

HALLMARK FINANCIAL SERVICES INC  
Form 10-Q  
May 05, 2016

**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, 2016

Commission file number 001-11252

**Hallmark Financial Services, Inc.**

(Exact name of registrant as specified in its charter)

|   |   |
|---|---|
| Nevada  | 87-0447375                              |
| (State or other jurisdiction of<br>Incorporation or organization) | (I.R.S. Employer<br>Identification No.) |

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777 Main Street, Suite 1000, 76102  
Fort Worth, Texas  
(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  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  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  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: Common Stock, par value \$.18 per share – 18,891,377 shares outstanding as of May 5, 2016.

PART I

FINANCIAL INFORMATION

Item 1. Financial Statements

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**Hallmark Financial Services, Inc. and Subsidiaries****Consolidated Balance Sheets**

(\$ in thousands, except par value )

| <u>ASSETS</u>  | March 31,<br>2016<br>(unaudited) | December<br>31, 2015 |
|--|----------------------------------|----------------------|
| Investments:   |                                  |                      |
| Debt securities, available-for-sale, at fair value (cost: \$570,080 in 2016 and \$538,629 in 2015) | \$564,758                        | \$531,325            |
| Equity securities, available-for-sale, at fair value (cost: \$27,460 in 2016 and \$24,951 in 2015) | 49,328                           | 47,504               |
| Total investments  | 614,086                          | 578,829              |
| Cash and cash equivalents  | 87,477                           | 114,446              |
| Restricted cash  | 8,733                            | 8,522                |
| Ceded unearned premiums  | 66,934                           | 65,094               |
| Premiums receivable  | 90,244                           | 83,376               |
| Accounts receivable  | 2,402                            | 2,005                |
| Receivable for securities  | 938                              | 10,424               |
| Reinsurance recoverable  | 120,161                          | 114,287              |
| Deferred policy acquisition costs  | 20,737                           | 20,366               |
| Goodwill   | 44,695                           | 44,695               |
| Intangible assets, net   | 14,342                           | 14,959               |
| Deferred federal income taxes, net   | 2,615                            | 3,360                |
| Federal income tax recoverable   | 328                              | 1,779                |
| Prepaid expenses   | 4,181                            | 3,213                |
| Other assets   | 12,176                           | 11,245               |
| Total assets   | \$1,090,049                      | \$1,076,600          |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>  |                                  |                      |
| Liabilities:   |                                  |                      |
| Revolving credit facility payable  | \$30,000                         | \$30,000             |
| Subordinated debt securities   | 56,702                           | 56,702               |
| Reserves for unpaid losses and loss adjustment expenses  | 449,129                          | 450,878              |
| Unearned premiums  | 221,546                          | 216,407              |
| Reinsurance balances payable   | 37,929                           | 33,741               |
| Pension liability  | 2,463                            | 2,496                |
| Payable for securities   | 2,910                            | 1,097                |
| Accounts payable and other accrued expenses  | 23,563                           | 23,253               |
| Total liabilities  | \$824,242                        | \$814,574            |

Commitments and Contingencies (Note 17)

Stockholders' equity:

|   |             |             |
|---|-------------|-------------|
| Common stock, \$.18 par value, authorized 33,333,333; issued 20,872,831 shares in 2016 and 2015 | 3,757       | 3,757       |
| Additional paid-in capital  | 123,619     | 123,480     |
| Retained earnings   | 145,575     | 141,501     |
| Accumulated other comprehensive income  | 8,279       | 7,418       |
| Treasury stock (1,893,291 shares in 2016 and 1,775,512 in 2015), at cost                        | (15,423 )   | (14,130 )   |
| Total stockholders' equity  | 265,807     | 262,026     |
|   | \$1,090,049 | \$1,076,600 |

