

Hallwood Group Inc  
Form 10-Q  
May 13, 2014  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON, D.C. 20549**

**FORM 10-Q**

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

**For the quarterly period ended March 31, 2014**

**OR**

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

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

**Commission file number: 1-8303**

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

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

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

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

**75219**  
**(Zip Code)**

**214-528-5588**

**(Registrant's telephone number, including area code)**

**Not Applicable**

**(Former name, former address and former fiscal year, if changed since last report)**

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company)

Smaller reporting company

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

**Class**  
Common Stock, \$0.10 par value per share

**Outstanding at April 30, 2014**  
1,525,166 shares



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**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**

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Table of Contents**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES****CONDENSED CONSOLIDATED BALANCE SHEETS**

(dollars in thousands)

(unaudited)

	March 31, 2014	December 31, 2013
<b>ASSETS</b>		
<b>Current Assets</b>		
Cash and cash equivalents	\$ 209	\$ 1,053
Accounts receivable, net		
Factors	11,931	13,730
Trade and other	4,376	3,264
Inventories	24,214	23,479
Deferred income tax	112	113
Prepays, deposits and other assets	579	724
Income taxes receivable / prepaid income taxes	361	77
	41,782	42,440
<b>Noncurrent Assets</b>		
Property, plant and equipment, net	19,311	19,580
Other assets	87	108
	19,398	19,688
<b>Total Assets</b>	<b>\$ 61,180</b>	<b>\$ 62,128</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
<b>Current Liabilities</b>		
Accounts payable	\$ 12,682	\$ 11,618
Accrued expenses and other current liabilities	4,023	4,196
Accounts payable related parties, net	978	752
	17,683	16,566
<b>Noncurrent Liabilities</b>		
Long term portion of loans payable (includes \$5,411 and \$5,411 to related parties as of March 31, 2014 and December 31, 2013, respectively)	9,336	6,586
Deferred income tax	187	187
	9,523	6,773

<b>Total Liabilities</b>	27,206	23,339
<b>Contingencies and Commitments (Note 11)</b>		
<b>Stockholders Equity</b>		
Common stock, issued 2,396,105 shares for both periods; outstanding 1,525,166 shares for both periods	240	240
Additional paid-in capital	51,700	51,700
Retained earnings (Accumulated deficit)	(4,562)	253
Treasury stock, 870,939 shares for both periods; at cost	(13,404)	(13,404)
<b>Total Stockholders Equity</b>	33,974	38,789
<b>Total Liabilities and Stockholders Equity</b>	\$ 61,180	\$ 62,128

See accompanying notes to condensed consolidated financial statements.

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

	<b>Three Months Ended March 31,</b>	
	<b>2014</b>	<b>2013</b>
<b>Revenues</b>		
Textile products sales	\$ 24,122	\$ 31,283
<b>Expenses</b>		
Textile products cost of sales	24,327	27,459
Administrative and selling expenses	4,677	4,968
	29,004	32,427
Operating loss	(4,882)	(1,144)
<b>Other Income (Expense)</b>		
Interest expense	(113)	(193)
Loss before income taxes	(4,995)	(1,337)
Income tax expense (benefit)	(180)	7
<b>Net Loss</b>	<b>\$ (4,815)</b>	<b>\$ (1,344)</b>
<b>Net Loss Per Common Share</b>		
Basic	\$ (3.16)	\$ (0.88)
Diluted	\$ (3.16)	\$ (0.88)
<b>Weighted Average Shares Outstanding</b>		
Basic	1,525	1,525
Diluted	1,525	1,525

See accompanying notes to condensed consolidated financial statements.

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**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**

**CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)**

(in thousands)

(unaudited)

	<b>Three Months Ended March 31,</b>	
	<b>2014</b>	<b>2013</b>
<b>Net Loss</b>	\$ (4,815)	\$ (1,344)
Other Comprehensive Income (Loss)		
None		
<b>Comprehensive Loss</b>	<b>\$ (4,815)</b>	<b>\$ (1,344)</b>

See accompanying notes to condensed consolidated financial statements.



Table of Contents**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS EQUITY**

(in thousands)

(unaudited)

	Common Stock		Additional	Retained	Treasury Stock	Total	
	Shares	Par Value	Paid-In Capital	(Accumulated Deficit)	Shares	Cost	Stockholders Equity
<b>Balance, January 1, 2014</b>	2,396	\$ 240	\$ 51,700	\$ 253	871	\$ (13,404)	\$ 38,789
Net loss				(4,815)			(4,815)
<b>Balance, March 31, 2014</b>	2,396	\$ 240	\$ 51,700	\$ (4,562)	871	\$ (13,404)	\$ 33,974

See accompanying notes to condensed consolidated financial statements.

Table of Contents**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(in thousands)

(unaudited)

	<b>Three Months Ended March 31,</b>	
	<b>2014</b>	<b>2013</b>
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net loss	\$ (4,815)	\$ (1,344)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation, amortization and impairment	610	600
Provision (recovery) for obsolete inventory	48	60
Provision (recovery) for doubtful accounts and factor dilution	(23)	(16)
Changes in assets and liabilities:		
(Increase) decrease in accounts receivable	710	(2,229)
Increase (decrease) in accounts payable	1,316	3,648
(Increase) decrease in inventories	(783)	1,681
Net change in income taxes receivable/payable	(283)	(33)
Increase (decrease) in accrued expenses and other current liabilities	53	247
Net change in other assets and liabilities	150	133
Net cash provided by (used in) operating activities	(3,017)	2,747
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Investments in property, plant and equipment	(577)	(415)
Net cash used in investing activities	(577)	(415)
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Proceeds from revolving credit facilities	10,975	12,965
Repayments of revolving credit facilities	(8,225)	(15,620)
Proceeds from loans payable		300
Repayments of loans payable		(79)
Net cash provided by (used in) financing activities	2,750	(2,434)
<b>DECREASE IN CASH AND CASH EQUIVALENTS</b>	(844)	(102)
<b>CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD</b>	1,053	193
<b>CASH AND CASH EQUIVALENTS, END OF PERIOD</b>	\$ 209	\$ 91

See accompanying notes to condensed consolidated financial statements.

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**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**Three months Ended March 31, 2014 and 2013**

**(unaudited)**

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

*Organization.* The Hallwood Group Incorporated (the Company) (NYSE MKT: HWG) was incorporated in Delaware in 1981 and operates as a holding company. The Company operates its principal business in the textile products industry through its wholly owned subsidiary, Brookwood Companies Incorporated ( Brookwood ). The consolidated financial statements include the accounts of the Company and its subsidiaries (collectively, Hallwood Group ).

*Interim Condensed Consolidated Financial Statements.* The interim condensed consolidated financial statements of Hallwood Group have been prepared in accordance with the instructions to Form 10-Q and do not include all of the information and disclosures required by accounting principles generally accepted in the United States of America. Although condensed, in the opinion of management, all adjustments (consisting only of normal recurring adjustments) considered necessary for a fair presentation have been included. These condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and related disclosures thereto included in Hallwood Group s annual report on Form 10-K for the year ended December 31, 2013.

*Textile Products.* Textile products operations are conducted through Brookwood. Brookwood is an integrated textile firm that develops and produces innovative fabrics and related products through specialized finishing, treating and coating processes. Brookwood has two principal subsidiaries at March 31, 2014:

Kenyon Industries, Inc. ( Kenyon ). Kenyon, located in Rhode Island, uses the latest technologies and processes in dyeing, finishing, coating and printing of woven synthetic products. Kenyon provides quality finishing services for fabrics used in a variety of markets, such as military, luggage and knapsacks, flag and banner, apparel, industrial and sailcloth.

Brookwood Laminating Inc. ( Brookwood Laminating ). Brookwood Laminating, located in Connecticut, uses the latest in processing technology to provide quality laminating services for fabrics used in military clothing and equipment, sailcloth, medical equipment, industrial applications and consumer apparel. Up to five layers of textile materials can be processed using both wet and dry lamination techniques.

Textile products operations accounts for all of Hallwood Group s operating revenues in 2014 and 2013. See Note 4 for additional information on Brookwood.

*Going Concern.* As described in this quarterly report on Form 10-Q and in the Company s annual report on Form 10-K for the year ended December 31, 2014, (i) as a holding company, the Company is dependent upon Brookwood for

cash, (ii) the Company does not currently have sufficient cash, either directly or through Brookwood, to fund its ongoing operating costs or obligations, including the HFL Loan, and (iii) Brookwood's ability to pay the Company a dividend or other advance is dependent upon circumstances that are outside of the Company's control. The Company can give no assurance that Brookwood will have the ability to satisfy the Company's cash flow needs, or that the Company would be able to obtain other sources of funding in such a circumstance (other than the HFL Loan, which was amended on March 26, 2014 to provide up to \$3,000,000 of liquidity in 2014), and therefore there is substantial doubt as to the Company's ability to continue as a going concern.

The Company's audited consolidated financial statements for the fiscal year ended December 31, 2013, as included in its annual report on Form 10-K, contained an audit opinion from its independent registered public accounting firm which includes explanatory language related to going concern resulting from the uncertainty of the payment of dividends from its subsidiary to fund the Company's ongoing operations and obligations.

*New Accounting Pronouncements.* Accounting standard-setting organizations frequently issue new or revised accounting rules. Hallwood Group regularly reviews new pronouncements to determine their impact, if any, on Hallwood Group's consolidated financial statements.

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**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**Three months Ended March 31, 2014 and 2013**

**(unaudited)**

In April 2014, the Financial Accounting Standards Board issued ASU 2014-08, Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity, which raises the threshold for a disposal to qualify as a discontinued operation and requires new disclosures of both discontinued operations and certain other disposals that do not meet the definition of a discontinued operation. For the Company, the guidance is effective for the interim and annual periods beginning December 29, 2014. The ASU is applied prospectively; however, early adoption is permitted for disposals (or classifications as held for sale) that have not been reported in financial statements previously issued or available for issue. The Company intends to early adopt this standard.

