HALLMARK FINANCIAL SERVICES INC
Form 10-Q
May 15, 2006

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

Securities Exchange Act of 1934

For the quarterly period ended March 31, 2006

Commission file number 0-16090

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

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

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

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes ___ No X

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: Common Stock, par value $.03 per share - 86,909,647 shares outstanding as of May 12, 2006.

PART I
FINANCIAL INFORMATION

Item 1. Financial Statements

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

ASSETS	March 31 2006	December 31 2005
	(unaudited)	(audited)
Investments:		
Debt securities, available-for-sale, at market value	$ 97,210	$ 79,360
Equity securities, available-for-sale, at market value	4,513	3,403
Short-term investments, available-for-sale, at market value	335	12,281
Total investments	102,058	95,044
Cash and cash equivalents	65,034	44,528
Restricted cash and investments	41,762	13,802
Premiums receivable	45,078	26,530
Accounts receivable	32,364	2,083
Prepaid reinsurance premium	1,314	767
Reinsurance recoverable	1,577	444
Deferred policy acquisition costs	11,091	9,164
Excess of cost over fair value of net assets acquired	31,781	4,836
Intangible assets	27,794	459
Deferred federal income taxes	-	3,992
Other assets	9,290	7,257
Total assets	$ 369,143	$ 208,906
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities:		
Notes payable	$ 48,968	$ 30,928
Note payable to related party	12,500	-
Convertible notes payable (net of $8,453 unamortized discount)	16,547	-
Structured settlements	23,804	-

Unpaid losses and loss adjustment expenses	43,672	26,321
Unearned premiums	57,853	36,027
Unearned revenue	11,184	4,055
Reinsurance balances payable	310	116
Accrued agent profit sharing	519	2,173
Accrued ceding commission payable	11,650	11,430
Pension liability	2,954	2,932
Deferred federal income taxes	6,081	-
Current federal income tax payable	2,220	300
Accounts payable and other accrued expenses	38,017	9,436
Total liabilities	276,279	123,718
Commitments and Contingencies		
Stockholders' equity:		
Common stock, $.03 par value (authorized 100,000,000 shares; issued 86,956,610 shares in 2006 and 86,856,610 shares in 2005)	2,609	2,606
Additional paid in capital	69,034	62,907
Retained earnings	24,715	22,289
Accumulated other comprehensive income (loss)	(3,417)	(2,597)
Treasury stock, at cost (46,963 shares in 2006 and 14,819 in 2005)	(77)	(17)
Total stockholders' equity	92,864	85,188
	$ 369,143	$ 208,906

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

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

	Three Months Ended March 31	
	2006	2005
Gross premiums written	$ 47,735	$ 10,634
Ceded premiums written	(1,956)	-
Net premiums written	45,779	10,634
Change in unearned premiums	(17,345)	(594)
Net premiums earned	28,434	10,040
Investment income, net of expenses	2,357	411
Realized loss	(83)	-
Finance charges	687	540
Commission and fees	12,264	4,812
Processing and service fees	857	1,634
Other income	4	8
Total revenues	44,520	17,445

Losses and loss adjustment expenses	16,690	6,026
Other operating costs and expenses	21,026	8,705
Interest expense	1,585	3
Interest expense from amortization of discount on convertible notes	1,117	-
Amortization of intangible asset	573	7
Total expenses	40,991	14,741
Income before tax	3,529	2,704
Income tax expense	1,103	889
Net income	$ 2,426	$ 1,815
Common stockholders net income per share:		
Basic	$ 0.02	$ 0.04
Diluted	$ 0.02	$ 0.04
Convertible noteholders net income per share:		
Basic	$ 0.02	n/a
Diluted	$ 0.02	n/a

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

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

	Three Months Ended March 31,	
	2006	2005
Common Stock		
Balance, beginning of period	$ 2,606	$ 1,106
Issuance of common stock upon option exercises	3	-
Balance, end of period	2,609	1,106
Additional Paid-In Capital		
Balance, beginning of period	62,907	19,647
Discount on convertible notes	6,032	-
Equity based compensation	24	9
Exercise of stock options	71	(16)
Balance, end of period	69,034	19,640
Retained Earnings		
Balance, beginning of period	22,289	13,103
Net income	2,426	1,815
Balance, end of period	24,715	14,918

Accumulated Other Comprehensive Income (Loss)		
Balance, beginning of period	(2,597)	(759)
Additional minimum pension liability, net of tax	-	30
Unrealized gains (losses) on securities, net of tax	(820)	(511)
Balance, end of period	(3,417)	(1,240)
Treasury Stock		
Balance, beginning of period	(17)	(441)
Acquisition of treasury shares	(100)	-
Exercise of stock options	40	29
Balance, end of period	(77)	(412)
Stockholders' Equity	$ 92,864	$ 34,012
Net income	$ 2,426	$ 1,815
Additional minimum pension liability, net of tax	-	30
Unrealized gains (losses) on securities, net of tax	(820)	(511)
Comprehensive Income	$ 1,606	$ 1,334

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

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

	Three Months Ended March 31	
	2006	2005
Cash flows from operating activities:		
Net income	$ 2,426	$ 1,815
Adjustments to reconcile net income to cash provided by (used in) operating activities:		
Depreciation and amortization expense	800	72
Interest expense related to amortization of discount on convertible notes	1,117	-
Deferred federal income tax expense	(1,756)	266
Realized loss on investments	83	-
Change in prepaid reinsurance premiums	(547)	-
Change in premiums receivable	(17,430)	(255)
Change in accounts receivable	(4,230)	1,103
Change in deferred policy acquisition costs	(1,927)	(372)
Change in unpaid losses and loss adjustment expenses	7,861	(443)
Change in unearned premiums	17,882	594
Change in unearned revenue	(2,230)	229
Change in accrued agent profit sharing	(1,654)	(1,417)
Change in reinsurance recoverable	(493)	1,146
Change in reinsurance balances payable	(455)	-
Change in current federal income tax payable/recoverable	1,033	(1,177)