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<br>March 31, |           |
|-------------------------------------|---------------------------------|-----------|
|                                     | 2016                            | 2015      |
| Gross premiums written              | \$128,447                       | \$125,059 |
| Ceded premiums written              | (40,821 )                       | (34,685 ) |
| Net premiums written                | 87,626                          | 90,374    |
| Change in unearned premiums         | (3,299 )                        | (3,678 )  |
| Net premiums earned                 | 84,327                          | 86,696    |
| Investment income, net of expenses  | 3,879                           | 2,845     |
| Net realized (losses) gains         | (227 )                          | 584       |
| Finance charges                     | 1,441                           | 1,299     |
| Commission and fees                 | 577                             | 9         |
| Other income                        | 31                              | 17        |
| Total revenues                      | 90,028                          | 91,450    |
| Losses and loss adjustment expenses | 55,395                          | 56,090    |
| Other operating expenses            | 26,896                          | 25,914    |
| Interest expense                    | 1,131                           | 1,140     |
| Amortization of intangible assets   | 617                             | 617       |
| Total expenses                      | 84,039                          | 83,761    |
| Income before tax                   | 5,989                           | 7,689     |
| Income tax expense                  | 1,915                           | 2,346     |
| Net income                          | 4,074                           | 5,343     |
| Net income per share:               |                                 |           |
| Basic                               | \$0.21                          | \$0.28    |
| Diluted                             | \$0.21                          | \$0.28    |

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



**Hallmark Financial Services, Inc. and Subsidiaries****Consolidated Statements of Comprehensive Income**

(Unaudited)

(\$ in thousands)

|  | Three Months<br>Ended<br>March 31,<br>2016    2015 |         |
|--|--|---------|
| Net income   | \$4,074  | \$5,343 |
| Other comprehensive income (loss):   |  |         |
| Change in net actuarial gain   | 28   | 26      |
| Tax effect on change in net actuarial gain                                 | (10 )  | (9 )    |
| Unrealized holding gains arising during the period                         | 1,371  | 7,069   |
| Tax effect on unrealized holding gains arising during the period           | (480 )   | (2,474) |
| Reclassification adjustment for gains included in net income               | (74 )  | (861 )  |
| Tax effect on reclassification adjustment for gains included in net income | 26   | 301     |
| Other comprehensive income, net of tax                                     | 861  | 4,052   |
| Comprehensive income   | \$4,935  | \$9,395 |

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



**Hallmark Financial Services, Inc. and Subsidiaries****Consolidated Statements of Stockholders' Equity**

(Unaudited)

(\$ in thousands)

|  | Three Months Ended<br>March 31, |                  |
|--|---------------------------------|------------------|
|  | 2016                            | 2015             |
| <b>Common Stock</b>  |                                 |                  |
| Balance, beginning of period   | \$3,757                         | \$3,757          |
| Balance, end of period   | 3,757                           | 3,757            |
| <b>Additional Paid-In Capital</b>  |                                 |                  |
| Balance, beginning of period   | 123,480                         | 123,194          |
| Equity based compensation  | 139                             | 371              |
| Shares issued under employee benefit plans                               | -                               | (10 )            |
| Balance, end of period   | 123,619                         | 123,555          |
| <b>Retained Earnings</b>   |                                 |                  |
| Balance, beginning of period   | 141,501                         | 119,638          |
| Net income   | 4,074                           | 5,343            |
| Balance, end of period   | 145,575                         | 124,981          |
| <b>Accumulated Other Comprehensive Income</b>                            |                                 |                  |
| Balance, beginning of period   | 7,418                           | 17,801           |
| Additional minimum pension liability, net of tax                         | 18                              | 17               |
| Unrealized holding gains arising during period, net of tax               | 891                             | 4,595            |
| Reclassification adjustment for gains included in net income, net of tax | (48 )                           | (560 )           |
| Balance, end of period   | 8,279                           | 21,853           |
| <b>Treasury Stock</b>  |                                 |                  |
| Balance, beginning of period   | (14,130 )                       | (12,353 )        |
| Acquisition of treasury stock  | (1,293 )                        | (287 )           |
| Shares issued under employee benefit plans                               | -                               | 212              |
| Balance, end of period   | (15,423 )                       | (12,428 )        |
| <b>Total Stockholders' Equity</b>  | <b>\$265,807</b>                | <b>\$261,718</b> |

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



**Hallmark Financial Services, Inc. and Subsidiaries****Consolidated Statements of Cash Flows**

(Unaudited)