*Consolidation Policy.* The Company's Brookwood subsidiary operates on a 5-4-4 week accounting cycle with its months ending on a Saturday for accounting purposes, while the Company operates on a traditional fiscal month accounting cycle. For purposes of the year-end financial statements the Brookwood cycle always ends on December 31, however, its quarterly interim financial statements may not correspond to the fiscal quarter-end. Hallwood Group's condensed consolidated financial statements as of March 31, 2014 and 2013 include Brookwood's operations through March 29, 2014 and March 30, 2013, respectively. Estimated operating results of Brookwood for the intervening periods to March 31, 2014 and 2013, respectively, are provided below (in thousands):

	<b>Amounts in Intervening Periods</b>	
	<b>Three Months Ended March 31,</b>	
	<b>2014</b>	<b>2013</b>
	<b>(1 day)</b>	<b>(not applicable)</b>
Textile products sales	\$ 135	\$
Textile products costs of sales	132	
Administrative and selling expenses	20	

**Note 2 - Hallwood Financial Limited Proposal and Merger Agreement**

On November 6, 2012, the Company received a proposal (the "HFL Proposal") from Hallwood Financial Limited ("Parent" or "Hallwood Financial") to acquire all of the outstanding shares of the Company's common stock that Parent does not beneficially own at a cash purchase price of \$10.00 per share. Parent is controlled by Anthony J. Gumbiner, Chairman and Chief Executive Officer of the Company and Parent currently owns 1,001,575, or 65.7%, of the issued and outstanding shares of common stock, par value \$0.10 per share, of the Company (such outstanding shares, collectively, the "Company Common Stock," and, each, a "Share").

In November 2012, the board of directors of the Company (the "Board") formed a special committee (the "Special Committee"), consisting of three independent directors of the Company, to evaluate the Merger (as defined below) and

other alternatives available to the Company.

On June 4, 2013, the Company announced that the Company, Parent, and HFL Merger Corporation, a Delaware corporation and a wholly owned subsidiary of the Parent ( Merger Sub ), entered into an Agreement and Plan of Merger (as amended by the Amendment to Agreement and Plan of Merger, dated as of July 11, 2013, and the Second Amendment to Agreement and Plan of Merger, dated as of February 7, 2014, the Merger Agreement ). The Merger Agreement provides that, upon the terms and subject to the conditions set forth in the Merger Agreement, Merger Sub will merge with and into the Company (the Merger ), with the Company continuing as the surviving corporation and a wholly owned subsidiary of Parent. The Special Committee unanimously determined that the transactions contemplated by the Merger Agreement (as in effect on such date), including the Merger, are advisable and in the best interests of the Company and its stockholders (other than the persons and entities associated with Mr. Gumbiner), and unanimously recommended that the Board approve and declare advisable the Merger Agreement and the transactions contemplated thereby, including the Merger, and that the Company s stockholders vote for the adoption of the Merger Agreement (as in effect on such date). Based in part on that recommendation, the Board (other than Mr. Gumbiner, who did not participate due to his interest in the Merger) unanimously (i) determined that the transactions contemplated by the Merger Agreement, including the Merger, are advisable and in the best interests of the Company and its stockholders (other than the persons and entities associated with Mr. Gumbiner), (ii) approved and declared advisable the execution, delivery and performance of the Merger Agreement and the consummation of the transactions contemplated thereby, including the Merger and (iii) resolved to recommend that the Company s stockholders vote for the adoption of the Merger Agreement. Accordingly, the Board (without Mr. Gumbiner s participation) unanimously recommended that the stockholders of the Company adopt the Merger Agreement.

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**(unaudited)**

On August 23, 2013, Gary L. Sample ( Plaintiff ) filed a purported class and derivative action in the Court of Chancery of the State of Delaware (the Delaware Court ) against the parties to the Merger Agreement and certain directors and officers of the Company (collectively, the Defendants ), asserting, among other things, that the original Merger Consideration (as defined below) was unfair and did not reflect the true value of the Company and all of its assets (the Sample Litigation ).

On February 7, 2014, Plaintiff and the Defendants (together, the Parties ) entered into a Stipulation of Settlement (the Stipulation ), by and through their respective attorneys, whereby the Parties agreed that, in order to resolve the Sample Litigation, the parties to the Merger Agreement would, among other actions, amend the Merger Agreement to increase the Merger Consideration by \$3.00 per share, from \$10.00 per Share to \$13.00 per Share, less any incentive fee and attorneys fees awarded by the Delaware Court to Plaintiff and Plaintiff s counsel in accordance with the Stipulation (the Increased Merger Consideration ). The Defendants specifically deny that they have engaged in any wrongdoing, deny that they committed any violation of law, deny that they breached any fiduciary duties, and deny liability of any kind to Plaintiff, the Company, or its stockholders. The Increased Merger Consideration will be paid if the Merger is consummated pursuant to the terms of the Merger Agreement as amended by the Second Amendment to the Merger Agreement, which was entered into by the Company, Parent, and Merger Sub as of February 7, 2014 (the Second Amendment ). The Delaware Court approved the Stipulation on March 28, 2014.

Pursuant to the Merger Agreement, Merger Sub will merge with and into the Company, with the Company continuing as the surviving corporation and a wholly owned subsidiary of Parent, and each share of Common Stock outstanding immediately prior to the effective time of the Merger (other than certain excluded and dissenting shares of Common Stock) will be cancelled and converted into the right to receive \$12.39 in cash, without interest (the Merger Consideration ) based on the settlement of the Sample Litigation. The Sample Litigation is more fully described in Note 14. The following excluded and dissenting shares of Common Stock will not be entitled to the Merger Consideration: (i) shares held by Parent, Merger Sub, the Company or any wholly owned subsidiary of the Company or held in the Company s treasury and (ii) shares outstanding immediately prior to the effective time of the Merger held by a stockholder who has neither voted in favor of the Merger nor consented thereto in writing and who has demanded properly in writing appraisal for such shares and otherwise properly perfected and not withdrawn or lost the right to an appraisal of such dissenting shares pursuant to Section 262 of the General Corporation Law of the State of Delaware.

Consummation of the Merger is subject to certain other customary conditions, including, among others, (i) absence of any order or injunction prohibiting the consummation of the Merger, (ii) subject to certain exceptions, the accuracy of representations and warranties with respect to the business of the Company, (iii) each of the Company and Parent having performed their respective obligations pursuant to the Merger Agreement and (iv) the absence of a Company Material Adverse Effect, which is defined in the Merger Agreement to include the occurrence of an Event of Default under that certain Loan Agreement, dated as of March 30, 2012, among Branch Banking and Trust Company, Brookwood Companies Incorporated, the Company and the other signatories thereto, filed with the SEC as Exhibit



10.20 to the Company's Annual Report on Form 10-K for the year ended December 31, 2011.

The Company's stockholders will be asked to consider and vote on a proposal to adopt the Merger Agreement at a special meeting of stockholders on May 15, 2014. In connection therewith, the Company has filed with the SEC and furnished to the Company's stockholders a proxy statement and other relevant documents. Before making any voting decision, the Company's stockholders are urged to read the proxy statement in its entirety when it becomes available and any other documents to be filed with the SEC in connection with the proposed Merger or incorporated by reference into the proxy statement because those documents will contain important information about the proposed Merger and the parties to the Merger. The Company's stockholders will be able to obtain a free copy of documents filed with the SEC at the SEC's website at <http://www.sec.gov>. In addition, the Company's stockholders may obtain a free copy of the Company's filings with the SEC from the Company's website at <http://www.hallwood.com/hwg/SEC.php> or by directing a request to: The Hallwood Group Incorporated, 3710 Rawlins, Suite 1500, Dallas, TX 75219; Attention: Investor Relations; Phone: (214) 528-5588 or (800) 225-0135.

The foregoing information only describes certain terms of the Merger Agreement, as amended, and is not a complete description of all of the parties' rights and obligations under the Merger Agreement, as amended. For the complete terms, please read: (a) the Merger Agreement attached as Exhibit 2.1 to the Company's Current Report on Form 8-K filed with the SEC on June 5, 2013; (b) the Amendment to Agreement and Plan of Merger, dated as of July 11, 2013, included as Exhibit 2.1 to the Company's Current Report on Form 8-K filed with the SEC on July 12, 2013; and (c) the Second Amendment to Agreement and Plan of Merger, dated as of February 7, 2014, included as Exhibit 2.1 to the Company's Current Report on Form 8-K filed with the SEC on February 10, 2014.

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**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**Three months Ended March 31, 2014 and 2013**

**(unaudited)**

The Company's shares trade on the NYSE MKT stock exchange under the symbol of HWG and closed on November 5, 2012 (the day prior to the receipt of the HFL Proposal) at \$6.00 per share. The Company's shares closed on May 6, 2014 at \$12.29 per share.

**Note 3 - Inventories**

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

	<b>March 31, 2014</b>	<b>December 31, 2013</b>
Raw materials	\$ 6,144	\$ 6,088
Work in progress	6,435	5,459
Finished goods	11,635	11,932
Total	\$ 24,214	\$ 23,479

**Note 4 - Operations of Brookwood Companies Incorporated**

*Receivables.* Brookwood maintains factoring agreements with several factors, which provide that receivables resulting from credit sales to customers, excluding U.S. Government, may be assigned for collection to the factor, subject to a commission and the factor's prior approval. Factored receivables were \$11,931,000 and \$13,730,000 at March 31, 2014 and December 31, 2013, which were net of a returned goods dilution allowance of \$115,000 and \$126,000, respectively.

Brookwood monitors its factors and their ability to fulfill their obligations to Brookwood in a timely manner. As of May 13, 2014, all of Brookwood's factors were complying with payment terms in accordance with factor agreements.

Trade receivables were \$4,203,000 and \$2,994,000 at March 31, 2014 and December 31, 2013, which were net of an allowance for doubtful accounts of \$39,000 and \$51,000, respectively.

*Sales Concentration.* Sales to one Brookwood customer, Tennier Industries, Inc. (Tennier), accounted for more than 10% of Brookwood's sales during the first quarter of 2014 and during the year 2013. Brookwood's relationship with Tennier is ongoing. Sales to Tennier, which are included in military sales, were \$2,054,000 and \$6,951,000 in the

2014 and 2013 first quarter, respectively. Sales to Tennier represented 8.5% and 22.2% of Brookwood's net sales in the 2014 and 2013 first quarters, respectively.

Military sales accounted for \$9,993,000 and \$15,714,000 in the 2014 and 2013 first quarter periods, respectively. The military sales represented 41.4% and 50.2% of Brookwood's net sales in the 2014 and 2013 first quarters, respectively. Generally, military sales represent sales of a product to a customer (prime and sub-prime contractors) that will be incorporated into an end product that will be used to fulfill a U.S. or international military contract.

*Stockholders' Equity.* The Company is the holder of all of Brookwood's outstanding \$13,500,000 Series A, \$13.50 annual dividend per share, redeemable preferred stock and all of its 10,000,000 outstanding shares of common stock. The preferred stock has an aggregate liquidation preference of \$13,500,000 plus accrued but unpaid dividends. At March 31, 2014, cumulative dividends in arrears on the preferred stock totaled approximately \$911,000.