Change in accrued ceding commission payable	220	(4)
Change in all other liabilities	7,906	(1,618)
Change in all other assets	976	(180)
Net cash provided by (used in) operating activities	9,582	(241)
Cash flows from investing activities:		
Purchases of property and equipment	(106)	(52)
Premium finance notes repaid, net of finance notes originated	(1,745)	-
Acquisition of subsidiaries, net of cash acquired	(25,964)	-
Change in restricted cash and investments	(25,138)	29
Purchases of debt and equity securities	(4,532)	(5,076)
Maturities and redemptions of investment securities	3,923	1
Net redemptions (purchases) of short-term investments	11,946	(1,297)
Net cash used in investing activities	(41,616)	(6,395)
Cash flows from financing activities:		
Proceeds from exercise of employee stock options	40	13
Proceeds from issuance of convertible debt	25,000	-
Proceeds from note payable to related party	12,500	-
Proceeds from revolving loan on credit facility	15,000	-
Net cash provided by financing activities	52,540	13
Increase (decrease) in cash and cash equivalents	20,506	(6,623)
Cash and cash equivalents at beginning of period	44,528	12,901
Cash and cash equivalents at end of period	$ 65,034	$ 6,278
Supplemental Cash Flow Information:		
Interest paid	$ 983	$ 3
Taxes paid	$ 1,800	$ 1,800

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

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

1. General

Hallmark Financial Services, Inc. ("Hallmark" and, together with subsidiaries, "we", "us", "our") is an insurance holding company engaged in the sale of property and casualty insurance products to businesses and individuals. Our business involves marketing and underwriting commercial insurance in Texas, New Mexico, Idaho, Oregon, Montana, Louisiana and Washington; marketing and underwriting non-standard personal automobile insurance in Texas, New Mexico and Arizona; marketing general aviation insurance in 44 states; claims administration; and other insurance related services. We pursue our business activities through subsidiaries whose operations are organized by producing companies into our Hallmark General Agency operating segment ("HGA Segment"), which includes the commercial insurance products and services handled by Hallmark General Agency, Inc.

("HGA") and Effective Claims Management, Inc.; our Texas General Agency operating segment ("TGA Segment"), which includes the commercial insurance products and services handled by Texas General Agency, Inc. ("TGA"), Pan American Acceptance Corporation ("PAAC") and TGA Special Risk, Inc. ("TGASRI"); our Phoenix General Agency operating segment ("PGA Segment"), which includes the non-standard personal automobile insurance products and services handled by American Hallmark General Agency, Inc. and Hallmark Claims Services, Inc. (both of which do business as Phoenix General Agency); and our aviation operating segment ("Aerospace Segment"), which includes the general aviation insurance products and services handled by Aerospace Holdings LLC ("Aerospace") and its wholly owned subsidiaries. The subsidiary companies in our TGA Segment and Aerospace Segment were all acquired effective January 1, 2006. The retained premium produced by our operating segments is supported by our insurance company subsidiaries: American Hallmark Insurance Company of Texas ("AHIC"); Phoenix Indemnity Insurance Company ("PIIC"); and Gulf States Insurance Company ("GSIC"), a wholly owned subsidiary of TGA which was acquired by Hallmark effective January 1, 2006.

2. Basis of Presentation

Our unaudited consolidated financial statements included herein have been prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") and include our accounts and the accounts of our subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation. Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to rules and regulations of the Securities and Exchange Commission ("SEC") for interim financial reporting. These financial statements should be read in conjunction with our audited financial statements for the year ended December 31, 2005 included in our Annual Report on Form 10-K filed with the SEC.

The interim financial data as of March 31, 2006 and 2005 is unaudited. However, in the opinion of management, the interim data includes all adjustments, consisting only of normal recurring adjustments, necessary for a fair statement of the results for the interim periods. The results of operations for the period ended March 31, 2006 are not necessarily indicative of the operating results to be expected for the full year.

Reclassification

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

Use of Estimates in the Preparation of the Financial Statements

Our preparation of financial statements in conformity with GAAP requires us to make estimates and assumptions that affect our reported amounts of assets and liabilities and our disclosure of contingent assets and liabilities at the date of our financial statements, as well as our reported amounts of revenues and expenses during the reporting period. Actual results could differ materially from those estimates.

Recently Issued Accounting Standards

In December 2002, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure" ("SFAS 148"). SFAS

148 amended FASB Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" ("SFAS 123") to provide alternative methods of transition for voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, SFAS 148 amended the disclosure requirements of SFAS 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. Effective January 1, 2003, we adopted the prospective method provisions of SFAS 148. Under the prospective method, we have applied the fair value based method of accounting for our stock-based payments for option grants after December 31, 2002.

In December 2004, FASB issued Statement of Financial Accounting Standards No. 123R "Share-Based Payment" ("SFAS 123R"), which revises SFAS 123 and supersedes Accounting Principles Board ("APB") Opinion No. 25 ("APB 25"). SFAS 123R eliminates an entity's ability to account for share-based payments using APB 25 and requires that all such transactions be accounted for using a fair value based method. In April 2005, the SEC deferred the effective date of SFAS 123R from the first interim or annual period beginning after June 15, 2005 to the next fiscal year beginning after June 15, 2005. We adopted SFAS 123R on January 1, 2006 using the modified-prospective transition method. Under the modified-prospective transition method, compensation cost recognized during the period should include compensation cost for all share-based payments granted to, but not yet vested as of January 1, 2006, based on grant date fair value estimates in accordance with the original provisions of SFAS 123 and compensation cost for all share-based payments granted after January 1, 2006 in accordance with SFAS 123R. Since we adopted the fair value method of SFAS 123 under the prospective method provision of SFAS 148 beginning January 1, 2003, we have a small amount of unvested share-based payments granted prior to January 1, 2003. During the first three months of 2006, we recognized approximately $3 thousand of additional compensation expense under SFAS 123R. SFAS 123R also requires the benefits of tax deductions in excess of recognized stock compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as previously required. (See Note 4, "Share-Based Payment Arrangements.")

Had compensation cost for all of our stock option grants under our stock compensation plans been determined based on fair value at the grant date in accordance with the fair value provisions of SFAS 123, our net income and earnings per share for the three months ended March 31, 2005 would have been the pro forma amounts indicated below. Actual results for the three months ended March 31, 2006 have been determined in accordance with the fair value provisions of SFAS 123R and, therefore, pro forma results for such period are not necessary.

(in thousands)	Three Months Ended March 31, 2005
Net income as reported	$ 1,815
Add: Stock-based compensation expenses included in reported net income, net of related tax effects	6
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(9)

Pro forma net income	$ 1,812
Earnings per share:	
Basic-as reported	$ 0.04
Basic-pro forma	$ 0.04
Diluted-as reported	$ 0.04
Diluted-pro forma	$ 0.04

3. Business Combinations

We account for business combinations using the purchase method of accounting. The cost of an acquired entity is allocated to the assets acquired (including identified intangible assets) and liabilities assumed based on their estimated fair values. The excess of the cost of an acquired entity over the net of the amounts assigned to assets acquired and liabilities assumed is an asset referred to as "excess of cost over net assets acquired" or "goodwill." Indirect and general expenses related to business combinations are expensed as incurred.