(\$ in thousands)

|   | Three Months Ended<br>March 31, |           |
|---|---------------------------------|-----------|
|   | 2016                            | 2015      |
| Cash flows from operating activities:   |                                 |           |
| Net income  | \$4,074                         | \$5,343   |
| Adjustments to reconcile net income to cash (used in) provided by operating activities: |                                 |           |
| Depreciation and amortization expense   | 948                             | 1,136     |
| Deferred federal income taxes   | 280                             | (819 )    |
| Net realized losses (gains)   | 227                             | (584 )    |
| Share-based payments expense  | 139                             | 371       |
| Change in ceded unearned premiums   | (1,840 )                        | (1,747 )  |
| Change in premiums receivable   | (6,868 )                        | (11,121 ) |
| Change in accounts receivable   | (397 )                          | 1,302     |
| Change in deferred policy acquisition costs   | (371 )                          | (384 )    |
| Change in unpaid losses and loss adjustment expenses                                    | (1,749 )                        | 7,470     |
| Change in unearned premiums   | 5,139                           | 5,425     |
| Change in reinsurance recoverable   | (5,874 )                        | (579 )    |
| Change in reinsurance balances payable  | 4,188                           | 3,528     |
| Change in current federal income tax recoverable  | 1,451                           | 2,445     |
| Change in all other liabilities   | 277                             | (6,430 )  |
| Change in all other assets  | (935 )                          | (1,647 )  |
| Net cash (used in) provided by operating activities                                     | (1,311 )                        | 3,709     |
| Cash flows from investing activities:   |                                 |           |
| Purchases of property and equipment   | (225 )                          | (456 )    |
| Net transfers (into) from restricted cash   | (211 )                          | 2,111     |
| Purchases of investment securities  | (58,384 )                       | (26,735 ) |
| Maturities, sales and redemptions of investment securities                              | 34,455                          | 20,923    |
| Net cash used in investing activities   | (24,365 )                       | (4,157 )  |
| Cash flows from financing activities:   |                                 |           |
| Proceeds from exercise of employee stock options  | -                               | 202       |
| Purchase of treasury shares   | (1,293 )                        | (288 )    |

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|  |           |           |
|--|-----------|-----------|
| Net cash used in financing activities            | (1,293 )  | (86 )     |
| Decrease in cash and cash equivalents            | (26,969 ) | (534 )    |
| Cash and cash equivalents at beginning of period | 114,446   | 130,985   |
| Cash and cash equivalents at end of period       | \$87,477  | \$130,451 |

Supplemental cash flow information:

|                   |         |         |
|-------------------|---------|---------|
| Interest paid     | \$1,131 | \$1,140 |
| Income taxes paid | \$184   | \$720   |

Supplemental schedule of non-cash investing activities:

|   |         |          |
|---|---------|----------|
| Change in receivable for securities related to investment disposals that settled after the balance sheet date | \$9,486 | \$(359 ) |
| Change in payable for securities related to investment purchases that settled after the balance sheet date    | \$1,813 | \$13,203 |

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

## **Hallmark Financial Services, Inc. and Subsidiaries**

### **Notes to Consolidated Financial Statements (Unaudited)**

#### **1. General**

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

We pursue our business activities primarily through subsidiaries whose operations are organized into product-specific operating units that are supported by our insurance company subsidiaries. Our MGA Commercial Products operating unit offers commercial insurance products and services in the excess and surplus lines market. Our Specialty Commercial operating unit offers general aviation and satellite launch insurance products and services, low and middle market commercial umbrella and primary/excess liability insurance, medical professional liability insurance products and services, and primary/excess commercial property coverages for both catastrophe and non-catastrophe exposures. Our Standard Commercial P&C operating unit offers industry-specific commercial insurance products and services in the standard market. Our Workers Compensation operating unit specializes in small and middle market workers compensation business. Effective July 1, 2015, this operating unit no longer markets or retains any risk on new or renewal policies. Our Specialty Personal Lines operating unit offers non-standard personal automobile and renters insurance products and services. Our insurance company subsidiaries supporting these operating units are American Hallmark Insurance Company of Texas, Hallmark Insurance Company, Hallmark Specialty Insurance Company, Hallmark County Mutual Insurance Company, Hallmark National Insurance Company and Texas Builders Insurance Company.