*2005 Long-Term Incentive Plan for Brookwood.* In December 2005, the Company adopted The Hallwood Group Incorporated 2005 Long-Term Incentive Plan for Brookwood Companies Incorporated ( 2005 Long-Term Incentive Plan for Brookwood ) to encourage employees of Brookwood to increase the value of Brookwood and to continue to be employed by Brookwood. The terms of the incentive plan provide for a total award amount to participants equal to 15% of the fair market value of consideration received by the Company in a change of control transaction, as defined, in excess of the sum of the liquidation preference plus accrued unpaid

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**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**Three months Ended March 31, 2014 and 2013**

**(unaudited)**

dividends on the Brookwood preferred stock (\$14,411,000 at March 31, 2014). The base amount will fluctuate in accordance with a formula that increases by the amount of the annual dividend on the preferred stock, currently \$1,823,000, and decreases by the amount of the actual preferred dividends paid by Brookwood to the Company. The plan generally defines a change of control transaction as a transaction approved by the Company's board of directors or by the holders of at least 50% of the voting capital stock of the Company that results in: (i) a change in beneficial ownership of the Company or Brookwood of 50% or more of the combined voting power, (ii) the sale of all or substantially all of the assets of Brookwood, or (iii) any other transaction that, in the Company's board of directors discretion, has substantially the same effect of item (i) or (ii). Certain transfers, generally among existing stockholders and their related parties, are exempted from the definition.

However, if the Company's board of directors determines that certain specified Brookwood officers, or other persons performing similar functions do not have, prior to the change of control transaction, in the aggregate an equity or debt interest of at least two percent in the entity with whom the change of control transaction is completed, then the minimum amount to be awarded under the plan shall be \$2,000,000. In addition, the Company agreed that, if members of Brookwood's senior management do not have, prior to a change of control transaction is completed in the aggregate an equity or debt interest of at least two percent in the entity with whom the change of control transaction (exclusive of any such interest any such individual receives with respect to his or her employment following the change of control transaction), then the Company will be obligated to pay an additional \$2,600,000. As of March 31, 2014, no amounts have been accrued or paid under the Long-Term Incentive Plan for Brookwood. The Merger will not constitute a change of control transaction under the plan.

**Note 5 - Loans Payable**

Loans payable at the balance sheet dates were as follows (in thousands):

	<b>March 31, 2014</b>	<b>December 31, 2013</b>
HFL Loan; due June 2015	\$ 5,411	\$ 5,411
Revolving Credit Facility; due March 2016	3,925	1,175
<b>Total</b>	<b>9,336</b>	<b>6,586</b>
Current portion		
Noncurrent portion	\$ 9,336	\$ 6,586

*Brookwood's Revolving Credit Facility.* On March 30, 2012, Brookwood and its subsidiaries entered into a loan agreement by and among Brookwood, its subsidiaries and Branch Banking and Trust Company ( BB&T ) (the Revolving Credit Facility ). The Revolving Credit Facility provided for borrowings of up to \$25,000,000 and is secured by a first lien on substantially all of the assets of Brookwood. The Revolving Credit Facility had a maturity date of March 30, 2014, however it was recently amended and restated as described below, extending the maturing date to March 30, 2016.

The interest rate on the Revolving Credit Facility was 2.66% and 1.165% at March 31, 2014 and December 31, 2013, respectively.

*Loan Covenants of the Revolving Credit Facility.* The Revolving Credit Facility, as amended, required Brookwood to satisfy certain financial covenants on the last day of each fiscal quarter. For each of the quarterly periods during 2013, Brookwood was in compliance with loan covenants of the Revolving Credit Facility.

*March 2014 amendment to Revolving Credit Facility.* On March 28, 2014, Brookwood and its subsidiaries executed an amended and restated credit agreement with BB&T (the Amended and Restated Credit Facility ). The Amended and Restated Credit Facility, which matures on March 30, 2016, allows for borrowings based generally on a percentage of eligible receivables with maximum borrowings of \$25 million. Interest rates are based on LIBOR plus a margin of between 1.50% and 2.50% based upon the fixed

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charge coverage ratio, as defined in the Amended and Restated Credit Facility. The Amended and Restated Credit Facility contains a minimum fixed charge coverage ratio covenant and a minimum excess availability covenant, each as defined in the Amended and Restated Credit Facility. The minimum fixed charge coverage ratio is 1.10 to 1.00 and will be measured quarterly beginning with the quarter ended September 30, 2014. The minimum excess availability covenant is measured monthly. In 2014, dividends and other distributions to Hallwood are limited to \$750,000 payable after September 30, 2014. In subsequent periods, Brookwood may make dividends and distributions to Hallwood as long as Brookwood is in compliance with both the minimum fixed charge coverage ratio and minimum excess availability covenants. While borrowings under the Amended and Restated Credit Facility are likely to be limited to amounts less than \$25 million, management believes that it will provide adequate liquidity for Brookwood through at least December 31, 2014. Should Brookwood, at its option, terminate its factoring relationship with BB&T, the Amended and Restated Credit Facility would also terminate. Brookwood management at this time has no intention of terminating its factoring relationship with BB&T during the term of the Amended and Restated Credit Facility. As of March 31, 2014, subject to the provisions of the Amended and Restated Credit Facility and borrowings of \$3,925,000, Brookwood had unused borrowing availability of approximately \$4.6 million under this credit facility. Brookwood was in compliance with loan covenants of the Amended and Restated Credit Facility as of March 31, 2014.

The terms of the Amended and Restated Credit Facility provide that the facility may be used for refinancing existing indebtedness, providing for working capital and financing ongoing operations and capital expenditures.

The Amended and Restated Credit Facility contains customary representations, warranties and affirmative covenants on behalf of Brookwood and also contains negative covenants which, among other things, prohibit Brookwood from any of the following (without obtaining prior BB&T written consent and with certain exceptions): (i) permitting liens (other than customary liens) to exist on any of its properties; (ii) incurring other debt other than accounts payable to trade creditors incurred in the ordinary course of business and factors; (iii) making capital expenditures in excess of \$5,000,000 in any year; (iv) purchasing substantially all of the assets of another entity; (v) entering into new leases except operating leases for machinery and equipment that do not in the aggregate require payments in excess of \$250,000 in any year and real estate leases in the ordinary course of business; (vi) paying dividends, or acquiring any of its stock, other than as described above in this section; (vii) making loans or advances to, or guaranties for the benefit of, any person; and (viii) disposing of its assets or properties except in the ordinary course of its business.

*Payments of Dividends.* Brookwood paid \$3,900,000 of dividends during 2013 to the Company, and as of May 13, 2014, Brookwood has not paid any dividends to the Company during 2014. In addition to the limitations described above in *March 2014 amendment to Revolving Credit Facility*, any future payments or advances would also be contingent upon the approval of Brookwood's board of directors and Brookwood's ability to meet the requirements of the Delaware corporate laws for the payment of dividends and compliance with other applicable laws and requirements.

*Restricted Net Assets.* Cash dividends and tax sharing payments by Brookwood to the Company are limited by the terms of the Amended and Restated Credit Facility and are contingent upon compliance with the loan covenants therein. This limitation on the transferability of assets constitutes a restriction of Brookwood's net assets, which were \$42,650,000 and \$45,033,000 at March 31, 2014 and December 31, 2013, respectively.

*HFL Loan.* In May 2012, to fund in part the payment of a judgment in a legal matter related to its investment in Hallwood Energy, L.P. ( Hallwood Energy ), the Company borrowed \$10,000,000 from Hallwood Family (BVI) L.P., a limited partnership associated with Mr. Anthony J. Gumbiner, the Company's chairman and principal stockholder (the HFL Loan ). The HFL Loan is secured by a subordinated pledge of all of the stock of Brookwood and by the Company's interest in the anticipated net refunds of federal income taxes, which were approximately \$4,300,000 that the Company received in 2013. In connection with the HFL Loan, a Pledge and Security Agreement and a Subordination and Intercreditor Agreement ( Intercreditor Agreement ) were entered into and effective May 9, 2012. The Intercreditor Agreement, among other things, subordinates any security interest or lien that Hallwood Family (BVI) L.P. may have in certain assets of the Company, including the stock of Brookwood, to BB&T. The HFL Loan bears interest at the rate of 6% per year, payable on a quarterly basis. The Company may prepay the HFL Loan at any time without penalty. The documents reflecting the HFL Loan contain representations, warranties and covenants that are typical for loans of this type.

On March 11, 2013, the promissory note associated with the HFL Loan was amended to primarily (i) extend the maturity date of the HFL Loan by two years until June 30, 2015 and (ii) provide for an additional advance of \$300,000 under the promissory note, resulting in a then outstanding balance of \$9,047,000.

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On May 13, 2013, the promissory note associated with the HFL Loan was amended, pursuant to a Second Amendment to Promissory Note, to convert it to a revolving credit facility, under certain conditions, to provide additional liquidity to the Company. The Company was advanced \$405,000 under HFL Loan's revolving credit facility in May 2013.

In late May 2013, the Company received a net refund of approximately \$4,300,000 from the IRS of 2010 federal taxes. The proceeds of these funds were used to pay \$4,000,000 towards principal and interest outstanding on the HFL Loan, with the balance retained for the Company's expenses and cash needs. As of December 31, 2013 and March 31, 2014, the outstanding balance of the HFL Loan was \$5,411,000.

On March 26, 2014, the promissory note associated with the HFL Loan was amended, pursuant to a Third Amendment to Promissory Note, to extend the revolving credit facility under certain conditions until December 31, 2014 to provide up to \$3,000,000 in funding for general and administrative expenses of the Company. Hallwood Family (BVI) L.P. will not have any obligation to advance any additional amounts to the Company on or after December 31, 2014.

The Company was advanced \$175,000 in April 2013 and \$200,000 in May 2014, prior to the filing of this Quarterly Report on Form 10-Q, under HFL Loan's revolving credit facility.

**Note 6 - Income Taxes**

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

	<b>Three Months Ended</b>	
	<b>March 31,</b>	
	<b>2014</b>	<b>2013</b>
Federal		
Current	\$	\$
Deferred		
Sub-total		
State		
Current	(180)	7
Deferred		
Sub-total	(180)	7



Total	\$ (180)	\$ 7
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The Company recorded no federal deferred tax benefit for the three months ended March 31, 2014 and 2013 since the deferred tax asset resulting from the estimated tax loss for the same periods in the amounts of \$1,637,000 and \$491,000, respectively was offset by a full valuation allowance.

