiums written and HNIC retains 5.5% of our total net premiums written. Prior to January 1, 2011, AHIC retained 46.0%, HIC retained 34.1% and HSIC retained 19.9% of our total net premiums written by all of our business units. This pooling arrangement has no impact on our consolidated financial statements reported in accordance with GAAP.

Results of Operations

Management Overview During the three and six months ended June 30, 2011, our total revenues were $78.5 million and $155.9 million, representing a 4% and 3% increase, respectively, from the $75.7 million and $151.5 million in total revenues for the same period of 2010. This increase in revenue was primarily attributable to increased earned premium due to increased production by our Personal Lines and E&S Commercial business units, increased net investment income and reduced adverse profit sharing commission revenue adjustments. These increases in revenue were partially offset by lower earned premium in our Standard Commercial Segment due to increased competition and continued soft market conditions.

We reported a $23 thousand net loss attributable to Hallmark for the three months ended June 30, 2011 as compared to $0.4 million net loss attributable to Hallmark for the same period during 2010. We reported a net loss attributable to Hallmark of $11.2 million for the six months ended June 30, 2011, which was $17.1 million lower than the $5.9 million net income reported for the six months ended June 30, 2010. On a diluted basis per share, we reported a net loss of $0.00 per share for the three months ended June 30, 2011, as compared to net loss of $0.02 per share for the same period in 2010. On a diluted basis per share, net loss per share was $0.56 for the six months ended June 30, 2011 as compared to net income per share of $0.29 for the same period during 2010. The increase in revenue for the three months and six months ended June 30, 2011 was offset by increased loss and loss adjustment expenses ("LAE") due primarily to higher current accident year loss estimates, as well as unfavorable prior year loss development of $0.7 million and $15.8 million recognized during the three and six months ended June 30, 2011, respectively, as compared to $4.3 million and $6.5 million recognized during the three and six months ended June 30, 2010. Of the $15.8 million unfavorable development recognized for the six months ended June 30, 2011, $9.5 million was a result of adverse prior year loss reserve development in our Personal Lines Segment in Florida. In addition, the results for the six months ended June 30, 2011 include $9.4 million in net losses from weather related claims. The adverse prior year development and the losses from the weather related claims contributed 17.7% to the 88.7% consolidated net loss ratio for the six months ended June 30, 2011. As a result of the pre-tax loss and an increase in the proportion of tax-exempt income relative to total pre-tax loss, the Company reported an income tax benefit of $9.6 million, or an effective income tax rate of 46.2%, for the six months ended June 30, 2011, as compared to income tax expense of $1.9 million, or an effective rate of 24.6%, for the same period during 2010.

Second Quarter 2011 as Compared to Second Quarter 2010

The following is additional business segment information for the three months ended June 30, 2011 and 2010 (in thousands):

Hallmark Financial Services, Inc
Consolidated Segment Data

	Three Months Ended June 30, 2011				
	Standard Commercial Segment	Specialty Commercial Segment	Personal Segment	Corporate	Consolidated
Produced premium (1)	$18,549	$47,343	$24,284	$-	$ 90,176
Gross premiums written	18,549	48,533	24,289	-	91,371
Ceded premiums written	(1,392)	(10,877)	(146)	-	(12,415)
Net premiums written	17,157	37,656	24,143	-	78,956
Change in unearned premiums	(1,796)	(5,171)	(411)	-	(7,378)
Net premiums earned	15,361	32,485	23,732	-	71,578
Total revenues	16,241	34,476	25,869	1,927	78,513
Losses and loss adjustment expenses	15,789	23,549	22,582	-	61,920
Pre-tax income (loss), net of non-controlling interest	(4,753)	873	(4,596)	(776)	(9,252)
Net loss ratio (2)	102.8%	72.5%	95.2%		86.5%
Net expense ratio (2)	33.9%	30.4%	27.6%		31.8%
Net combined ratio (2)	136.7%	102.9%	122.8%		118.3%

	Three Months Ended June 30, 2010				
	Standard Commercial Segment	Specialty Commercial Segment	Personal Segment	Corporate	Consolidated
Produced premium (1)	$18,804	$40,351	$22,613	$-	$ 81,768
Gross premiums written	18,792	41,775	22,613	-	83,180
Ceded premiums written	(909)	(9,123)	(15)	-	(10,047)
Net premiums written	17,883	32,652	22,598	-	73,133
Change in unearned premiums	(1,246)	(2,036)	97	-	(3,185)
Net premiums earned	16,637	30,616	22,695	-	69,948
Total revenues	17,265	32,124	24,754	1,544	75,687
Losses and loss adjustment expenses	13,652	21,231	17,175	-	52,058