These operating units are segregated into three reportable industry segments for financial accounting purposes. The Specialty Commercial Segment includes our MGA Commercial Products operating unit and our Specialty Commercial operating unit. The Standard Commercial Segment includes our Standard Commercial P&C operating unit and our Workers Compensation operating unit. The Personal Segment consists solely of our Personal Lines operating unit.

#### **2. Basis of Presentation**

Our unaudited consolidated financial statements included herein have been prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) and include our accounts and the accounts of our subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation. Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to rules and regulations of the Securities and Exchange Commission (“SEC”) for interim financial reporting. These unaudited consolidated financial statements should be read in conjunction with our audited consolidated financial statements for the year ended December 31, 2015 included in our Annual Report on Form 10-K filed with the SEC.

The interim financial data as of March 31, 2016 and 2015 is unaudited. However, in the opinion of management, the interim data includes all adjustments, consisting of normal recurring adjustments, necessary for a fair statement of the results for the interim periods. The results of operations for the period ended March 31, 2016 are not necessarily indicative of the operating results to be expected for the full year.

### **Business Combinations**

We account for business combinations using the acquisition method of accounting pursuant to Accounting Standards Codification (“ASC”) 805, “Business Combinations.” The base cash purchase price plus the estimated fair value of any non-cash or contingent consideration given for an acquired business is allocated to the assets acquired (including identified intangible assets) and liabilities assumed based on the estimated fair values of such assets and liabilities. The excess of the fair value of the total consideration given for an acquired business over the aggregate net fair values assigned to the assets acquired and liabilities assumed is recorded as goodwill. Contingent consideration is recognized as a liability at fair value as of the acquisition date with subsequent fair value adjustments recorded in the consolidated statements of operations. The valuation of contingent consideration requires assumptions regarding anticipated cash flows, probabilities of cash flows, discount rates and other factors. Significant judgment is employed in determining the propriety of these assumptions as of the acquisition date and for each subsequent period. Accordingly, future business and economic conditions, as well as changes in any of the assumptions, can materially impact the amount of contingent consideration expense we record in any given period. Indirect and general expenses related to business combinations are expensed as incurred.

### **Income Taxes**

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

### **Use of Estimates in the Preparation of the Financial Statements**

Our preparation of financial statements in conformity with GAAP requires us to make estimates and assumptions that affect our reported amounts of assets and liabilities and our disclosure of contingent assets and liabilities at the date of our consolidated financial statements, as well as our reported amounts of revenues and expenses during the reporting period. Refer to “Critical Accounting Estimates and Judgments” under Item 7 of our Annual Report on Form 10-K for the year ended December 31, 2015 for information on accounting policies that we consider critical in preparing our consolidated financial statements. Actual results could differ materially from those estimates.

### **Fair Value of Financial Instruments**

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

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

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



Revolving Credit Facility Payable: A revolving credit facility with The Frost National Bank had a carried value of \$30.0 million and a fair value of \$30.1 million as of March 31, 2016. The fair value is based on discounted cash flows using a discount rate derived from LIBOR spot rates plus a market spread resulting in discount rates ranging between 3.6% to 4.3% for each future payment date. This revolving credit facility would be included in Level 3 of the fair value hierarchy if it was reported at fair value.

Subordinated Debt Securities: Our trust preferred securities have a carried value of \$56.7 million and a fair value of \$42.6 million as of March 31, 2016. The fair value of our trust preferred securities is based on discounted cash flows using a current yield to maturity of 8.0%, which is based on similar issues to discount future cash flows. Our trust preferred securities would be included in Level 3 of the fair value hierarchy if they were reported at fair value.

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

### *Variable Interest Entities*

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

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

We evaluate on an ongoing basis our investments in Trust I and Trust II (collectively the “Trusts”) and have determined that we do not have a variable interest in the Trusts. Therefore, the Trusts are not included in our consolidated financial statements.

We are also involved in the normal course of business with variable interest entities (“VIE’s”) primarily as a passive investor in mortgage-backed securities and certain collateralized corporate bank loans issued by third party VIE’s. The

maximum exposure to loss with respect to these investments is the investment carrying values included in the consolidated balance sheets.