The net deferred tax asset (liability) for the Company was (\$75,000) and (\$75,000) at March 31, 2014 and December 31, 2013, respectively.

At December 31, 2013, the deferred tax assets, before valuation allowance, was comprised principally of \$5,944,000 related to the anticipated carryforward of taxable losses; \$667,000 of tax credits; and offset by other deferred tax liabilities of \$315,000. The total valuation allowance at December 31, 2013 was \$6,371,000.

At March 31, 2014, the deferred tax assets, before valuation allowance, was comprised principally of \$7,581,000 related to the anticipated carryforward of taxable losses; \$667,000 of tax credits; and offset by other deferred tax liabilities of \$315,000. Due to continuing uncertainty related to taxable income to be reported in future periods (after consideration of historical results, current business trends, and other objectively verifiable information), the Company recorded an additional valuation allowance at March 31, 2014 in the amount of \$1,637,000 and continues to record a valuation allowance on all of its deferred tax assets at March 31, 2014. The total valuation allowance at March 31, 2014 was \$8,008,000.

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**Note 7 - Fair Value of Financial Instruments**

The following table summarizes the valuation of the Company's financial instruments based upon the inputs used to measure fair value in the three levels of the fair value hierarchy as of March 31, 2014 and December 31, 2013.

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

	<b>March 31, 2014</b>		
	<b>Level</b>	<b>Level</b>	<b>Level</b>
	<b>1</b>	<b>2</b>	<b>3</b>
Cash Equivalents			
Money market funds	\$ 2	\$	\$

	<b>December 31, 2013</b>		
	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>
	<b>1</b>	<b>2</b>	<b>3</b>
Cash Equivalents			
Money market funds	\$ 2	\$	\$

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

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

Management reviewed the carrying value of its loans payable in connection with interest rates currently available to the Company for borrowings with similar characteristics and maturities. Management determined that the estimated fair value of the loans payable (all of which are classified as Level 2) would be approximately \$9,336,000 and \$6,582,000 at March 31, 2014 and December 31, 2013, compared to the carrying value of \$9,336,000 and \$6,586,000,

respectively.

The fair value information presented as of March 31, 2014 and December 31, 2013 is based on pertinent information available to management. Although management is not aware of any factors that would significantly affect the estimated fair value amounts, such amounts have not been comprehensively revalued for purposes of these financial statements since that date and, therefore current estimates of fair value may differ significantly from the amounts presented herein.

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**Note 8 - Supplemental Disclosures to the Condensed Consolidated Statements of Cash Flows**

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

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

Description	Three months Ended March 31,	
	2014	2013
Accrued capital expenditures in accounts payable and accrued expenses:		
Amount at end of period	\$ 34	\$ 35

*Supplemental disclosures of cash payments:*

Income taxes paid (refunded)	\$ 104	\$ 44
Interest paid	14	61

**Note 9 - Computation of Income (Loss) Per Common Share**

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

Description	Three Months Ended March 31,	
	2014	2013
<b>Weighted Average Shares Outstanding</b>		
Basic and diluted	1,525	1,525

<b>Net Income (Loss)</b>		
Basic and diluted	\$ (4,815)	\$ (1,344)

No shares were excluded from the calculation of diluted earnings per share.

#### **Note 10 - Related Party Transactions**

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

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

	<b>Three Months Ended March 31,</b>	
	<b>2014</b>	<b>2013</b>
Consulting fees	\$ 249	\$ 249
Interest expense on HFL Loan	83	130
Office space and administrative services	57	70
Travel and other expenses	17	15
<b>Total</b>	<b>\$ 406</b>	<b>\$ 464</b>

In May 2012, to fund in part the payment of a judgment in a legal matter related to its investment in Hallwood Energy, the Company entered into the HFL Loan with Hallwood Family (BVI) L.P., a limited partnership associated with Mr. Gumbiner. The interest expense payable on the HFL Loan was \$357,000 and \$275,000 at March 31, 2014 and December 31, 2013 respectively. See Note 5 for more information.

In addition, from time to time, HIL and Mr. Gumbiner have performed services for certain affiliated entities that are not subsidiaries of the Company, for which they have received consulting fees, bonuses, stock options, profit interests or other forms of compensation and expenses. No such services were performed, or compensation earned, during 2014 or 2013. The Company recognizes a proportionate share of such compensation and expenses, based upon its ownership percentage in the affiliated entities, through the utilization of the equity method of accounting.

HIL and certain of its affiliates in which Mr. Gumbiner has an indirect financial interest share common offices, facilities and certain staff in the Company's Dallas office for which these companies reimburse the Company. Certain individuals employed by the Company, in addition to their services provided to the Company, perform services on behalf of the HIL-related affiliates. In addition, HIL utilizes some of the Dallas office space for purposes unrelated to the Company's business. The Company pays certain common general and administrative expenses for salaries, rent and other office expenses and charges the HIL-related companies an overhead reimbursement fee for the share of the expenses allocable to these companies. For the three months ended March 31, 2014 and 2013, these companies reimbursed the Company \$26,000 and \$30,000, respectively, for such expenses.

**Note 11 - Litigation, Contingencies and Commitments**

Reference is made to Note 15 to the consolidated financial statements contained in Hallwood Group's annual report on Form 10-K for the year ended December 31, 2013.

*Litigation.* From time to time, the Company, its subsidiaries, certain of its affiliates and others have been named as defendants in lawsuits relating to various transactions in which the Company or its affiliated entities participated. Although the Company does not believe that the results of any of these matters are likely to have a material adverse effect on its financial position, results of operations or cash flows, except as described below, it is possible that any of the matters could result in material liability. Hallwood Group has spent significant amounts in professional fees and other associated costs in connection with these matters, and it expenses professional fees and other costs associated with litigation matters as incurred.

In July 2007, Nextec Applications, Inc. filed *Nextec Applications, Inc. v. Brookwood Companies Incorporated and The Hallwood Group Incorporated* in the United States District Court for the Southern District of New York (SDNY No. CV 07-6901) claiming that Brookwood infringed five United States patents pertaining to internally-coated webs. In October 2007, the Company was dismissed from the lawsuit. Nextec later added additional patents to the lawsuit. After a number of motions, only two patents remained in the action and were being asserted against the process and machine for making defendants' Agility Storm-Tec X-Treme and Eclipse Storm-Tec X-Treme fabrics, which constitute two levels of the Military's Extended Cold Weather Clothing System. Nextec was seeking a permanent injunction as well as damages in an amount to be determined at trial. After a five week trial that

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ended on June 1, 2012, the Court ruled from the bench that, while Nextec's patents were valid, Brookwood had not infringed any of the patents in the lawsuit. On July 20, 2012, Nextec filed a motion requesting that the Court either correct/amend its finding of non-infringement or grant a new trial, which the Court subsequently denied. The Court's Order and Final Judgment was issued June 21, 2012. Nextec filed a notice of appeal and Brookwood a notice of cross-appeal. The United States Court of Appeals for the Federal Circuit heard oral argument on November 6, 2013. On November 18, 2013, the United States Court of Appeals for the Federal Circuit summarily affirmed the Southern District of New York's ruling that Brookwood did not infringe any of the patents belonging to Nextec. Nextec has not appealed the decision and the deadline for filing an appeal has expired. Separately, and prior to trial, Brookwood filed requests for reexamination by the United States Patent and Trademark Office of the remaining patent claims at issue in the litigation. The United States Patent and Trademark Office granted the reexamination requests and issued first office actions rejecting all the reexamined patent claims as unpatentable over the prior art of record. With respect to one of the patents, the Patent Office has since received Nextec's responsive arguments and subsequently issued a reexamination certificate. With respect to the second patent, the Patent Office has since received Nextec's responsive arguments and has issued a final rejection to that patent. Nextec has appealed this rejection.

On April 5, 2013, Nextec filed *Nextec Applications, Inc. v. United States* in the U.S. Court of Federal Claims under 28 U.S.C. §1498(a). In that suit, Nextec initially asserted that the United States was liable for infringement of six Nextec patents arising out of the Government's acceptance, receipt, and/or use of military uniforms incorporating the same Brookwood fabrics at issue in the District Court litigation. Following a motion to dismiss filed by the United States Government, which the Court of Federal Claims denied, Nextec filed an Amended Complaint on January 21, 2014, asserting only three patents, U.S. Patent No. 5,004,643, U.S. Patent No. 5,869,172, and U.S. Patent No. 6,129,978. The U.S. Government moved to strike the Amended Complaint on the ground that it included U.S. Patent No. 5,869,172, a patent that the Government contended was dismissed as part of the Court's ruling on the motion to dismiss. On February 20, 2014, the Government filed a motion requesting that the Court notify Brookwood of the lawsuit and issue a notice allowing Brookwood to appear, if it desires, as an interested party. The Court granted the Government's motion to issue notice. Nextec then objected to Brookwood's inclusion as an interested third party. On March 19, 2014, the Court issued an order denying the Government's Motion to Strike and rejecting Nextec's objections to Brookwood's inclusion in the case. The March 19<sup>th</sup> order further directed the Government to file its answer to Nextec's amended complaint by April 17, 2014 and to notice, as a potentially interested party, ADS, Inc., the primary contractor to the United States in the military contract at issue. The Court further ordered that any third parties will need to file their answer to Nextec's amended complaint by May 2, 2014 and that the parties shall file a joint preliminary status report by May 19, 2014. The Government filed its Answer to the Amended Complaint on April 17, 2014, and ADS and Brookwood each filed their respective Answers to the Amended Complaint on May 2, 2014. The military contract referenced in Nextec's amended complaint contains the FAR 52.227-3 Patent Indemnity clause which may require ADS to indemnify the U.S. Government for any patent infringement arising under the contract. Brookwood, as ADS's subcontractor has accepted certain flow-down provisions, and may be required to indemnify ADS, Inc. for any potential patent infringement arising under the military contract. Separately, and prior to its notice in the case, Brookwood filed requests for *ex parte* reexaminations by the United States Patent and



Trademark Office ( Patent Office ) of claims from the remaining patents at issue in the case. With respect to U.S. Patent No. 5,004,643, Brookwood has filed for an *inter partes review* proceeding ( IPR ) as well before the Patent Office, which will determine the validity of the 643 patent within 18 months. The three reexaminations and the IPR are currently pending before the Patent Office. The Patent Office has since issued final rejections for claims involved in the 643 and the 978 *ex parte* reexaminations; Nextec will have until June 11, 2014 and June 3, 2014, respectively, to appeal these rejections.