Pre-tax income (loss), net of non-controlling interest	(1,870)	967	1,132	(1,570)	(1,341)
Net loss ratio (2)	82.1 %	69.3 %	75.7 %		74.4 %
Net expense ratio (2)	32.5 %	29.5 %	22.5 %		30.1 %
Net combined ratio (2)	114.6 %	98.8 %	98.2 %		104.5 %

(1) Produced premium is a non-GAAP measurement that management uses to track total premium produced by our operations. Produced premium excludes unaffiliated third party premium fronted on our HCM & HNIC subsidiaries. We believe this is a useful tool for users of our financial statements to measure our premium production whether retained by our insurance company subsidiaries or assumed by third party insurance carriers who pay us commission revenue.

(2) The net loss ratio is calculated as incurred losses and LAE divided by net premiums earned, each determined in accordance with GAAP. The net expense ratio is calculated for our business units that retain 100% of produced premium as total operating expenses for the unit offset by agency fee income divided by net premiums earned, each determined in accordance with GAAP. For the business units that do not retain 100% of the produced premium, the net expense ratio is calculated as underwriting expenses of the insurance company subsidiaries for the unit offset by agency fee income, divided by net premiums earned, each determined in accordance with GAAP. Net combined ratio is calculated as the sum of the net loss ratio and the net expense ratio.

Standard Commercial Segment

Gross premiums written for the Standard Commercial Segment were $18.5 million for the three months ended June 30, 2011, which was $0.3 million, or 1%, less than the $18.8 million reported for the same period in 2010. Net premiums written were $17.2 million for the three months ended June 30, 2011 as compared to $17.9 million reported for the same period in 2010. The decrease in gross premium volume was predominately due to increased competition and continued soft market conditions.

Total revenue for the Standard Commercial Segment of $16.2 million for the three months ended June 30, 2011 was $1.1 million less than the $17.3 million reported during the same period in 2010. This 6% decrease in total revenue was mostly due to decreased net premiums earned of $1.3 million offset by a lower adverse profit share commission revenue adjustment of $0.2 million during the second quarter of 2011 compared to $0.6 million for the second quarter of 2010.

Our Standard Commercial Segment reported a pre-tax loss of $4.8 million for the three months ended June 30, 2011 as compared to a pre-tax loss of $1.9 million for the same period of 2010. This increase in pre-tax loss was primarily the result of higher loss and LAE of $2.1 million and the decreased revenue discussed above, partially offset by lower operating expenses of $0.3 million driven by lower production related expenses and professional services.

The Standard Commercial Segment reported a net loss ratio of 102.8% for the three months ended June 30, 2011 as compared to 82.1% for the same period of 2010. The gross loss ratio before reinsurance for the three months ended June 30, 2011 was 90.3% as compared to the 91.4% reported for the same period of 2010, in both cases as a result of higher than anticipated large property losses. The increase in the net loss ratio was also impacted by a reinsurance recoverable on a large property loss during the second quarter of 2010. A number of actions have been implemented during the second quarter of 2011 to mitigate the future impact of large property losses, including rate increases and underwriting restrictions on property driven accounts. During the three months ended June 30, 2011, the Standard Commercial Segment reported favorable loss reserve development of $0.8 million as compared to $1.1 million unfavorable loss development during the same period of 2010.

Specialty Commercial Segment

The $34.5 million of total revenue for the three months ended June 30, 2011 was $2.4 million higher than the $32.1 million reported by the Specialty Commercial Segment for the same period in 2010. This increase in revenue was primarily due to higher net premiums earned of $1.9 million largely from increased production in our E&S Commercial business unit and a new space risk program entered into during the first quarter of 2011 in which we can retain up to $2.0 million per risk for satellite launches. Further contributing to this increased revenue was higher net investment income of $0.2 million and a lower adverse profit sharing commission revenue adjustment of $22 thousand during the second quarter of 2011 as compared to an adverse $0.4 million profit sharing commission adjustment for the same period the prior year.