Effective January 1, 2006, we acquired all of the issued and outstanding capital stock of TGA and certain affiliated companies (collectively, the "TGA Group") for an aggregate cash purchase price of up to $45.6 million, consisting of unconditional consideration of $37.6 million and contingent consideration of $8.0 million. Of the unconditional consideration, $13.9 million was paid at closing and $14.3 million will be paid on or before January 1, 2007 and $9.5 million will be paid on or before January 1, 2008. The payment of any contingent consideration is conditioned on the sellers complying with certain restrictive covenants and TGA Group achieving certain operational objectives related to premium production and loss ratios. The contingent consideration, if any, will be payable on or before March 30, 2009, unless the sellers elect to defer payment until March 30 of any subsequent year in order to permit further development of the loss ratios. In addition to the purchase price, we will pay $2.0 million to the sellers in consideration of their compliance with certain restrictive covenants, including a covenant not to compete for a period of five years after closing. Of this additional amount, $750 thousand was paid at closing, $750 thousand will be paid on or before January 1, 2007 and $500 thousand will be paid on or before January 1, 2008.

TGA is a managing general agency involved in the marketing, underwriting and servicing of property and casualty insurance products, with a particular emphasis on commercial automobile and general liability risks produced on an excess and surplus lines basis. The other affiliated companies in the TGA Group are TGA's wholly owned insurance subsidiary, GSIC, which reinsures a portion of the business written by TGA; TGASRI, which brokers mobile home insurance; and PAAC, which finances premiums on property and casualty insurance products marketed by TGA and TGASRI. The acquisition is expected to significantly expand the scope of our insurance marketing operations and provide opportunities for increased underwriting by our insurance company subsidiaries. Interim GAAP financial statements for TGA Group are not available for 2005 and, therefore, quarterly supplemental pro forma disclosures are not included in this report.

Effective January 1, 2006, we also acquired all of the issued and outstanding membership interests in Aerospace for an aggregate consideration of up to $15.0 million, consisting of unconditional consideration of $12.5 million due in cash at closing and contingent consideration of up to $2.5

million. The unconditional consideration of $12.5 million is allocated $11.9 million to the purchase price and $0.6 million to the seller's compliance with certain restrictive covenants, including a covenant not to compete for a period of five years after closing. The payment of contingent consideration is conditioned on the seller complying with its restrictive covenants and Aerospace achieving certain operational objectives related to premium production and loss ratios. The contingent consideration, if any, will be payable in cash on or before March 30, 2009, unless the seller elects to defer a portion of the payment in order to permit further development of loss ratios.

Aerospace, through various wholly owned subsidiaries, including Aerospace Insurance Managers, Inc., is involved in the marketing and servicing of general aviation property and casualty insurance products with a particular emphasis on private and small commercial aircraft. With the acquisition of Aerospace, Hallmark entered the general aviation market as part of our continuing strategy to expand into specialty lines businesses. Interim GAAP financial statements for Aerospace are not available for 2005 and, therefore, quarterly supplemental pro forma disclosures are not included in this report.

4. Supplemental Cash Flow Information

Effective January 1, 2006, we acquired TGA Group and Aerospace. (See Note 3, "Business Combinations.") In conjunction with the acquisitions, cash and cash equivalents were used in the acquisitions as follows (in thousands):

	TGA Group	Aerospace
Fair value of tangible assets excluding cash and cash equivalents	$ 52,906	$ 8,391
Fair value of intangible assets acquired	31,585	12,575
Capitalized direct expenses	232	36
Structured settlement	(23,542)	-
Liabilities assumed	(48,522)	(7,697)
Cash and cash equivalents used in acquisitions	$ 12,659	$ 13,305

For the three months ended March 31, 2006 and 2005, we had non-cash stock-based compensation expense of $25 thousand and $9 thousand, respectively.

5. Share-Based Payment Arrangements

Our 2005 Long Term Incentive Plan ("2005 LTIP") is a stock compensation plan for key employees and non-employee directors that was approved by the shareholders on May 26, 2005. There are 5,000,000 shares authorized for issuance under the 2005 LTIP. Our 1994 Key Employee Long Term Incentive Plan (the "Employee Plan") and 1994 Non-Employee Director Stock Option Plan (the "Director Plan") both expired in 2004.

As of March 31, 2006, there were incentive stock options to purchase 530,000 shares of our common stock outstanding under the 2005 LTIP, leaving 4,470,000 shares reserved for future issuance. As of March 31, 2006, there were incentive stock options to purchase 611,500 shares outstanding under the Employee Plan and non-qualified stock options to purchase 150,000 shares outstanding under the Director Plan. In addition, as of March 31, 2006, there were outstanding non-qualified stock options to purchase 100,000

shares of our common stock granted to certain non-employee directors outside the Director Plan in lieu of fees for service on our board of directors in 1999. The exercise price of all such outstanding stock options is equal to the fair market value of our common stock on the date of grant.

Options granted under the Employee Plan prior to October 31, 2003, vest 40% six months from the date of grant and an additional 20% on each of the first three anniversary dates of the grant and terminate ten years from the date of grant. Options granted under the 2005 LTIP and the Employee Plan after October 31, 2003, vest 10%, 20%, 30% and 40% on the first, second, third and fourth anniversary dates of the grant, respectively, and terminate five years from the date of grant. All options granted under the Director Plan vest 40% six months from the date of grant and an additional 10% on each of the first six anniversary dates of the grant and terminate ten years from the date of grant. The options granted to non-employee directors outside the Director Plan fully vested six months after the date of grant and terminate ten years from the date of grant.

A summary of the status of our stock options as of and changes during the year-to-date ended March 31, 2006 is presented below:

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value ($000)
Outstanding at January 1, 2006	1,516,500	$ 0.82	-	-
Granted	-	$ -	-	-
Exercised	(125,000)	$ 0.92	-	-
Forfeited or expired	-	$ -	-	-
Outstanding at March 31, 2006	1,391,500	$ 0.81	5.6	$ 1,226
Exercisable at March 31, 2006	487,000	$ 0.55	3.7	$ 553

There were no options granted in either the first quarter of 2006 or 2005. The total intrinsic value of options exercised during the first quarter of 2006 and 2005 was $103 thousand and $19 thousand, respectively. The total cost of share-based payments charged against income before income tax benefit for the first quarter of 2006 and 2005 was $22 thousand and $9 thousand, respectively. The amount of related income tax benefit recognized in income for the first quarter of 2006 and 2005 was $8 thousand and $3 thousand, respectively. As of March 31, 2006, there was $0.4 million of total unrecognized compensation cost related to non-vested share-based compensation arrangements granted under our plans, of which $0.1 million is expected to be recognized in each of 2006, 2007, 2008 and 2009.