*Stockholders Lawsuit.* On August 23, 2013, a complaint was filed in the Delaware Court of Chancery (the Delaware Court ) captioned *Sample v. Gumbiner et al., Civil Action No. 8833-VCN*. The action named as defendants the directors of the Company, and also named as defendants Parent and Merger Sub. The Company is also named as a defendant, or in the alternative, as a nominal defendant.

In part, the action purported to be a class action of the Company s stockholders brought by a single individual stockholder challenging the Merger. The plaintiff alleged that all defendants other than Merger Sub breached fiduciary duties to those stockholders in connection with the proposed Merger as a consequence of an allegedly unfair merger process and an allegedly unfair merger price. The complaint also alleged that Merger Sub aided and abetted these claimed breaches of fiduciary duty.

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In part, the action also purported to be a derivative action brought on behalf of the Company against Mr. Gumbiner and Charles A. Crocco, Jr., based on various matters relating to the investment by the Company in Hallwood Energy in 2008, various related transactions engaged in by the Company or employees, executives, or advisors to the Company, a dividend declared by the Company in 2008, and Hallwood Energy's Chapter 11 bankruptcy court proceeding. The complaint alleges that Mr. Gumbiner and Mr. Crocco engaged in wrongful conduct and/or breached fiduciary duties with respect to these matters and should be held liable to the Company. The complaint further alleged that the \$10.00 per share offered in the Merger was unfair and did not reflect the true value of the Company and all of its assets, including potential claims against Mr. Gumbiner, other Company executives and advisors.

The plaintiff sought an order from the Delaware Court (i) certifying the action as a class action, (ii) finding that the defendants other than Merger Sub breached fiduciary duties to the plaintiff and the class, and that Merger Sub aided and abetted those breaches, (iii) finding that those breaches have proximately caused the plaintiff and the class damage in an amount subject to proof at trial, (iv) awarding the plaintiff and the class any damages that are proven at trial, (v) alternatively, finding that the action is properly brought as a derivative action and that demand of the Board is excused as to the claims asserted, (vi) alternatively, awarding the company such damages are proven at trial with respect to the derivative action, (vii) awarding the plaintiff its costs and expenses in connection with this action, including expert and attorney's fees, and (viii) awarding such further and other relief as the Delaware Court deems just and appropriate.

On February 7, 2014, the plaintiff and the defendants in the Sample Litigation (together, the Parties) entered into the Stipulation, by and through their respective attorneys, whereby the Parties agreed that, in order to resolve the Sample Litigation, the parties to the Merger Agreement would, among other actions, amend the Merger Agreement to increase the Merger Consideration by \$3.00 per share, from \$10.00 per share to \$13.00 per share, less a proportionate deduction for any incentive fee and attorneys' fees that may be awarded by the Delaware Court to the plaintiff and the plaintiff's counsel in accordance with the Stipulation. The plaintiff further sought an award of attorney's fees based on the Company's supplemental disclosures, but an award by the Delaware Court of attorney's fees based on supplemental disclosures will not affect the Merger Consideration. The defendants specifically deny that they have engaged in any wrongdoing, deny that they committed any violation of law, deny that they breached any fiduciary duties, and deny liability of any kind to the plaintiff, the Company, or its stockholders. The increased Merger Consideration will be paid if the Merger is consummated pursuant to the terms of the Merger Agreement as amended by the Second Amendment.

On March 28, 2014, the Delaware Court approved the Settlement, including an incentive fee of \$10,000 and attorney's fees of \$310,000, which is deducted from the \$13.00 per share consideration agreed in the Second Amendment, with a final Merger Consideration of \$12.39 per share. The Delaware Court reserved decision on plaintiff's request for an award of attorneys' fees in connection with the supplemental disclosures, but this reservation will not impact the Merger Consideration. All known and unknown claims against the defendants relating to the Sample Litigation, the Merger, the Settlement, and investments in securities issued by the Company between November 6, 2012 and the date

of the Merger, including derivative claims, have been released pursuant to the Delaware Court's approval of the Settlement.

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

The Company's Brookwood subsidiary is subject to a number of environmental laws, regulations, licenses and permits and has ongoing discussions with environmental regulatory authorities, including the U.S. Environmental Protection Agency (the EPA), the Rhode Island Department of Environmental Management (RIDEM), and the Connecticut Department of Energy and Environmental Protection (CTDEEP) on a number of matters, including compliance with wastewater discharge and treatment regulations, the control of chemicals used in the companies' coating operations that are classified as air pollutants, the presence of groundwater and soil contaminants at the companies' facilities, and hazardous waste management.

From time to time Brookwood and its subsidiaries have paid fines or penalties for alleged failure to comply with certain environmental requirements, which did not exceed \$10,000 in the aggregate during the three years ended December 31, 2013. In addition, Brookwood and its subsidiaries have entered into various settlements and agreements with the regulatory authorities.

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requiring the companies to perform certain tests, undertake certain studies, and install remedial facilities. Brookwood and its subsidiaries incurred capital expenditures to comply with environmental regulations of approximately \$421,000 in the year ended December 31, 2013, and \$1,000 during the three months ended March 31, 2014. In addition, Brookwood and its subsidiaries regularly incur expenses associated with various studies and tests to monitor and maintain compliance with diverse environmental requirements.

**Note 12 - Segments and Related Information**

The Company operates as a holding company with its principal business in the textile products industry through its Brookwood subsidiary. The following represents the Company's reportable amounts by business segment for the three months ended March 31, 2014 and 2013, respectively (in thousands):

	<b>Textile Products</b>	<b>Other</b>	<b>Consolidated</b>
<b>Three Months ended March 31, 2014</b>			
Total revenue from external sources	\$ 24,122	\$	\$ 24,122
Operating income (loss)	\$ (3,751)	\$ (1,131)	\$ (4,882)
Other income (expense), net	(30)	(83)	(113)
Income (loss) before income taxes	\$ (3,781)	\$ (1,214)	\$ (4,995)
<b>Three Months ended March 31, 2013</b>			
Total revenue from external sources	\$ 31,283	\$	\$ 31,283
Operating income (loss)	\$ 94	\$ (1,238)	\$ (1,144)
Other income (expense), net	(62)	(131)	(193)
Income (loss) before income taxes	\$ 32	\$ (1,369)	\$ (1,337)

No differences have occurred in the basis or methodologies used in the preparation of this interim segment information from those used in the annual report on Form 10-K for the year ended December 31, 2013. The total assets for Hallwood Group's operating segments have not materially changed since the December 31, 2013.



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This Quarterly Report on Form 10-Q (this Form 10-Q), including but not limited to the section of this Form 10-Q entitled Management's Discussion and Analysis of Financial Condition and Results of Operations, information concerning the Company's business prospects or future financial performance, anticipated revenues, expenses, profitability or other financial items, including the outcome of pending litigation, and its strategies, plans and objectives, together with other statements that are not historical facts, includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (the Securities Act), and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act). Forward-looking statements generally can be identified by the use of forward-looking terminology, such as may, might, will, would, expect, intend, could, should, anticipate, doubt or believe. The Company intends that all forward-looking statements be subject to the safe harbors created by these laws. All statements other than statements of historical information provided herein are forward-looking and may contain information about financial results, economic conditions, trends, and known uncertainties. All forward-looking statements are based on current expectations regarding important risk factors. Many of these risks and uncertainties are beyond the Company's ability to control, and, in many cases, the Company cannot predict all of the risks and uncertainties that could cause actual results to differ materially from those expressed in the forward-looking statements. Actual results could differ materially from those expressed in the forward-looking statements, and readers should not regard those statements as a representation by the Company or any other person that the results expressed in the statements will be achieved. Important risk factors that could cause results or events to differ from current expectations are described in the Company's annual report on Form 10-K for the year ended December 31, 2013 under Item 1A Risk Factors. These factors are not intended to be an all-encompassing list of risks and uncertainties that may affect the operations, performance, development and results of the Company's business. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. The Company undertakes no obligation to release publicly the results of any revisions to these forward-looking statements which may be made to reflect events or circumstances after the date hereof, including without limitation, changes in its business strategy or planned capital expenditures, growth plans, or to reflect the occurrence of unanticipated events, although other risks and uncertainties may be described, from time to time, in the Company's periodic reports and filings with the Securities and Exchange Commission (the SEC).

**Overview**

*General.* The Hallwood Group Incorporated (the Company) (NYSE MKT: HWG) was incorporated in Delaware in 1981 and operates as a holding company. The Company operates its principal business in the textile products industry through its wholly owned subsidiary, Brookwood Companies Incorporated ( Brookwood ). Information contained herein includes references to the Company and its subsidiaries (collectively, the Hallwood Group ).

*Going Concern.* As described in this quarterly report on Form 10-Q and in the Company's annual report on Form 10-K for the year ended December 31, 2013, (i) as a holding company, the Company is dependent upon Brookwood for cash, (ii) the Company does not currently have sufficient cash, either directly or through Brookwood, to fund its ongoing operating costs or obligations, including the HFL Loan, and (iii) Brookwood's ability to pay the Company a dividend or other advance is dependent upon circumstances that are outside of the Company's control. The Company can give no assurance that Brookwood will have the ability to satisfy the Company's cash flow needs, or that the

Company would be able to obtain other sources of funding if needed, and therefore there is substantial doubt as to the Company's ability to continue as a going concern.

The Company's audited consolidated financial statements for the fiscal year ended December 31, 2013, as included in its annual report on Form 10-K, contained an audit opinion from its independent registered public accounting firm which includes explanatory language related to going concern resulting from the uncertainty of the payment of dividends from its subsidiary to fund the Company's ongoing operations and obligations.

*Hallwood Financial Proposal and Merger Agreement* On November 6, 2012, the Company received a proposal (the HFL Proposal) from Hallwood Financial Limited (Parent or Hallwood Financial) to acquire all of the outstanding shares of the Company's common stock that Parent does not beneficially own at a cash purchase price of \$10.00 per share. Parent is controlled by Anthony J. Gumbiner, Chairman and Chief Executive Officer of the Company and Parent currently owns 1,001,575, or 65.7%, of the issued and outstanding shares of common stock, par value \$0.10 per share, of the Company (such outstanding shares, collectively, the Company Common Stock, and, each, a Share).

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In November 2012, the board of directors of the Company (the Board) formed a special committee (the Special Committee), consisting of three independent directors of the Company, to evaluate the Merger (as defined below) and other alternatives available to the Company.