Pre-tax income for the Specialty Commercial Segment of $0.9 million for the second quarter of 2011 was $0.1 million lower than the $1.0 million reported for the same period in 2010. The decrease in pre-tax income was primarily due to higher loss and LAE expenses of $2.3 million and higher operating expenses of $0.3 million. The increase in operating expenses for the three months ended June 30, 2011 were the result of increased production related expenses of $0.2 million and increased other expenses of $0.1 million, primarily professional services. The higher operating expenses were offset by lower amortization of intangible assets of $0.1 million and the increased revenue discussed above.

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The Specialty Commercial Segment reported a net loss ratio of 72.5% for the three months ended June 30, 2011 as compared to 69.3% for the same period during 2010 as a result of higher current accident year loss trends predominately in our commercial auto lines of business. The loss and LAE during the second quarter of 2011 includes $49 thousand of favorable loss reserve development as compared to $2.5 million unfavorable development during the second quarter of 2010.

Personal Segment

Net premiums written for our Personal Segment increased $1.5 million during the second quarter of 2011 to $24.1 million compared to $22.6 million for the second quarter of 2010. The increase in premium was due mostly to the recent acquisition of HNIC partially offset by a reduction in premium written in Florida.

Total revenue for the Personal Segment increased 5.0% to $25.9 million for the second quarter of 2011 from $24.8 million for the second quarter of 2010. Higher earned premium of $1.0 million was the primary reason for the increase in revenue for the period. Increased investment income of $0.1 million further contributed to the increase in revenue during the second quarter of 2011.

Pre-tax loss for the Personal Segment was $4.6 million for the three months ended June 30, 2011 as compared to pre-tax income of $1.1 million for the same period of 2010. The pre-tax loss was driven by increased losses and LAE of $5.4 million, increased operating expenses of $1.3 million due mostly to increased production and salary and related expense and increased amortization of intangible assets of $0.1 million related to the acquisition of HNIC, partially offset by increased revenue discussed above.

The Personal Segment reported a net loss ratio of 95.2% for the three months ended June 30, 2011 as compared to 75.7% for the second quarter of 2010. The increase in the net loss ratio was primarily due to higher current accident year loss trends and claims developing much worse than anticipated due to rapid growth in the Florida claim volume and the complexity related to Florida personal injury protection claims. The net loss ratio for our Florida related business was 141.3% for the quarter ended June 30, 2011, which equates to approximately 13.4% of the net loss ratio reported as of June 30, 2011. During late 2010 and into 2011, a number of actions have been taken to address the issues in Florida. We have increased prices, changed policy renewal terms and suspended new business production, significantly increased our personal lines claims department capabilities and made other increases in our claims staffing, including experienced claims personnel in Florida. We expect that these actions will in time adjust our book of business back to profitable levels. The loss and LAE during the three months ended June 30, 2011 includes $1.5 million of adverse prior year development as compared to $0.7 million of adverse prior year development for the same period during 2010. The Personal Segment reported a net expense ratio of 27.6% for the three months ended June 30, 2011 as compared to 22.5% for the second quarter of 2010. The increase in the expense ratio is due predominately to increased production expenses related to the renewal and appointment of agents from our recent acquisition of HNIC and increased professional service fees.

Corporate

Total revenue for Corporate increased by $0.4 million for the three months ended June 30, 2011 as compared to the same period the prior year. This increase in total revenue was due to higher net investment income of $0.4 million for the three months ended June 30, 2011 as compared to the same period of the prior year.

Corporate pre-tax loss was $0.8 million for the three months ended June 30, 2011 as compared to $1.6 million pre-tax loss for the same period the prior year. The decrease in pre-tax loss was the result of the increased revenue discussed above and lower operating expenses of $0.4 million due mostly to a $0.2 million adjustment to the expected earn-out payable in conjunction with the acquisition of HNIC, lower salary and other related expenses of $0.1 million and lower professional fees of $0.1 million.