The fair value of each stock option granted is estimated on the date of grant using the Black-Scholes option pricing model. Expected volatilities are based on historical volatility of Hallmark's shares. The risk-free interest rates for periods within the contractual term of the options are based on rates for U.S. Treasury Notes with maturity dates corresponding to the options expected lives on the dates of grant.

6. Segment Information

The following is business segment information for the three months ended March 31, 2006 and 2005 (in thousands):

	Three Months Ended March 31, 2006	Three Months Ended March 31, 2005
Revenues:		
HGA Segment	$ 17,540	$ 6,280
TGA Segment	14,099	-
PGA Segment	10,797	11,161
Aerospace Segment	1,869	-
Corporate	215	4
Consolidated	$ 44,520	$ 17,445
Pre-tax income (loss):		
HGA Segment	$ 3,360	$ 1,068
TGA Segment	1,728	-
PGA Segment	2,051	2,442
Aerospace Segment	(109)	-
Corporate	(3,501)	(806)
Consolidated	$ 3,529	$ 2,704

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

	Mar. 31, 2006	Dec. 31, 2005
Assets		
HGA Segment	$ 141,198	$ 136,220
TGA Segment	109,655	-
PGA Segment	68,187	68,264
Aerospace Segment	22,112	-
Corporate	27,991	4,422
Consolidated	$ 369,143	$ 208,906

7. Reinsurance

We reinsure a portion of the risk we underwrite in order to control the exposure to losses and to protect capital resources. We cede to reinsurers a portion of these risks and pay premiums based upon the risk and exposure of the policies subject to such reinsurance. Ceded reinsurance involves credit risk and is generally subject to aggregate loss limits. Although the reinsurer is liable to us to the extent of the reinsurance ceded, we are ultimately liable as the direct insurer on all risks reinsured. Reinsurance recoverables are reported after allowances for uncollectible amounts. We monitor the financial condition of reinsurers on an ongoing basis and review our reinsurance arrangements periodically. Reinsurers are selected based on their financial condition, business practices and the price of their product offerings. Refer to Note 6 of our Form 10-K for the year ended December 31, 2005 for more discussion of our reinsurance.

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

Three Months Ended
March 31,

	2006	2005
Ceded earned premiums	$ 1,397	$ -
Reinsurance recoveries	$ 776	$ (391)

8. Notes Payable

On June 21, 2005, our newly formed trust subsidiary completed a private placement of $30.0 million of 30-year floating rate trust preferred securities. Simultaneously, we borrowed $30.9 million from the trust subsidiary and contributed $30.0 million to AHIC in order to increase policyholder surplus. The note bears an initial interest rate of 7.725% until June 15, 2015, at which time interest will adjust quarterly to the three month LIBOR rate plus 3.25 percentage points. As of March 31, 2006, the note balance was $30.9 million.

On January 27, 2006, we borrowed $15.0 million under the revolving credit facility with The Frost National Bank to fund the cash required to close the TGA Group acquisition. As of March 31, 2006, the balance on the revolving note was $15.0 million. (See Note 3, "Business Combinations" and Note 12, "Credit Facility.")

Also included in notes payable is $3.0 million of various short-term notes payable to banks by PAAC, bearing variable interest rates ranging from 4.75% to 7.75%. These notes are secured by PAAC's finance notes receivables. The line of credit available under PAAC's current borrowing arrangements is $5.0 million, approximately $3.0 million of which was borrowed at March 31, 2006. PAAC's borrowing arrangements contain various restrictive covenants which, among other things, require maintenance of minimum amounts of tangible net worth and working capital. At March 31, 2006, PAAC was not in compliance with certain of such covenants but had received a waiver for the violations.

9. Note Payable to Related Party

On January 3, 2006, we executed a promissory note payable to Newcastle Partners, L.P. in the amount of $12.5 million in order to obtain funding to complete the acquisition of Aerospace. The promissory note bears interest at the rate of 10% per annum. The unpaid principal balance of the promissory note, together with all accrued and unpaid interest, is due and payable on demand at any time after June 30, 2006. As of March 31, 2006 the promissory note balance was $12.5 million.

10. Convertible Notes Payable

On January 27, 2006, we issued $25.0 million in subordinated convertible promissory notes to Newcastle Special Opportunity Fund I, L.P. and Newcastle Special Opportunity Fund II, L.P., which are investment partnerships managed by an entity controlled by Mark E. Schwarz, our Chairman and Chief Executive Officer. Each convertible note bears interest at 4% per annum until paid or converted, which rate increases to 10% per annum in the event of default. Interest is payable quarterly in arrears commencing March 31, 2006. The convertible notes mature on July 27, 2007, and may not be prepaid. Conversion of the convertible notes is in all events subject to shareholder approval. Following shareholder approval, the principal of the convertible notes must be converted by the holders into shares of our common stock on or before maturity at a conversion rate of $1.28 per share (subject to certain anti-dilution provisions).

In accordance with the FASB Emerging Issues Task Force ("EITF") Issue No. 98-5 "Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios" and EITF Issue No. 00-27 "Application of Issue No. 98-5 to Certain Convertible Instruments," the convertible notes contain a beneficial conversion feature requiring a discount to the carrying amount of the notes equal to (i) the difference between the stated conversion rate and the market price of our common stock on the date of issuance, multiplied by (ii) the number of shares into which the notes are convertible. Per EITF Issue No. 98-5 and EITF Issue No. 00-27, upon issuance we recorded a $9.6 million discount to the convertible notes which will be amortized straight line as interest expense over the term of the convertible notes, with any unamortized balance of the discount expensed upon conversion of the notes. The discount to the convertible notes was offset by increases to deferred federal income taxes and additional paid in capital, resulting in a temporary increase in our book value which will decline as the discount is amortized. Ultimately, the discount on the convertible notes will have no effect on our book value.

Interest expense resulting from amortization of the discount on the convertible notes during the first fiscal quarter of 2006 was $1.1 million, resulting in a convertible notes balance of $16.5 million as of March 31, 2006. This interest expense had the effect of reducing our operating income for the period, but had no effect on our cash flow.

11. Structured Settlements

In connection with the acquisition of the TGA Group, we recorded a payable for the future guaranteed payments of $25.0 million discounted at 4.4%, the rate of two year US Treasuries (the only investment permitted on the trust account securing such future payments which is classified in restricted cash and investments on our balance sheet). (See Note 3, "Business Combinations.") As of March 31, 2006, the balance of the structured settlements was $23.8 million.