On June 4, 2013, the Company announced that the Company, Parent, and HFL Merger Corporation, a Delaware corporation and a wholly owned subsidiary of the Parent (Merger Sub), entered into an Agreement and Plan of Merger (as amended by the Amendment to Agreement and Plan of Merger, dated as of July 11, 2013, and the Second Amendment to Agreement and Plan of Merger, dated as of February 7, 2014, the Merger Agreement). The Merger Agreement provides that, upon the terms and subject to the conditions set forth in the Merger Agreement, Merger Sub will merge with and into the Company (the Merger), with the Company continuing as the surviving corporation and a wholly owned subsidiary of Parent. The Special Committee unanimously determined that the transactions contemplated by the Merger Agreement (as in effect on such date), including the Merger, are advisable and in the best interests of the Company and its stockholders (other than the persons and entities associated with Mr. Gumbiner), and unanimously recommended that the Board approve and declare advisable the Merger Agreement and the transactions contemplated thereby, including the Merger, and that the Company's stockholders vote for the adoption of the Merger Agreement (as in effect on such date). Based in part on that recommendation, the Board (other than Mr. Gumbiner, who did not participate due to his interest in the Merger) unanimously (i) determined that the transactions contemplated by the Merger Agreement, including the Merger, are advisable and in the best interests of the Company and its stockholders (other than the persons and entities associated with Mr. Gumbiner), (ii) approved and declared advisable the execution, delivery and performance of the Merger Agreement and the consummation of the transactions contemplated thereby, including the Merger and (iii) resolved to recommend that the Company's stockholders vote for the adoption of the Merger Agreement. Accordingly, the Board (without Mr. Gumbiner's participation) unanimously recommended that the stockholders of the Company adopt the Merger Agreement.

On August 23, 2013, Gary L. Sample (Plaintiff) filed a purported class and derivative action in the Court of Chancery of the State of Delaware (the Delaware Court) against the parties to the Merger Agreement and certain directors and officers of the Company (collectively, the Defendants), asserting, among other things, that the original Merger Consideration (as defined below) was unfair and did not reflect the true value of the Company and all of its assets (the Sample Litigation).

On February 7, 2014, Plaintiff and the Defendants (together, the Parties) entered into a Stipulation of Settlement (the Stipulation), by and through their respective attorneys, whereby the Parties agreed that, in order to resolve the Sample Litigation, the parties to the Merger Agreement would, among other actions, amend the Merger Agreement to increase the Merger Consideration by \$3.00 per share, from \$10.00 per Share to \$13.00 per Share, less any incentive fee and attorneys' fees awarded by the Delaware Court to Plaintiff and Plaintiff's counsel in accordance with the Stipulation (the Increased Merger Consideration). The Defendants specifically deny that they have engaged in any wrongdoing, deny that they committed any violation of law, deny that they breached any fiduciary duties, and deny liability of any kind to Plaintiff, the Company, or its stockholders. The Increased Merger Consideration will be paid if the Merger is consummated pursuant to the terms of the Merger Agreement as amended by the Second Amendment to the Merger Agreement, which was entered into by the Company, Parent, and Merger Sub as of February 7, 2014 (the Second



Amendment ).

On March 25, 2014, the Delaware Court held a public hearing regarding the Settlement, during which it indicated its approval of the Settlement. On March 28, 2014, the Delaware Court entered a Final Order and Judgment approving the Settlement. The Delaware Court's order awarded a \$10,000 incentive fee to the plaintiff and \$310,000 in attorney's fees to the plaintiff's counsel. This means that the Merger Consideration will equal \$12.39 per share. In addition to awarding a \$10,000 incentive fee and \$310,000 in attorney's fees, the Delaware Court reserved judgment on a separate application for additional attorney's fees relating to disclosure by the Company of certain information, which resulted from the Settlement. The Company will not be responsible for payment of any such separate disclosure-based award of attorney's fees and, regardless of whether the Delaware Court grants such an award, the Merger Consideration will not decrease as a result. All known and unknown claims against the defendants relating to the Sample Litigation, the Merger, the Settlement, and investments in securities issued by the Company between November 6, 2012 and the date of the Merger, including derivative claims, have been released pursuant to the Delaware Court's approval of the Settlement.

Pursuant to the Merger Agreement, Merger Sub will merge with and into the Company, with the Company continuing as the surviving corporation and a wholly owned subsidiary of Parent, and each share of Common Stock outstanding immediately prior to the effective time of the Merger (other than certain excluded and dissenting shares of Common Stock) will be cancelled and converted into the right to receive \$12.39 in cash, without interest (the Merger Consideration ) based on the settlement of the

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Sample Litigation. The Sample Litigation is more fully described in Item 3 of our annual report on Form 10-K, Legal Proceedings. The following excluded and dissenting shares of Common Stock will not be entitled to the Merger Consideration: (i) shares held by Parent, Merger Sub, the Company or any wholly owned subsidiary of the Company or held in the Company's treasury and (ii) shares outstanding immediately prior to the effective time of the Merger held by a stockholder who has neither voted in favor of the Merger nor consented thereto in writing and who has demanded properly in writing appraisal for such shares and otherwise properly perfected and not withdrawn or lost the right to an appraisal of such dissenting shares pursuant to Section 262 of the General Corporation Law of the State of Delaware.

Consummation of the Merger is subject to certain other customary conditions, including, among others, (i) absence of any order or injunction prohibiting the consummation of the Merger, (ii) subject to certain exceptions, the accuracy of representations and warranties with respect to the business of the Company, (iii) each of the Company and Parent having performed their respective obligations pursuant to the Merger Agreement and (iv) the absence of a Company Material Adverse Effect, which is defined in the Merger Agreement to include the occurrence of an Event of Default under that certain Loan Agreement, dated as of March 30, 2012, among Branch Banking and Trust Company, Brookwood Companies Incorporated, the Company and the other signatories thereto, filed with the SEC as Exhibit 10.20 to the Company's Annual Report on Form 10-K for the year ended December 31, 2011.

The Company's stockholders will be asked to consider and vote on a proposal to adopt the Merger Agreement at a special meeting of stockholders on May 15, 2014. In connection therewith, the Company has filed with the SEC and furnished to the Company's stockholders a proxy statement and other relevant documents. Before making any voting decision, the Company's stockholders are urged to read the proxy statement in its entirety when it becomes available and any other documents to be filed with the SEC in connection with the proposed Merger or incorporated by reference into the proxy statement because those documents will contain important information about the proposed Merger and the parties to the Merger. The Company's stockholders will be able to obtain a free copy of documents filed with the SEC at the SEC's website at <http://www.sec.gov>. In addition, the Company's stockholders may obtain a free copy of the Company's filings with the SEC from the Company's website at <http://www.hallwood.com/hwg/SEC.php> or by directing a request to: The Hallwood Group Incorporated, 3710 Rawlins, Suite 1500, Dallas, TX 75219; Attention: Investor Relations; Phone: (214) 528-5588 or (800) 225-0135.

The foregoing information only describes certain terms of the Merger Agreement, as amended, and is not a complete description of all of the parties' rights and obligations under the Merger Agreement, as amended. For the complete terms, please read: (a) the Merger Agreement attached as Exhibit 2.1 to the Company's Current Report on Form 8-K filed with the SEC on June 5, 2013; (b) the Amendment to Agreement and Plan of Merger, dated as of July 11, 2013, included as Exhibit 2.1 to the Company's Current Report on Form 8-K filed with the SEC on July 12, 2013; and (c) the Second Amendment to Agreement and Plan of Merger, dated as of February 7, 2014, included as Exhibit 2.1 to the Company's Current Report on Form 8-K filed with the SEC on February 10, 2014.

The Company's shares trade on the NYSE MKT stock exchange under the symbol of HWG and closed on November 5, 2012 (the day prior to the receipt of the HFL Proposal) at \$6.00 per share. The Company's shares closed

on May 6, 2014 at \$12.29 per share.

*Textile Products.* In 2014 and 2013, Hallwood Group derived all of its operating revenues from the textile activities of its Brookwood subsidiary; consequently, the Company's success is highly dependent upon Brookwood's success. Brookwood's success will be influenced in varying degrees by its ability to continue sales to existing customers, costs, availability of supplies, its response to competition and its ability to generate new markets and products.

While Brookwood has enjoyed substantial revenues from its military business, there is no assurance that such revenues will continue. Brookwood's sales to the customers from whom it derives its military business have been volatile and difficult to predict, a trend management believes will continue. Generally, military sales represent sales of a product to a customer (prime and sub-prime contractors) that will be incorporated into an end product that will be used to fulfill a U.S. or international military contract. In recent years, orders from the military for goods generally were significantly affected by the increased activity of the U.S. military. As this activity changes, then orders from the military generally, including orders for Brookwood's products, may be similarly affected. Military sales of \$9,993,000 in the 2014 first quarter were 36.4% lower than the comparable period in 2013 of \$15,714,000. Orders were weak in the fourth quarter of 2013 and through much of the first quarter of 2014 but have improved in March and into the second quarter of 2014 through the date of this quarterly report on Form 10-Q. We believe the reduction of sales and orders described is due at least in part to a reduction of deployed troops and continued debate in congress and the administration regarding federal spending and we are unable to know if the recent improvement in orders will continue. If such conditions persist, orders from the military, including orders for Brookwood's products, may experience further decline which could have a material adverse effect on Brookwood's operating results and financial condition.

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

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

Brookwood continues to identify new market niches. In addition to its existing products and proprietary technologies, Brookwood has developed advanced breathable, waterproof laminate and other materials, which have been well received by its customers. Continued development of these fabrics for military, industrial and consumer applications is a key element of Brookwood's business plan. The ongoing success of Brookwood is contingent on its ability to maintain its level of military business or expand its sales of its consumer and industrial product lines. While volatile, the significant opportunities for the military product line necessitate that it be a key focus of Brookwood's sales and marketing efforts; however, during this time of relative weakness of sales and orders of military products, Brookwood is aggressively seeking new customers and opportunities for our consumer and industrial product lines. There can be no assurance that the positive results of the past can be sustained or that competitors will not aggressively seek to replace products developed by Brookwood.

The textile products business is not interdependent with the Company's other business operations, if any. The Company does not guarantee the Brookwood bank facility and is not obligated to contribute additional capital. Conversely, Brookwood does not guarantee debts of the Company or any of the Company's other subsidiaries and is not obligated to make payments to the Company beyond amounts potentially due under the tax sharing agreement. In addition to the limitations described in Note 5 in the accompanying condensed consolidated financial statements, any future dividend payments or advances would also be contingent upon the approval of Brookwood's board of directors and Brookwood's ability to meet the requirements of the Delaware corporate laws for the payment of dividends and compliance with other applicable laws and requirements.