Six Months Ended June 30, 2011 as Compared to Six Months Ended June 30, 2010

The following is additional business segment information for the six months ended June 30, 2011 and 2010 (in thousands):

Hallmark Financial Services, Inc.
Consolidated Segment Data

	Six Months Ended June 30, 2011				
	Standard Commercial Segment	Specialty Commercial Segment	Personal Segment	Corporate	Consolidated
Produced premium (1)	$36,004	$85,877	$51,987	$-	$173,868
Gross premiums written	36,004	88,615	56,464	-	181,083
Ceded premiums written	(2,564)	(18,597)	(4,732)	-	(25,893)
Net premiums written	33,440	70,018	51,732	-	155,190
Change in unearned premiums	(2,187)	(6,318)	(4,994)	-	(13,499)
Net premiums earned	31,253	63,700	46,738	-	141,691
Total revenues	33,668	67,619	50,919	3,715	155,921
Losses and loss adjustment expenses	28,414	43,350	53,941	-	125,705
Pre-tax income (loss), net of non-controlling interest	(5,133)	4,331	(17,810)	(2,259)	(20,871)
Net loss ratio (2)	90.9%	68.1%	115.4%		88.7%
Net expense ratio (2)	32.6%	30.2%	25.8%		31.2%
Net combined ratio (2)	123.5%	98.3%	141.2%		119.9%

	Six Months Ended June 30, 2010				
	Standard Commercial Segment	Specialty Commercial Segment	Personal Segment	Corporate	Consolidated
Produced premium (1)	$36,901	$75,633	$49,744	$-	$162,278
Gross premiums written	36,889	78,406	49,744	-	165,039
Ceded premiums written	(1,945)	(17,147)	(19)	-	(19,111)
Net premiums written	34,944	61,259	49,725	-	145,928
Change in unearned premiums	(1,426)	80	(7,619)	-	(8,965)
Net premiums earned	33,518	61,339	42,106	-	136,963
Total revenues	35,299	64,611	45,968	5,632	151,510
Losses and loss adjustment expenses	27,268	37,627	30,261	-	95,156

Pre-tax income (loss), net of non-controlling interest	(2,809)	7,314	3,782	(452)	7,835
Net loss ratio (2)	81.4 %	61.3 %	71.9 %		69.5 %
Net expense ratio (2)	31.7 %	28.8 %	22.1 %		29.5 %
Net combined ratio (2)	113.1 %	90.1 %	94.0 %		99.0 %

(1) Produced premium is a non-GAAP measurement that management uses to track total premium produced by our operations. Produced premium excludes unaffiliated third party premium fronted on our HCM & HNIC subsidiaries. We believe this is a useful tool for users of our financial statements to measure our premium production whether retained by our insurance company subsidiaries or assumed by third party insurance carriers who pay us commission revenue.

(2) The net loss ratio is calculated as incurred losses and LAE divided by net premiums earned, each determined in accordance with GAAP. The net expense ratio is calculated for our business units that retain 100% of produced premium as total operating expenses for the unit offset by agency fee income divided by net premiums earned, each determined in accordance with GAAP. For the business units that do not retain 100% of the produced premium, the net expense ratio is calculated as underwriting expenses of the insurance company subsidiaries for the unit offset by agency fee income, divided by net premiums earned, each determined in accordance with GAAP. Net combined ratio is calculated as the sum of the net loss ratio and the net expense ratio.

Standard Commercial Segment

Gross premiums written for the Standard Commercial Segment were $36.0 million for the six months ended June 30, 2011, which was $0.9 million, or 2.0%, less than the $36.9 million reported for the same period in 2010. Net premiums written were $33.4 million for the six months ended June 30, 2011 as compared to $34.9 million reported for the same period in 2010. The decrease in gross premium volume was predominately due to increased competition and continued soft market conditions.

Total revenue for the Standard Commercial Segment of $33.7 million for the six months ended June 30, 2011 was $1.6 million less than the $35.3 million reported during the same period in 2010. This 5% decrease in total revenue was due to decreased net premiums earned of $2.3 million and lower investment income of $0.2 million, partially offset by favorable profit share revenue adjustments of $0.2 million for the six months ended June 30, 2011 as compared to an adverse adjustment of $0.6 million for the same period in 2010.

Our Standard Commercial Segment reported a pre-tax loss of $5.1 million for the six months ended June 30, 2011 as compared to pre-tax loss of $2.8 million for the same period of 2010. Higher loss and LAE expenses of $1.1 million, primarily as a result of weather related losses, and decreased revenue contributed to this pre-tax loss reported for the six months ended June 30, 2011. Partially offsetting the decline in results were lower operating expenses of $0.5 million primarily due to lower production related expenses.