12. Credit Facility

On June 29, 2005, we entered into a credit facility with The Frost National Bank. The credit facility was amended and restated on January 27, 2006 to a $20.0 million revolving credit facility, with a $5.0 million letter of credit sub-facility. We borrowed $15.0 million under the revolving credit facility to fund the cash required to close the TGA Group acquisition. Principal outstanding under the revolving credit facility generally bears interest at the three month Eurodollar rate plus 2.00%, payable quarterly in arrears. We pay letter of credit fees at the rate of 1.00% per annum. Our obligations under the revolving credit facility are secured by a security interest in the capital stock of all of our subsidiaries, guaranties of all of our subsidiaries and the pledge of substantially all of our assets. The revolving credit facility contains covenants which, among other things, require us to maintain certain financial and operating ratios and restrict certain distributions, transactions and organizational changes. The amended and restated credit agreement terminates on January 27, 2008. As of March 31, 2006, there was $15.0 million outstanding under our revolving credit facility, and we were in compliance with or had obtained waivers of all of our covenants. In the third quarter of 2005, we issued a $4.0 million letter of credit under this facility to collateralize certain obligations under the agency agreement between HGA and Clarendon National Insurance Company effective July 1, 2004.

13. Deferred Policy Acquisition Costs

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

	Three Months Ended March 31, 2006	Three Months Ended March 31, 2005
Deferred	$ (8,720)	$ (6,087)
Amortized	6,793	5,715
Net Deferred	$ (1,927)	$ (372)

14. Earnings per Share

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

	Three Months Ended March 31, 2006	Three Months Ended March 31, 2005
Common Stockholders:		
Weighted average shares - basic	86,874	42,471
Effect of dilutive securities	788	694
Weighted average shares - assuming dilution	87,662	43,165
Convertible Noteholders:		
Weighted average shares - basic and assuming dilution	19,531	n/a

For the basic and diluted earnings per share calculation for the three months ended March 31, 2006, net income was allocated $2.0 million to common stockholders and $0.4 million to holders of convertible notes. For the three months ended March 31, 2006 and 2005, no shares attributable to outstanding stock options were excluded from the calculation of diluted earnings per share.

In accordance with FASB Statement of Financial Accounting Standards No. 128, "Earnings Per Share" ("SFAS 128"), we have restated the basic and diluted weighted average shares outstanding for the three months ended March 31, 2005 for the effect of a bonus element from our stockholder rights offering completed in the second quarter of 2005. According to SFAS 128, there is an assumed bonus element in a rights issue whose exercise price is less than the market value of the stock at the close of the rights offering period. This bonus element is treated as a stock dividend for reporting earnings per share.

15. Net Periodic Pension Cost

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

Three Months Ended
March 31,

	2006	2005
Interest cost	$ 171	$ 181
Amortization of net loss	40	19
Expected return on plan assets	(157)	(184)
Net periodic pension cost	$ 54	$ 16

We contributed $32 thousand and $36 thousand to our frozen defined benefit cash balance plan during the first three months of 2006 and 2005, respectively. Refer to Note 13 of our Form 10-K for the year ended December 31, 2005 for more discussion of our retirement plans.

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

Introduction

Hallmark Financial Services, Inc. ("Hallmark" and, together with subsidiaries, "we", "us", "our") is an insurance holding company engaged in the sale of property and casualty insurance products to businesses and individuals. Our business involves marketing and underwriting commercial insurance in Texas, New Mexico, Idaho, Oregon, Montana, Louisiana and Washington; marketing and underwriting non-standard personal automobile insurance in Texas, New Mexico and Arizona; marketing general aviation insurance in 44 states; claims administration; and other insurance related services. We pursue our business activities through subsidiaries whose operations are organized by producing companies into our Hallmark General Agency operating segment ("HGA Segment"), which includes the commercial insurance products and services handled by Hallmark General Agency, Inc. ("HGA") and Effective Claims Management, Inc.; our Texas General Agency operating segment ("TGA Segment"), which includes the commercial insurance products and services handled by Texas General Agency, Inc. ("TGA"), Pan American Acceptance Corporation ("PAAC") and TGA Special Risk, Inc. ("TGASRI"); our Phoenix General Agency operating segment ("PGA Segment"), which includes the non-standard personal automobile insurance products and services handled by American Hallmark General Agency, Inc. and Hallmark Claims Services, Inc. (both of which do business as Phoenix General Agency); and our aviation operating segment ("Aerospace Segment"), which includes the general aviation insurance products and services handled by Aerospace Holdings LLC ("Aerospace") and its wholly owned subsidiaries. The subsidiary companies in our TGA Segment and Aerospace Segment were all acquired effective January 1, 2006. The retained premium produced by our operating segments is supported by our insurance company subsidiaries: American Hallmark Insurance Company of Texas ("AHIC"); Phoenix Indemnity Insurance Company ("PIIC"); and Gulf States Insurance Company ("GSIC"), a wholly owned subsidiary of TGA which was acquired by Hallmark effective January 1, 2006.

Financial Condition and Liquidity

Sources and uses of funds. Our sources of funds are from insurance related operations, financing activities and investing activities. Major sources of funds from operations include premiums collected (net of policy cancellations and premiums ceded), commissions, and processing and service fees. On a consolidated basis, our cash and investments (excluding restricted cash and investments) at March 31, 2006 were $167.1 million compared to $139.6 million at December 31, 2005. Most of this increase is attributable to the acquisitions of TGA and certain affiliated companies (collectively, the "TGA Group") on January 1, 2006, which contributed $20.0 million in cash and investments as of March 31, 2006.

Net cash provided by our consolidated operating activities was $9.6 million for the first three months of 2006 compared to net cash used of $0.2 million for the first three months of 2005. The increase in operating cash flow primarily resulted from the retention of HGA Segment and TGA Segment business in the first quarter 2006 that was not retained by us in the first quarter of 2005. The net effect on operating cash flows was an increase of $9.8 million resulting from an increase in collected premiums net of paid loss and loss adjustment expenses partially offset by lower collected commission and claim fee revenue.

Cash used by investing activities during the first three months of 2006 was $41.6 million as compared to $6.4 million for the same period in 2005. The increase in cash used by investing activities is mostly due to the acquisitions of TGA Group and Aerospace in the first quarter of 2006 which used $26.0 million, net of cash acquired. Also contributing to the increase in cash used by investing activities was the funding of $25.0 million to a trust account securing the future guaranteed payments to the TGA Group sellers, as well as PAAC's $1.7 million repayment of premium finance notes, net of premium finance notes originated. Partially offsetting these uses was a $13.2 million increase in net redemptions of short-term investments in the first quarter of 2006 versus the same period in 2005 and $3.9 million in maturities and redemptions of investment securities in 2006.