**Presentation**

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

### **Results of Operations**

Hallwood Group reported a net loss of \$4,815,000 for the 2014 first quarter, compared to a net loss of \$1,344,000 for the 2013 first quarter. Revenue was \$24,122,000 and \$31,283,000 for the 2014 and 2013 first quarters, respectively.

Hallwood Group had an operating income (loss) of \$(4,882,000) and \$(1,144,000) for the first quarter of 2014 and 2013, respectively. Brookwood had operating income (loss) of \$(3,751,000) and \$94,000 for the 2014 and 2013 first quarters, respectively; whereas the Company had an operating income (loss) of \$(1,131,000) and \$(1,238,000) for the 2014 and 2013 first quarters, respectively.

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Textile products sales of \$24,122,000 decreased by \$7,161,000, or 22.9%, in the 2014 first quarter, compared to \$31,283,000 in the 2013 first quarter. The decrease in 2014 was principally due to fluctuations in sales of specialty fabric to U.S. military contractors as a result of changes to orders from the military to Brookwood's customers. Military sales accounted for \$9,993,000 in the 2014 first quarter period, compared to \$15,714,000 in the 2013 first quarter. Military sales represented 41.4% and 50.2% of Brookwood's net sales in the 2014 and 2013 first quarters, respectively. Orders were weak in the fourth quarter of 2013 and through much of the first quarter of 2014 but have improved in March and into the second quarter of 2014 through the date of this quarterly report on Form 10-Q. We believe the reduction of sales and orders described is due at least in part to a reduction of deployed troops and continued debate in congress and the administration regarding federal spending and we are unable to know if the recent improvement in orders will continue. Generally, military sales represent sales of a product to a customer (prime and sub-prime contractors) that will be incorporated into an end product that will be used to fulfill a U.S. or international military contract.

Sales to one Brookwood customer, Tennier Industries, Inc. (Tennier), accounted for more than 10% of Brookwood's sales during the first quarter of 2013 and during the year 2013. Brookwood's relationship with Tennier is ongoing. Sales to Tennier, which are included in military sales, were \$2,054,000 in the 2014 first quarter compared to \$6,951,000 in the 2013 first quarter. Sales to Tennier in the first quarters of 2014 and 2013 represented 8.5% and 22.2%, respectively.

**Expenses**

Textile products cost of sales of \$24,327,000 for the 2014 first quarter decreased by \$3,132,000, or 11.4%, compared to \$27,459,000 in the 2013 first quarter. The 2014 decrease is primarily a result of the fluctuations in textile product sales, principally from variances in military sales, and changes in overall product mix in a quarter to quarter comparison. Cost of sales includes all costs associated with the manufacturing process, including but not limited to, materials, labor, utilities, royalties, depreciation on manufacturing equipment and all costs associated with the purchase, receipt and transportation of goods and materials to Brookwood's facilities, including inbound freight, purchasing and receiving costs, inspection costs, internal transfer costs and other costs of the distribution network. Brookwood believes that the reporting and composition of cost of sales and gross margin is comparable with similar companies in the textile converting and finishing industry.

The gross profit (loss) margin for the 2014 first quarter was (0.8)%, compared to 12.2% for the 2013 first quarter. The decrease in gross profit margin was attributed to varying levels of sales volume (principally a 36.4% reduction in military sales in the 2014 first quarter, as compared to the 2013 first quarter), changes in product mix, increased energy costs and a more competitive pricing environment, primarily in the military market.

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

	<b>Three Months Ended March 31,</b>	
	<b>2014</b>	<b>2013</b>
Brookwood Company	\$ 3,546	\$ 3,730
	1,131	1,238
<b>Total</b>	<b>\$ 4,677</b>	<b>\$ 4,968</b>

Brookwood's administrative and selling expenses of \$3,546,000 for the 2014 first quarter decreased by \$184,000, or 4.9% from the same period in 2013. Brookwood's administrative and selling expenses included items such as payroll, professional fees, sales commissions, marketing, rent, insurance and travel. Brookwood conducts research and development activities related to the exploration, development and production of innovative products and technologies. Research and development costs were approximately \$248,000 and \$169,000 for the 2014 and 2013 first quarters, respectively.

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The Company's administrative expenses decreased \$107,000, or 8.6%, for the 2014 first quarter, compared to the 2013 first quarter. The decrease was attributable to a reduction in certain professional fees.

**Other Income (Expense)**

Interest expense was comprised of the following (in thousands):

	<b>Three Months Ended March 31,</b>	
	<b>2014</b>	<b>2013</b>
Brookwood	\$ 30	\$ 62
Company	83	131
<b>Total</b>	<b>\$ 113</b>	<b>\$ 193</b>

Brookwood's interest expense principally relates to its revolving credit facility. The Company's interest expense substantially relates to the HFL Loan, which was entered into in May 2012.

**Income Taxes**

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

	<b>Three Months Ended March 31,</b>	
	<b>2014</b>	<b>2013</b>
Federal		
Current	\$	\$
Deferred		
Sub-total		
State		
Current	(180)	7
Deferred		
Sub-total	(180)	7



Total	\$ (180)	\$ 7
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The Company recorded no federal deferred tax benefit for the three months ended March 31, 2014 and 2013 since the deferred tax asset resulting from the estimated tax loss for the same periods in the amounts of \$1,637,000 and \$491,000, respectively was offset by a full valuation allowance.

The net deferred tax asset (liability) for the Company was (\$75,000) and (\$75,000) at March 31, 2014 and December 31, 2013, respectively.

At March 31, 2014, the deferred tax assets, before valuation allowance, was comprised principally of \$7,581,000 related to the anticipated carryforward of taxable losses; \$667,000 of tax credits; and offset by other deferred tax liabilities of \$315,000. Due to continuing uncertainty related to taxable income to be reported in future periods (after consideration of historical results, current business trends, and other objectively verifiable information), the Company recorded an additional valuation allowance at March 31, 2014 in the amount of \$1,637,000 and continues to record a valuation allowance on all of its deferred tax assets at March 31, 2014. The total valuation allowance at March 31, 2014 was \$8,008,000.

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There have been no changes to the critical accounting policies identified and set forth in Hallwood Group's annual report on Form 10-K for the year ended December 31, 2013.

**Related Party Transactions**

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

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

	<b>Three Months Ended</b>	
	<b>March 31,</b>	
	<b>2014</b>	<b>2013</b>
Consulting fees	\$ 249	\$ 249
Interest expense on HFL loan	83	130
Office space and administrative services	57	70
Travel and other expenses	17	15
<b>Total</b>	<b>\$ 406</b>	<b>\$ 464</b>

In May 2012, to fund in part the payment of a judgment in a legal matter related to its investment in Hallwood Energy, L.P., the Company entered into the HFL Loan with Hallwood Family (BVI) L.P., a limited partnership associated with Mr. Gumbiner. The interest expense payable on the HFL Loan was \$357,000 and \$275,000 at March 31, 2014 and December 31, 2013 respectively. See Note 5 for more information.

In addition, from time to time, HIL and Mr. Gumbiner have performed services for certain affiliated entities that are not subsidiaries of the Company, for which they have received consulting fees, bonuses, stock options, profit interests

or other forms of compensation and expenses. No such services were performed, or compensation earned, during 2014 or 2013. The Company recognizes a proportionate share of such compensation and expenses, based upon its ownership percentage in the affiliated entities, through the utilization of the equity method of accounting.

HIL and certain of its affiliates in which Mr. Gumbiner has an indirect financial interest share common offices, facilities and certain staff in the Company's Dallas office for which these companies reimburse the Company. Certain individuals employed by the Company, in addition to their services provided to the Company, perform services on behalf of the HIL-related affiliates. In addition, HIL utilizes some of the Dallas office space for purposes unrelated to the Company's business. The Company pays certain common general and administrative expenses for salaries, rent and other office expenses and charges the HIL-related companies an overhead reimbursement fee for the share of the expenses allocable to these companies. For the three months ended March 31, 2014 and 2013, these companies reimbursed the Company \$26,000 and \$30,000, respectively, for such expenses.

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Refer to Note 11 in the accompanying condensed consolidated financial statements for a discussion of litigation matters.

**Contractual Obligations and Commercial Commitments**

The Company and its subsidiaries have entered into various contractual obligations and commercial commitments in the ordinary course of conducting its business operations, which are provided below as of March 31, 2014 (in thousands):

	Payments Due During the Years Ending December 31,						Total
	2014*	2015	2016	2017	2018	Thereafter	
<b>Contractual Obligations</b>							
Revolving Credit Facility	\$	\$	\$ 3,925	\$	\$	\$	\$ 3,925
HFL Loan		5,411					5,411
Operating leases	562	583	212				1,357
<b>Total</b>	<b>\$ 562</b>	<b>\$ 5,994</b>	<b>\$ 4,137</b>	<b>\$</b>	<b>\$</b>	<b>\$</b>	<b>\$ 10,693</b>

\* For the nine months ending December 31, 2014.

Interest costs associated with Brookwood's Revolving Credit Facility, which bears interest at variable rates, are not a material component of the Company's consolidated expenses. Estimated interest payments, based on the principal balance as of March 31, 2014, average principal balances during 2014, and weighted average interest rates are approximately \$126,000 on an annual basis. Estimated interest payments associated with the Company's HFL Loan, based on the principal balance as of March 31, 2014, are approximately \$320,000 per year.

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

*2005 Long-Term Incentive Plan for Brookwood.* In December 2005, the Company adopted The Hallwood Group Incorporated 2005 Long-Term Incentive Plan for Brookwood Companies Incorporated ( 2005 Long-Term Incentive Plan for Brookwood ) to encourage employees of Brookwood to increase the value of Brookwood and to continue to be employed by Brookwood. The terms of the incentive plan provide for a total award amount to participants equal to 15% of the fair market value of consideration received by the Company in a change of control transaction, as defined, in excess of the sum of the liquidation preference plus accrued unpaid dividends on the Brookwood preferred stock

(\$14,411,000 at March 31, 2014). The base amount will fluctuate in accordance with a formula that increases by the amount of the annual dividend on the preferred stock, currently \$1,823,000, and decreases by the amount of the actual preferred dividends paid by Brookwood to the Company. The plan generally defines a change of control transaction as a transaction approved by the Company's board of directors or by the holders of at least 50% of the voting capital stock of the Company that results in: (i) a change in beneficial ownership of the Company or Brookwood of 50% or more of the combined voting power, (ii) the sale of all or substantially all of the assets of Brookwood, or (iii) any other transaction that, in the Company's board of directors discretion, has substantially the same effect of item (i) or (ii). Certain transfers, generally among existing stockholders and their related parties, are exempted from the definition.