The Standard Commercial Segment reported a net loss ratio of 90.9% for the six months ended June 30, 2011 as compared to 81.4% for the same period in 2010. The gross loss ratio before reinsurance for the six months ended June 30, 2011 was 92.3% as compared to the 84.7% reported for the same period of 2010. The higher gross and net loss ratio for the six months ended June 30, 2011 were mostly due to higher current accident year claim activity including winter storm related losses due primarily to freeze damage. The increase in the net loss ratio was also impacted by a reinsurance recoverable on a large property loss during 2010. During the six months ended June 30, 2011 the Standard Commercial Segment reported unfavorable loss reserve development of $0.5 million, as compared to unfavorable development of $3.3 million for the same period during 2010.

Specialty Commercial Segment

The $67.6 million of total revenue for the Specialty Commercial Segment during the six months ended June 30, 2011 was $3.0 million higher than the $64.6 million reported for the same period in 2010. This increase in revenue was due to higher net premiums earned of $2.4 million due predominately to increased production in our E&S Commercial business unit and a new space risk program entered into during the first quarter of 2011 in which we can retain up to $2.0 million per risk for satellite launches. Further contributing to this increased revenue was higher net investment income of $0.6 million and a lower adverse profit sharing commission adjustment of $56 thousand for the six months ended June 30, 2011 as compared to an adverse $0.2 million profit share commission adjustment for the same period the prior year, partially offset by lower finance charges of $0.1 million.

Pre-tax income for the Specialty Commercial Segment of $4.3 million for the first six months of 2011 was $3.0 million lower than the $7.3 million reported for the same period in 2010. The decrease in pre-tax income was primarily due to higher loss and LAE expenses of $5.7 million, partially offset by the increased revenue discussed above and lower amortization of intangible assets of $0.2 million. Further contributing to this decrease in pre-tax income for the first six months of 2011 were (i) increased production related expenses of $0.2 million, (ii) higher salary and related expense of $0.1 million, (iii) increased other expenses of $0.2 million, primarily professional services.

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The Specialty Commercial Segment reported a net loss ratio of 68.1% for the six months ended June 30, 2011 as compared to 61.3% for the same period during 2010. The higher net loss ratio was impacted by higher current accident year loss trends predominately in our commercial auto lines of business. The Specialty Commercial Segment reported $1.0 million of unfavorable prior year development for the six months ended June 30, 2011 as compared to $2.5 million of unfavorable development for the same period during 2010.

Personal Segment

Net premiums written for our Personal Segment increased $2.0 million during the first six months of 2011 to $51.7 million compared to $49.7 million for the first six months of 2010. The increase in premium was due mostly to the recent acquisition of HNIC partially offset by a reduction in premium written in Florida.

Total revenue for the Personal Segment increased 11% to $50.9 million for the first six months of 2011 from $46.0 million for the first six months of 2010. Higher earned premium of $4.6 million was the primary reason for the increase in revenue for the period. Increased net investment income of $0.2 million and increased finance charges of $0.1 million further contributed to the increase in revenue during the first six months of 2011.

Pre-tax loss for the Personal Segment was $17.8 million for the six months ended June 30, 2011 as compared to pre-tax income of $3.8 million for the same period of 2010. Increased revenue was offset by increased losses and LAE of $23.7 million, increased operating expenses of $2.6 million due mostly to increased production and salary and related expense, and increased amortization of intangible assets of $0.3 million related to the acquisition of HNIC.

The Personal Segment reported a net loss ratio of 115.4% for the six months ended June 30, 2011 as compared to 71.9% for the same period of 2010. The increase in the net loss ratio was primarily due to higher current accident year loss trends and claims developing much worse than anticipated due to rapid growth in the Florida claim volume and the complexity related to Florida personal injury protection claims. The net loss ratio for our Florida related business was 314.0% for the six months ended June 30, 2011, which equates to approximately 39.6% of the net loss ratio reported as of June 30, 2011. During late 2010 and into 2011, a number of actions have been taken to address the issues in Florida. We have increased prices, changed policy renewal terms and suspended new business production, significantly increased our personal lines claims department capabilities and made other increases in our claims staffing, including experienced claims personnel in Florida. We expect that these actions will in time adjust our book of business back to profitable levels. The loss and LAE during the six months ended June 30, 2011 includes $14.3 million of adverse prior year development as compared to $0.7 million of adverse prior year development for the same period during 2010. The Personal Segment reported a net expense ratio of 25.8% for the six months ended June 30, 2011 as compared to 22.1% for the same period of 2010. The increase in the expense ratio is due predominately to increased production expenses related to the renewal and appointment of agents from our recent acquisition of HNIC and increased professional service fees.