Cash provided by financing activities during the first three months of 2006 was $52.5 million as compared to $13 thousand for the same period of 2005. The cash provided in 2006 was primarily from the issuance of three debt instruments in January. The first was a promissory note payable to Newcastle Partners, L.P. in the amount of $12.5 million to fund the cash required to close the Aerospace acquisition. This note bears interest at the rate of 10% per annum. The unpaid principal balance of the promissory note, together with all accrued and unpaid interest, is due and payable on demand at any time after June 30, 2006. The second debt instrument was $25.0 million in subordinated convertible promissory notes to the Newcastle Special Opportunity Fund I, L.P. and Newcastle Special Opportunity Fund II, L.P. Each convertible note bears interest at 4% per annum until paid or converted, which rate increases to 10% per annum in the event of default. Interest is payable quarterly in arrears commencing March 31, 2006. Conversion of the notes is in all events subject to shareholder approval. Following shareholder approval, the principal of the notes must be converted by the holders into approximately 19.5 million shares of our common stock (subject to certain anti-dilution provisions) on or before maturity on July 27, 2007. Absent shareholder approval, principal and all accrued but unpaid interest is due at maturity. The notes may not be prepaid. The $25.0 million raised with these notes was used to fund a trust account securing future guaranteed payments to the TGA Group sellers. The third debt instrument was $15.0 million borrowed under our revolving credit facility with Frost Bank to fund the cash required to close the TGA Group acquisition.

As a holding company, Hallmark is dependent on dividend payments and management fees from its subsidiaries to meet operating expenses and debt obligations. As of March 31, 2006, Hallmark had $1.5 million in cash and invested assets. Cash and invested assets of our non-insurance subsidiaries were $3.9 million as of March 31, 2006.

Property and casualty insurance companies domiciled in the State of Texas are limited in the payment of dividends to their shareholders in any twelve-month period, without the prior written consent of the Texas Department of Insurance, to the greater of statutory net income for the prior calendar year or 10% of statutory policyholders' surplus as of the prior year end. Dividends may only be paid from unassigned surplus funds.

During 2006, AHIC's ordinary dividend capacity is $6.4 million. PIIC, domiciled in Arizona, is limited in the payment of dividends to the lesser of 10% of prior year policyholder's surplus or prior year's net investment income, without prior written approval from the Arizona Department of Insurance. During 2006, PIIC's ordinary dividend capacity is $1.6 million. GSIC, domiciled in Oklahoma, is limited in the payment of dividends to the greater of 10% of prior year policyholder's surplus or prior year's statutory net income, without prior written approval from the Oklahoma Insurance Department. During 2006, GSIC's ordinary dividend capacity is $0.1 million. None of AHIC, PIIC or GSIC paid a dividend to Hallmark during the first three months of 2006.

Credit facility. On June 29, 2005, we entered into a credit facility with The Frost National Bank. The credit facility was amended and restated on January 27, 2006 to a $20.0 million revolving credit facility, with a $5.0 million letter of credit sub-facility. We borrowed $15.0 million under the revolving credit facility to fund the cash required to close the TGA Group acquisition. Principal outstanding under the revolving credit facility generally bears interest at the three month Eurodollar rate plus 2.00%, payable quarterly in arrears. We pay letter of credit fees at the rate of 1.00% per annum. Our obligations under the revolving credit facility are secured by a security interest in the capital stock of all of our subsidiaries, guaranties of all of our subsidiaries and the pledge of substantially all of our assets. The revolving credit facility contains covenants which, among other things, require us to maintain certain financial and operating ratios and restrict certain distributions, transactions and organizational changes. The amended and restated credit agreement terminates on January 27, 2008. As of March 31, 2006, there was $15.0 million outstanding under our revolving credit facility, and we were in compliance with or had obtained waivers of all of our covenants. In the third quarter of 2005, we issued a $4.0 million letter of credit under this facility to collateralize certain obligations under the agency agreement between HGA and Clarendon National Insurance Company effective July 1, 2004.

Trust preferred securities. On June 21, 2005, our newly formed trust subsidiary completed a private placement of $30.0 million of 30-year floating rate trust preferred securities. Simultaneously, we borrowed $30.9 million from the trust subsidiary and contributed $30.0 million to AHIC in order to increase policyholder surplus. The note bears an initial interest rate of 7.725% until June 15, 2015, at which time interest will adjust quarterly to the three month LIBOR rate plus 3.25 percentage points. As of March 31, 2006, the note balance was $30.9 million.

Conclusion. Based on budgeted and year-to-date cash flow information, we believe that we have sufficient liquidity to meet our projected insurance obligations, operational expenses and capital expenditure requirements for the foreseeable future. However, we expect additional capital to be required to satisfy the debt obligations to Newcastle which are payable on demand after June 30, 2006. We have previously indicated our intent to obtain such additional capital through a rights offering of our common stock to existing shareholders during 2006. While a rights offering is still being considered, we are also exploring additional alternatives to satisfy our capital needs. There can be no assurance that we will be able to obtain the required additional capital on advantageous terms.

Results of Operations

Management Overview. During the first quarter of fiscal 2006, our total revenues were $44.5 million, representing a 155.2% increase over the $17.4 million in total revenues for the comparable period of fiscal 2005. The increase in total revenues for the first three months of fiscal 2006 as compared to the first three months of fiscal 2005 was primarily attributable

to the acquisitions of TGA Group and Aerospace in the first quarter of 2006, which contributed $16.0 million in revenue. The retention of business produced by the HGA Segment and underwritten by AHIC that was previously retained by third parties also contributed $10.3 million to the increase in quarterly revenue.

We reported net income of $2.4 million for the three months ended March 31, 2006, as compared to $1.8 million in the same period in the prior year. The increase in net income for the first three months of 2006 versus the same period in 2005 was primarily attributable to the retention of the HGA Segment business and quarterly results from the TGA Group, partially offset by interest expense from the amortization of a deemed discount on convertible promissory notes.

During the first quarter of fiscal 2006, we recorded a $1.1 million interest expense from amortization attributable to the deemed discount on convertible promissory notes issued in January, 2006. (See Note 10, "Convertible Notes Payable.") In the absence of this non-cash expense, our net income for the three months ended March 31, 2006 would have been $3.1 million, representing a 72.5% increase over the similar period of fiscal 2005.