However, if the Company's board of directors determines that certain specified Brookwood officers, or other persons performing similar functions do not have, prior to the change of control transaction, in the aggregate an equity or debt interest of at least two percent in the entity with whom the change of control transaction is completed, then the minimum amount to be awarded under the plan shall be \$2,000,000. In addition, the Company agreed that, if members of Brookwood's senior management do not have, prior to a change of control transaction is completed in the aggregate an equity or debt interest of at least two percent in the entity with whom the change of control transaction (exclusive of any such interest any such individual receives with respect to his or her employment following the change of control transaction), then the Company will be obligated to pay an additional \$2,600,000. As of March 31, 2014, no amounts have been accrued or paid under the Long-Term Incentive Plan for Brookwood. The Merger will not constitute a change of control transaction under the plan.

Table of Contents**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES****Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS****Off-Balance Sheet Arrangements**

Hallwood Group has no off-balance sheet arrangements.

**Financial Covenants**

*Brookwood.* The Revolving Credit Facility, as amended, required Brookwood to satisfy certain financial covenants on the last day of each fiscal quarter. For each of the quarterly periods during 2013, Brookwood was in compliance with loan covenants of the Revolving Credit Facility. The principal financial ratios required under Brookwood's Revolving Credit Facility were as follows:

Description	Requirement	Quarters Ended in 2013			
		Dec 31,	Sept 30,	June 30,	Mar 31,
Current ratio	must be greater than ratio of 1.40	2.67	2.60	2.62	2.54
Total liabilities to tangible net worth	must be less than ratio of 1.50	0.39	0.42	0.41	0.43
Total funded debt to EBITDA	must be less than ratio of 4.00	0.27	0.26	0.43	1.53

On March 28, 2014, Brookwood and its subsidiaries executed an amended and restated credit agreement with BB&T (the Amended and Restated Credit Facility). The Amended and Restated Credit Facility contains a minimum fixed charge coverage ratio covenant and a minimum excess availability covenant, each as defined in the Amended and Restated Credit Facility. The minimum fixed charge coverage ratio is 1.10 to 1.00 and will be measured quarterly beginning with the quarter ended September 30, 2014. The minimum excess availability covenant is measured monthly.

As of March 31, 2014, subject to the provisions of the Amended and Restated Credit Facility and borrowings of \$3,925,000, Brookwood had unused borrowing availability of approximately \$4.6 million under this credit facility. Brookwood was in compliance with loan covenants of the Amended and Restated Credit Facility as of March 31, 2014.

Pursuant to the March 2014 amendment, in order to maintain compliance with such covenants in the future, Brookwood may be required to limit aggregate borrowings under the Amended and Restated Credit Facility to less than \$25,000,000 at the end of each fiscal quarter. For more information about the Amended and Restated Credit Facility, see Note 5 in the accompanying condensed consolidated financial statements.

Cash dividends and tax sharing payments by Brookwood to the Company are limited by the terms of the Amended and Restated Credit Facility and are contingent upon compliance with the loan covenants therein. This limitation on the transferability of assets constitutes a restriction of Brookwood's net assets, which were \$42,650,000 and \$45,033,000 as of March 31, 2014 and December 31, 2013, respectively.

## **Liquidity and Capital Resources**

*General.* The Company, through its Brookwood subsidiary, principally operates in the textile products segment. Hallwood Group's cash position decreased by \$844,000 during the 2014 three month period to \$209,000 as of March 31, 2014. The principal source of cash in the 2014 three month period was \$2,750,000 of net borrowings of the Revolving Credit Facility, as amended in March 2014. The primary uses of cash were \$3,017,000 used by operating activities and \$577,000 for property, plant and equipment, principally at Brookwood. The amounts outstanding under the Amended and Restated Credit Facility and HFL Loan were \$3,925,000 and \$5,411,000, respectively, at March 31, 2014.

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**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**

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

As further discussed under Item 1A, Risk Factors of the Company's annual report on Form 10-K for the year ended December 31, 2013, (i) as a holding company, the Company is dependent upon Brookwood for cash, (ii) the Company does not currently earn sufficient cash, directly or through Brookwood, to fund its ongoing operating costs or obligations, including the HFL Loan, and (iii) Brookwood's ability to pay the Company a dividend or other advance is dependent upon circumstances that are outside of the Company's control. The Company can give no assurance that Brookwood will have the ability to satisfy the Company's cash flow needs, or that the Company would be able to obtain other sources of funding in such a circumstance (other than the HFL Loan, which was amended on March 26, 2014 to provide up to \$3,000,000 of liquidity in 2014), and therefore there is substantial doubt as to the Company's ability to continue as a going concern.

The Company's audited consolidated financial statements for the fiscal year ended December 31, 2013, included in the Company's annual report on Form 10-K, contains an audit report from its independent public accounting firm which included explanatory language related to going concern resulting from the uncertainty of the payment of dividends from its subsidiary to fund the Company's ongoing operations and obligations.

As a holding company, the Company is dependent on Brookwood to receive the cash necessary to fund its ongoing operations and its obligations. Brookwood paid \$3,900,000 of dividends during 2013 to the Company, and as of May 13, 2014, Brookwood has not paid any dividends to the Company during 2014. At March 31, 2014 and December 31, 2013, the Company had approximately \$155,000 and \$972,000, respectively, of cash and cash equivalents.

If for any reason Brookwood is unable to pay a cash dividend or other advance to the Company, the Company would be required to seek alternative sources of funding. The Company has not yet determined what, if any, sources would be available to it (other than the HFL Loan, which was amended on March 26, 2014 to provide up to \$3,000,000 of liquidity in 2014, and is discussed in Note 5 of the accompanying condensed consolidated financial statements), but will consider such alternatives as an additional or new facility or term loan and potential sales of assets or additional securities. No assurance can be given that any such additional sources of funding will be available to the Company, which could result in the Company not being able to continue as a going concern. Any failure to receive from Brookwood cash required by the Company could have a material adverse effect on the Company's financial position, results of operations and cash flows and could substantially impair the Company's ability to continue as a going concern. The consolidated financial statements have been prepared assuming the Company will continue as a going concern and do not include any adjustments that might result should the Company be unable to continue as a going concern.

The Company believes that it will satisfy its recurring and normal operating costs, or general and administrative expenses, for 2014 with its cash on hand and the funds available to the Company through the extension of the revolving credit facility associated with the HFL Loan. On March 28, 2014 Brookwood executed an Amended and Restated Credit Agreement, as defined and discussed Note 5 of the accompanying condensed consolidated financial statements. Although Brookwood expects to have sufficient borrowing capacity in 2014, dividends and other distributions to Hallwood in 2014 are limited to \$750,000 payable after September 30, 2014. In subsequent periods,



Brookwood may make dividends and distributions to Hallwood as long as Brookwood is in compliance with both the minimum fixed charge coverage ratio and minimum excess availability covenants.

The Company was advanced \$175,000 in April 2013 and \$200,000 in May 2014, prior to the filing of this Quarterly Report on Form 10-Q, under HFL Loan s revolving credit facility.

Additionally, any payment of a dividend or advance by Brookwood to the Company is dependent on a number of other factors including compliance with the loan covenants in Brookwood s Amended and Restated Credit Facility, as amended, with Branch Banking & Trust, the approval of Brookwood s board of directors, Brookwood s ability to meet the requirements of the Delaware corporate laws for payment of dividends, and compliance with other applicable laws and requirements. As a result, no assurance can be given that these amounts will be available when required.

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**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**

**Item 4. CONTROLS AND PROCEDURES**

**Disclosure Controls and Procedures**

Disclosure controls and procedures are designed to ensure that information required to be disclosed in the reports filed or submitted under the Securities Exchange Act of 1934, as amended, (the Exchange Act), is recorded, processed, summarized and reported within the time period specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed under the Exchange Act is accumulated and communicated to management, including the Chief Executive Officer and the Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

An evaluation was performed under the supervision and with the participation of the Company's management, including its Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of the end of the period covered by this quarterly report. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective as of the end of the period covered by this quarterly report.

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

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

**Table of Contents****THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES****PART II OTHER INFORMATION**

Item		
1	Legal Proceedings	
	Note 11 to the Company's condensed consolidated financial statements included within this quarterly report on Form 10-Q, is incorporated herein by reference.	
1A	Risk Factors	N/A
2	Unregistered Sales of Equity Securities and Use of Proceeds	None
3	Defaults upon Senior Securities	None
4	Mine Safety Disclosures	N/A
5	Other Information	None
6	Exhibits	
2.1	Second Amendment to Agreement and Plan of Merger, dated as of February 7, 2014, among Hallwood Financial Limited, HFL Merger Corporation, and the Company, is incorporated by reference to Exhibit 2.1 to the Company's current report on Form 8-K dated February 7, 2014, File No. 1-8303.	
10.1	Third Amendment of Promissory Note, dated as of March 26, 2014, by and among the Company and Hallwood Family (BVI), L.P., is incorporated by reference to Exhibit 10.28 to the Company's annual report on Form 10-K filed on March 31, 2014, File No. 1-8303.	
10.2	Amended and Restated Loan Agreement, dated as of March 28, 2014, by and among Branch Banking and Trust Company, Brookwood Companies Incorporated and certain of its subsidiaries, is incorporated by reference to Exhibit 10.29 to the Company's annual report on Form 10-K filed on March 31, 2014, File No. 1-8303.	
10.3	Amended and Restated Security Agreement, dated as of March 28, 2014, by and among Branch Banking and Trust Company, Brookwood Companies Incorporated and certain of its subsidiaries, is incorporated by reference to Exhibit 10.30 to the Company's annual report on Form 10-K filed on March 31, 2014, File No. 1-8303.	
31.1	Certification of the Chief Executive Officer, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.	
31.2	Certification of the Chief Financial Officer, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.	
32.1	Certification of Chief Executive Officer and Chief Financial Officer, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.	
101.INS	XBRL Instance Document	

101.SCH	XBRL Taxonomy Extension Schema
101.CAL	XBRL Taxonomy Extension Calculation Linkbase
101.DEF	XBRL Additional Taxonomy Extension Definition Linkbase
101.LAB	XBRL Taxonomy Extension Label Linkbase
101.PRE	XBRL Taxonomy Extension Presentation Linkbase

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**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES**

**SIGNATURE**

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

**THE HALLWOOD GROUP INCORPORATED**

Dated: May 13, 2014

By: /s/ Richard Kelley  
Richard Kelley  
Vice President Chief Financial Officer  
(Principal Financial and Accounting Officer)

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**Table of Contents****THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES****INDEX TO EXHIBITS**

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