Corporate

Total revenue for Corporate decreased by $1.9 million for the six months ended June 30, 2011 as compared to the same period the prior year. This decrease in total revenue was due primarily to gains of $2.8 million recognized on our investment portfolio for the six months ended June 30, 2011 as compared to $5.4 million of gains recognized during the same period in 2010. This decrease in revenue was offset by higher net investment income of $0.7 million for the six months ended June 30, 2011 as compared to the same period of the prior year.

Corporate pre-tax loss was $2.3 million for the six months ended June 30, 2011 as compared to a $0.5 million pre-tax loss for the same period the prior year. The increase in pre-tax loss was the result of the decreased revenue discussed above.

Financial Condition and Liquidity

Sources and Uses of Funds

Our sources of funds are from insurance-related operations, financing activities and investing activities. Major sources of funds from operations include premiums collected (net of policy cancellations and premiums ceded), commissions, and processing and service fees. As a holding company, Hallmark is dependent on dividend payments and management fees from its subsidiaries to meet operating expenses and debt obligations. As of June 30, 2011, Hallmark had $6.8 million in unrestricted cash and invested assets at the holding company. Unrestricted cash and invested assets of our non-insurance subsidiaries were $7.9 million as of June 30, 2011. As of that date, our insurance subsidiaries held $36.2 million of cash and cash equivalents as well as $438.9 million in debt securities with an average modified duration of 2.8 years. Accordingly, we do not anticipate selling long-term debt instruments to meet any liquidity needs.

AHIC and TBIC, both domiciled in Texas, are limited in the payment of dividends to their stockholders in any 12-month period, without the prior written consent of the Texas Department of Insurance, to the greater of statutory net income for the prior calendar year or 10% of statutory policyholders' surplus as of the prior year end. Dividends may only be paid from unassigned surplus funds. HIC, domiciled in Arizona, is limited in the payment of dividends to the lesser of 10% of prior year policyholders' surplus or prior year's net investment income, without prior written approval from the Arizona Department of Insurance. HSIC, domiciled in Oklahoma, is limited in the payment of dividends to the greater of 10% of prior year policyholders' surplus or prior year's statutory net income, not including realized capital gains, without prior written approval from the Oklahoma Insurance Department. HNIC, domiciled in Ohio, is limited in the payment of dividends to the greater of 10% of statutory policyholders' surplus as of the prior December 31 or statutory net income as of the prior December 31 without prior written approval from the Ohio Insurance Department. During 2011, the aggregate ordinary dividend capacity of these subsidiaries is $20.0 million, of which $16.3 million is available to Hallmark. As a county mutual, dividends from HCM are payable to policyholders. None of our insurance company subsidiaries paid a dividend to Hallmark during the first six months of 2011 or the 2010 fiscal year.

Comparison of June 30, 2011 to December 31, 2010

On a consolidated basis, our cash and investments (excluding restricted cash) at June 30, 2011 were $489.8 million compared to $493.0 million at December 31, 2010.

Comparison of Six Months Ended June 30, 2011 and June 30, 2010

Net cash provided by our consolidated operating activities was $11.0 million for the first six months of 2011 compared to net cash provided by operating activities of $17.4 million for the first six months of 2010. The decrease in operating cash flow was primarily due to increased claim payments in our Personal Segment and weather related claim payments in our Standard Commercial Segment during the first six months of 2011, partially offset by higher premiums collected and a decrease in federal income tax payments due to the pre-tax loss reported during the first six months of 2011.

Net cash used in investing activities during the first six months of 2011was $15.7 million as compared to $54.4 million for the first six months of 2010. During the first six months of 2011 maturities, sales and redemptions of investment securities increased $93.8 million and transfers to restricted cash decreased $2.8 million, partially offset by (i) a $43.5 million increase in purchases of debt and equity securities, (ii) a $0.3 million increase in purchases of property and equipment, and (iii) a $14.0 million payment for the acquisition of HNIC during the first quarter 2011.

Cash used in financing activities during the first six months of 2011 was $5.0 million primarily related to the repurchase of the Company’s common stock during the second quarter of 2011.