The following is a reconciliation of our net income without such interest expense to our reported results (in thousands). Management believes this reconciliation provides useful supplemental information in evaluating the operating results of our business. This disclosure should not be viewed as a substitute for net income determined in accordance with GAAP:

	Quarter Ended March 31, 2006
Income excluding interest expense from amortization of discount, net of tax	$ 3,130
Interest expense from amortization of discount	1,117
Less related tax effect	(413)
	704
Net income	$ 2,426

On a common stockholder diluted per share basis, net income was $0.02 for the three months ended March 31, 2006 and $0.04 for the same period in 2005. The decrease in diluted earnings per share to common stockholders was due to the combined impact of issuing 50.0 million shares in a stockholder rights offering in the second quarter of 2005 and allocating a portion of net income to the holders of convertible notes in the first quarter of 2006. (See Note 14, "Earnings Per Share.")

The following is additional business segment information for the three months ended March 31, 2006 and 2005 (in thousands):

	Three Months Ended March 31,	
	2006	2005
Revenues:		
HGA Segment	$ 17,540	$ 6,280
TGA Segment	14,099	-
PGA Segment	10,797	11,161

Aerospace Segment	1,869	-
Corporate	215	4
Consolidated	$ 44,520	$ 17,445
Pre-tax income (loss):		
HGA Segment	$ 3,360	$ 1,068
TGA Segment	1,728	-
PGA Segment	2,051	2,442
Aerospace Segment	(109)	-
Corporate	(3,501)	(806)
Consolidated	$ 3,529	$ 2,704

First Quarter 2006 as compared to the First Quarter 2005

HGA Segment

Beginning in the third quarter of 2005, our HGA Segment (formerly known as the Commercial Lines Operation) began retaining written premium through AHIC that was previously retained by third parties. This resulted in net written premium for the HGA Segment of $21.7 million for the quarter ended March 31, 2006.

Total revenue for the HGA Segment of $17.5 million for the first quarter of 2006 was $11.2 million more than the $6.3 million reported in the first quarter of 2005. This 179.3% increase in total revenue was primarily due to net premiums earned of $14.3 million for the quarter from the issuance of AHIC policies produced by the HGA Segment. Increased net investment income contributed an additional $0.9 million to the increase in revenue for the quarter. These increases in revenue were partially offset by lower ceding commission revenue of $3.3 million and lower processing and service fees of $0.7 million, in both cases due to the shift from a third party agency structure to an insurance underwriting structure.

Pre-tax income for Hallmark General Agency of $3.4 million for the first quarter of 2006 increased $2.3 million, or 214.6%, over the $1.1 million reported for the first quarter of 2005. Increased revenue, as discussed above, was the primary reason for the increase in pre-tax income, partially offset by increased loss and loss adjustment expenses of $7.8 million and additional production expenses of $0.9 million.

TGA Segment

The members of the TGA Segment were all acquired effective January 1, 2006. The $14.1 million of revenues was derived mostly from third party commission revenue of $9.2 million on the portion of business produced by the TGA Segment that was retained by third parties and from $4.3 million of earned premium on produced business that was assumed by GSIC or AHIC. The remaining $0.6 million of revenue was derived from investment income and finance charges.

Pre-tax income for the TGA Segment of $1.7 million was due to revenue as discussed above less (i) incurred loss and loss adjustment expenses of $2.6 million on the portion of the business assumed by GSIC or AHIC, (ii) $9.7 million in operating expenses, comprised mostly of commission expense and salary related expenses, and (iii) $0.5 million of amortization of intangible assets acquired in the acquisition of the TGA Group.

PGA Segment

Net premium written for our PGA Segment (formerly known as the Personal Lines Operation) increased $0.5 million during the first quarter of 2006 to $11.1 million compared to $10.6 million in the first quarter of 2005.

Revenue for the PGA Segment decreased 3.3% to $10.8 million for the first quarter of 2006 from $11.2 million for the same period in 2005. Lower earned premium of $0.3 million was primarily due to the timing and pattern of written premium. Also contributing to the decrease in revenue was $0.1 million of third party commission revenue recognized in the first quarter of 2005 that was discontinued due to the 100% assumption of the Texas non-standard automobile premium beginning late in 2004.

Pre-tax income for the PGA Segment decreased $0.4 million, or 16.0%, for the first quarter of 2006 compared to the first quarter of 2005. Lower revenue as discussed above was the primary cause of the decrease in pre-tax income for the quarter.

Aerospace Segment

The members of the Aerospace Segment were all acquired effective January 1, 2006. The $1.9 million of revenues was derived mostly from third party commission revenue of $1.7 million on the portion of business produced by Aerospace Insurance Managers, Inc. ("AIM"), a wholly owned subsidiary of Aerospace, which is retained by third parties. An additional $0.1 million of revenue was derived from earned premium on business assumed by Mannequin PCC Ltd. Cell A-22 ("Mannequin"), a wholly owned captive cell of Aerospace located in Guernsey. Mannequin currently assumes approximately 2.5% of the business produced by AIM.

Pre-tax loss for the Aerospace Segment of $0.1 million for the first quarter of 2006 was due to revenue discussed above less (i) operating expenses of $1.7 million, comprised mostly of commission expense and salary related expenses, (ii) loss and loss adjustment expenses of $0.2 million, and (iii) $0.1 million of amortization of intangible assets acquired in the acquisition of Aerospace.

Corporate

Corporate pre-tax loss was $3.5 million for the first quarter of 2006 as compared to $0.8 million for the same period in 2005. The increased loss was primarily due to interest expense of $1.5 million in the first quarter of 2006 comprised of (i) $0.6 million from the trust preferred securities issued in the second quarter of 2005 (see Note 8, "Notes Payable"), (ii) $0.3 million from the related party promissory note issued in January 2006 (see Note 9, "Note Payable to Related Party"), (iii) $0.2 million of amortization of the discount on the future guaranteed payments to the TGA Group sellers (see Note 11, "Structured Settlements"), (iv) $0.2 million from borrowings under our revolving credit facility with The Frost National Bank in January 2006 (see Note 8, "Notes Payable" and Note 12, "Credit Facility"), and (v) $0.2 million from the issuance of convertible notes issued in January 2006 (see Note 10, "Convertible Notes Payable"). Also contributing to the increase in pre-tax loss for the quarter was $1.1 million in interest expense from amortization attributable to the deemed discount on convertible promissory notes issued in January, 2006. (See Note 10, "Convertible Notes Payable.") This expense had no impact on our cash flow and will ultimately have no effect on our book value.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

As of March 31, 2006, there had been no material changes in the market

risks described in the Company's Form 10-K for the year ended December 31, 2005.

Item 4. Controls and Procedures.

The Chief Executive Officer and Chief Financial Officer of the Company have evaluated the Company's disclosure controls and procedures and have concluded that, as of the end of the period covered by this report, such disclosure controls and procedures were effective in ensuring that information required to be disclosed by the Company in the reports that it files or submits under the Securities Exchange Act of 1934 is timely recorded, processed, summarized and reported. The Chief Executive Officer and Chief Financial Officer also concluded that such disclosure controls and procedures were effective in ensuring that information required to be disclosed by the Company in the reports that it files or submits under such Act is accumulated and communicated to the Company's management, including its Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. During the most recent fiscal quarter, there have been no changes in the Company's internal controls over financial reporting that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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

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

PART II
OTHER INFORMATION

Item 1. Legal Proceedings.

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

Item 1A. Risk Factors.

In addition to the other information set forth in this report, you should carefully consider the risk factors discussed in Part I, "Item 1A. Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2005, which could materially affect our business, financial condition or future results. There have been no material changes from the risk factors described in such Annual Report on Form 10-K, except as follows:

If we are unable to raise additional capital or restructure our indebtedness to Newcastle, we may have difficulty satisfying current liquidity requirements.

We funded the acquisition of Aerospace by borrowing $12.5 million from Newcastle on January 3, 2006. The principal and accrued interest of this bridge loan are payable on demand at any time after June 30, 2006. We have previously announced our intention to retire this debt through a rights offering of our common stock to existing shareholders during 2006. Although such a rights offering is still under consideration, we are also exploring other alternatives to satisfy our capital needs. If we are unable to obtain additional capital or restructure the payment schedule of the bridge loan, we may be unable to repay the bridge loan when demand is made. Any default under the bridge loan to Newcastle would also be an event of default under our primary secured credit facility and, therefore, could have a material adverse affect on our liquidity and operations.

The failure to maintain favorable financial strength ratings could negatively impact our ability to compete successfully.

Third party rating agencies assess and rate the claims-paying ability of insurers based upon criteria established by the agencies. Financial strength ratings are used by agents and clients as an important means of assessing the financial strength and quality of insurers. During 2005, A.M. Best, a nationally recognized insurance industry rating service and publisher, upgraded the financial strength rating of PIIC from "B (Fair)" to "B+ (Very Good)" and upgraded the financial strength rating of AHIC from "B (Fair)" to "A- (Excellent)". To maintain these ratings, the capitalization and operating performance of our insurance subsidiaries must be consistent with projections provided to A.M. Best. Our failure to maintain our current financial strength ratings could adversely affect our ability to sell insurance policies and inhibit us from competing effectively.

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

Information previously furnished in our Current Report on Form 8-K filed February 2, 2006.

Item 3. Defaults Upon Senior Securities.

None.

Item 4. Submission of Matters to a Vote of Security Holders.

None.

Item 5. Other Information.

None.

Item 6. Exhibits.

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

Exhibit Number	Description
3(a)	Articles of Incorporation of the registrant, as amended (incorporated by reference to Exhibit 3(a) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1993).
3(b)	By-Laws of the registrant, as amended (incorporated by reference to Exhibit 3(b) to the registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2005).
3(c)	Amendment of Article VII of the Amended and Restated Bylaws of Hallmark Financial Services, Inc., adopted July 19, 2002 (incorporated by reference to Exhibit 10(b) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended September 30, 2002).
4(a)	Specimen certificate for Common Stock, $0.03 par value per share, of the registrant (incorporated by reference to Exhibit 4 to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1991).
4(b)	Indenture dated as of June 21, 2005, between Hallmark Financial Services, Inc. and JPMorgan Chase Bank, National Association (incorporated by reference to Exhibit 4.1 to the registrant's Current Report on Form 8-K filed June 27, 2005).
4(c)	Amended and Restated Declaration of Trust of Hallmark Statutory Trust I dated as of June 21, 2005, among Hallmark Financial Services, Inc., as sponsor, Chase Bank USA, National Association, as Delaware trustee, and JPMorgan Chase Bank, National Association, as institutional trustee, and Mark Schwarz and Mark Morrison, as administrators (incorporated by reference to Exhibit 4.2 to the registrant's Current Report on Form 8-K filed June 27, 2005).
4(d)	Form of Junior Subordinated Debt Security Due 2035 (incorporated by reference to Exhibit 4.1 to the registrant's Current Report on Form 8-K filed June 27, 2005).
4(e)	Form of Capital Security Certificate (incorporated by reference to Exhibit 4.2 to the registrant's Current Report on Form 8-K filed June 27, 2005).
4(f)	Promissory Note dated January 3, 2006, between Hallmark Financial Services, Inc. and Newcastle Partners, L.P. (incorporated by reference to Exhibit 4.1 to the registrant's Current Report on Form 8-K filed January 5, 2006).
4(g)	First Restated Credit Agreement dated January 27, 2006, between Hallmark Financial Services, Inc. and The Frost National Bank (incorporated by reference to Exhibit 4.1 to

	the registrant's Current Report on Form 8-K filed February 2, 2006).
4(h)	Convertible Promissory Note dated January 27, 2006, between Hallmark Financial Services, Inc. and Newcastle Special Opportunity Fund I, L.P. and Newcastle Special Opportunity Fund II, L.P. (incorporated by reference to Exhibit 4.2 to the registrant's Current Report on Form 8-K filed February 2, 2006).
10(a)	Form of Purchase Agreement dated January 27, 2006, between Hallmark Financial Services, Inc. and Newcastle Special Opportunity Fund I, Ltd. and Newcastle Special Opportunity Fund II, L.P. (incorporated by reference to Exhibit 10.1 to the registrant's Current Report on Form 8-K filed February 2, 2006).
10(b)	Form of Registration Rights Agreement dated January 27, 2006, between Hallmark Financial Services, Inc. and Newcastle Special Opportunity Fund I, Ltd. and Newcastle Special Opportunity Fund II, L.P. (incorporated by reference to Exhibit 10.2 to the registrant's Current Report on Form 8-K filed February 2, 2006).
31(a)	Certification of Chief Executive Officer required by Rule 13a-14(a) or Rule 15d-14(a).
31(b)	Certification of Chief Financial Officer required by Rule 13a-14(a) or Rule 15d-14(a).
32(a)	Certification of Chief Executive Officer Pursuant to 18 U.S.C. 1350.
32(b)	Certification of Chief Financial Officer Pursuant to 18 U.S.C. 1350.

SIGNATURES

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

HALLMARK FINANCIAL SERVICES, INC.
(Registrant)

Date: May 15, 2006 /s/ Mark E. Schwarz

Mark E. Schwarz, Chairman
(Chief Executive Officer)

Date: May 15, 2006 /s/ Mark J. Morrison

Mark J. Morrison, President
(Chief Operating Officer and
Chief Financial Officer)