Credit Facilities

Our First Restated Credit Agreement with The Frost National Bank dated January 27, 2006 was most recently amended effective March 21, 2011 to increase the revolving commitment to $15.0 million from $5.0 million. This amendment further revised various affirmative and negative covenants. We pay interest on the outstanding balance at our election at a rate of the prime rate or LIBOR plus 2.5%. We pay an annual fee of 0.25% of the average daily unused balance of the credit facility. We pay letter of credit fees at the rate of 1.00% per annum. Our obligations under the revolving credit facility are secured by a security interest in the capital stock of all of our subsidiaries, guarantees of all of our subsidiaries and the pledge of all of our non-insurance company assets. The revolving credit facility contains covenants that, among other things, require us to maintain certain financial and operating ratios and restrict certain distributions, transactions and organizational changes. As of June 30, 2011, we were in compliance with or had obtained waivers of all of our covenants. As of June 30, 2011, we had $2.8 million outstanding under this facility.

Trust Preferred Securities

On June 21, 2005, we entered into a trust preferred securities transaction pursuant to which we issued $30.9 million aggregate principal amount of subordinated debt securities due in 2035. To effect the transaction, we formed a Delaware statutory trust, Hallmark Statutory Trust I (“Trust I”). Trust I issued $30.0 million of preferred securities to investors and $0.9 million of common securities to us. Trust I used the proceeds from these issuances to purchase the subordinated debt securities. Our Trust I subordinated debt securities bear an initial interest rate of 7.725% until June 15, 2015, at which time interest will adjust quarterly to the three-month LIBOR rate plus 3.25 percentage points. Trust I pays dividends on its preferred securities at the same rate. Under the terms of our Trust I subordinated debt securities, we pay interest only each quarter and the principal of the note at maturity. The subordinated debt securities are uncollaterized and do not require maintenance of minimum financial covenants. As of June 30, 2011, the balance of our Trust I subordinated debt was $30.9 million.

On August 23, 2007, we entered into a trust preferred securities transaction pursuant to which we issued $25.8 million aggregate principal amount of subordinated debt securities due in 2037. To effect the transaction, we formed a Delaware statutory trust, Hallmark Statutory Trust II ("Trust II"). Trust II issued $25.0 million of preferred securities to investors and $0.8 million of common securities to us. Trust II used the proceeds from these issuances to purchase the subordinated debt securities. Our Trust II subordinated debt securities bear an initial interest rate of 8.28% until September 15, 2017, at which time interest will adjust quarterly to the three-month LIBOR rate plus 2.90 percentage points. Trust II pays dividends on its preferred securities at the same rate. Under the terms of our Trust II subordinated debt securities, we pay interest only each quarter and the principal of the note at maturity. The subordinated debt securities are uncollaterized and do not require maintenance of minimum financial covenants. As of June 30, 2011, the balance of our Trust II subordinated debt was $25.8 million.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

There have been no material changes to the market risks discussed in Item 7A of our Form 10-K for the fiscal year ended December 31, 2010.

Item 4. Controls and Procedures.

The principal executive officer and principal financial officer of Hallmark have evaluated our disclosure controls and procedures and have concluded that, as of the end of the period covered by this report, such disclosure controls and procedures were effective in ensuring that information required to be disclosed by us in the reports that we file or submit under the Securities Exchange Act of 1934 is timely recorded, processed, summarized and reported. The principal executive officer and principal financial officer also concluded that such disclosure controls and procedures were effective in ensuring that information required to be disclosed by us in the reports that we file or submit under such Act is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure. During the most recent fiscal quarter, there have been no changes in our internal controls over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Risks Associated with Forward-Looking Statements Included in this Form 10-Q

This Form 10-Q contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, which are intended to be covered by the safe harbors created thereby. These statements include the plans and objectives of management for future operations, including plans and objectives relating to future growth of our business activities and availability of funds. The forward-looking statements included herein are based on current expectations that involve numerous risks and uncertainties. Assumptions relating to the foregoing involve judgments with respect to, among other things, future economic, competitive and market conditions, regulatory framework, weather-related events and future business decisions, all of which are difficult or impossible to predict accurately and many of which are beyond our control. Although we believe that the assumptions underlying the forward-looking statements are reasonable, any of the assumptions could be inaccurate and, therefore, there can be no assurance that the forward-looking statements included in this Form 10-Q will prove to be accurate. In light of the significant uncertainties inherent in the forward-looking statements included herein, the inclusion of such information should not be regarded as a representation by us or any other person that our objectives and plans will be achieved.

PART II
OTHER INFORMATION

Item 1. Legal Proceedings.

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

We disagree with the Comptroller and intend to vigorously fight their assertion that TGA is liable for the surplus lines premium taxes. At this stage, we cannot predict the course of any proceedings, the timing of any rulings or other significant events relating to such surplus lines tax audit. Given these limitations and the inherent difficulty of projecting the outcome of regulatory disputes, we are presently unable to reasonably estimate the possible loss or legal costs that are likely to arise out of the surplus lines tax audit or any future proceedings relating to this matter.

We are engaged in other legal proceedings in the ordinary course of business, none of which, either individually or in the aggregate, are believed likely to have a material adverse effect on our consolidated financial position or results of operations, in the opinion of management. The various legal proceedings to which we are a party are routine in nature and incidental to our business.

Item 1A. Risk Factors.

There have been no material changes to the risk factors discussed in Item 1A of our Form 10-K for the fiscal year ended December 31, 2010.

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

Purchases of Equity Securities by the Issuer

The Company's stock buyback program was initially announced on April 18, 2008, to authorize the repurchase of up to 1,000,000 shares of our common stock in the open market or in privately negotiated transactions (the "Stock Repurchase Plan"). The first repurchases under the Stock Repurchase Plan were made during the third quarter of fiscal 2009 during which the Company repurchased 750,000 shares of our common stock. On January 24, 2011 the Company announced an increase in its authorization to repurchase of up to an additional 3,000,000 shares. The Stock Repurchase Plan does not have an expiration date.

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The following table furnishes information for purchases made pursuant to the Stock Repurchase Plan during the quarter ended June 30, 2011:

Period	Total Number of Shares Purchased	Average Price Paid Per Share	Cumulative Number of Shares Purchased as Part of Publicly Announced Plan	Maximum Number of Shares that May Yet Be Purchased Under the Plan
April 1- 30, 2011	-	-	750,000	3,250,000
May 1 - 31, 2011	29,933	$ 7.13	779,933	3,220,067
June 1 - 30, 2011	654,408	$ 7.18	1,434,341	2,565,659

Item 3. Defaults Upon Senior Securities.

None.

Item 4. (Removed and Reserved.)

Item 5. Other Information.

None.

Item 6. Exhibits.

The following exhibits are filed herewith or incorporated herein by reference:

Exhibit Number	Description
3(a)	Restated Articles of Incorporation of the registrant, as amended (incorporated by reference to Exhibit 3.1 to the registrant’s Registration Statement on Form S-1 [Registration No. 333-136414] filed September 8, 2006).
3(b)	Amended and Restated By-Laws of the registrant (incorporated by reference to Exhibit 3.1 to the registrant’s Current Report on Form 8-K filed October 1, 2007).
31(a)	Certification of principal executive officer required by Rule 13a-14(a) or Rule 15d-14(a).

Exhibit Number	Description
31(b)	Certification of principal financial officer required by Rule 13a-14(a) or Rule 15d-14(a).
32(a)	Certification of principal executive officer Pursuant to 18 U.S.C. 1350.
32(b)	Certification of principal financial officer Pursuant to 18 U.S.C. 1350.
101 INS	XBRL Instance Document (incorporated by reference to Exhibit 101 INS to the registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2011 originally filed August 9, 2011).
101 SCH	XBRL Taxonomy Extension Schema Document (incorporated by reference to Exhibit 101 SCH to the registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2011 originally filed August 9, 2011).
101 CAL	XBRL Taxonomy Extension Calculation Linkbase Document (incorporated by reference to Exhibit 101 CAL to the registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2011 originally filed August 9, 2011).
101 LAB	XBRL Taxonomy Extension Label Linkbase Document (incorporated by reference to Exhibit 101 LAB to the registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2011 originally filed August 9, 2011).
101 PRE	XBRL Taxonomy Extension Presentation Linkbase Document (incorporated by reference to Exhibit 101 PRE to the registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2011 originally filed August 9, 2011).
101 DEF	XBRL Taxonomy Extension Definition Linkbase Document (incorporated by reference to Exhibit 101 DEF to the registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2011 originally filed August 9, 2011).

SIGNATURES

In accordance with the requirements of the Exchange Act, the registrant has caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

HALLMARK FINANCIAL SERVICES, INC.
(Registrant)

Date: September 16, 2011

/s/ Mark J. Morrison
Mark J. Morrison, Chief Executive Officer and President

Date: September 16, 2011

/s/ Jeffrey R. Passmore
Jeffrey R. Passmore, Chief Accounting Officer and Senior Vice President