**New Accounting Pronouncements**

In May 2014, the Financial Accounting Standards Board (“FASB”) issued guidance which revises the criteria for revenue recognition. Insurance contracts are excluded from the scope of the new guidance. Under the guidance, the transaction price is attributed to underlying performance obligations in the contract and revenue is recognized as the entity satisfies the performance obligations and transfers control of a good or service to the customer. Incremental costs of obtaining a contract may be capitalized to the extent the entity expects to recover those costs. The guidance is effective for reporting periods beginning after December 15, 2017 and is to be applied retrospectively. We are in the process of evaluating the impact of adoption, which is not expected to be material to our results of operations or financial position.

In February 2015, the FASB issued ASU 2015-02, "Amendments to the Consolidation Analysis" (Topic 810). ASU 2015-02 changes the analysis that a reporting entity must perform to determine whether entities should be consolidated if they are deemed variable interest entities. It is effective for annual reporting periods, and interim periods within those years, beginning after December 15, 2015. We have adopted this standard as of the effective date, and the adoption did not impact our financial statements.

In May 2015, the FASB issued guidance which requires additional disclosures about short-duration contracts for products in effect for typically a year or less. The disclosures will focus on the liability for unpaid claims and claim adjustment expenses. This guidance is effective for annual periods beginning after December 15, 2015 and interim periods within annual periods beginning after December 15, 2016. We are in the process of evaluating the impact of the adoption, which is not expected to be material to our results of operations or financial position.

### 3. Acquisitions, Dispositions and Business Combinations

On June 30, 2015, Redpoint Comp Holdings LLC (“Purchaser”) acquired exclusive renewal rights to our current in-force Texas workers compensation policies, together with certain physical assets associated with the administration of such in-force policies. In consideration for such renewal rights and physical assets, Purchaser assumed certain office lease obligations and offered employment to certain of our employees associated with the Workers Compensation operating unit. Purchaser also agreed to administer the run-off of all of our current workers compensation policies and claims for a period of three years. In connection with the transaction, we made a one-time payment to the Purchaser of \$83,000. We also agreed not to compete in the workers compensation line of insurance in the State of Texas (with certain exceptions) until after the assumed office lease obligations expire on October 31, 2017. We recorded a gain of \$0.2 million during the second quarter of 2015.

On September 15, 2015, we executed Amendment No. 1 to the sale agreement with the Purchaser. Pursuant to the Amendment, the Purchaser has agreed to pay us \$115,000 and administer the run-off of all of our workers compensation policies and claims in perpetuity or through final conclusion (rather than for three years as contemplated by the original agreement) in consideration of us assigning to Purchaser the commission on all unearned premiums on such policies as of July 1, 2015. We recorded an additional gain of \$0.4 million during the third quarter of 2015 as a result of this Amendment No.1.

### 4. Fair Value

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

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

Level 1: quoted prices in active markets for identical assets;

Level 2: inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, inputs of identical assets for less active markets, and inputs that are observable for the asset or liability, either directly

or indirectly, for substantially the full term of the instrument; and

- Level 3: inputs to the valuation methodology that are unobservable for the asset or liability.

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

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

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

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

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

There were no transfers between Level 1 and Level 2 securities during the periods presented.

The following table presents for each of the fair value hierarchy levels, our assets that are measured at fair value on a recurring basis at March 31, 2016 and December 31, 2015 (in thousands):

|   | As of March 31, 2016  |  |                                     |           |
|---|---|--|-------------------------------------|-----------|
|   | Quoted<br>Prices<br>in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level<br>1) | Other<br>Observable<br>Inputs<br>(Level 2) | Unobservable<br>Inputs<br>(Level 3) | Total     |
| U.S. Treasury securities and obligations of U.S. Government | \$-   | \$ 74,569                                  | \$ -                                | \$74,569  |
| Corporate bonds   | -   | 160,695                                    | -                                   | 160,695   |
| Collateralized corporate bank loans                         | -   | 80,391                                     | -                                   | 80,391    |
| Municipal bonds   | -   | 178,564                                    | 14,116                              | 192,680   |
| Mortgage-backed   | -   | 56,423                                     | -                                   | 56,423    |
| Total debt securities                                       | -   | 550,642                                    | 14,116                              | 564,758   |
| Total equity securities                                     | 48,706  | -  | 622                                 | 49,328    |
| Total debt and equity securities                            | \$48,706  | \$ 550,642                                 | \$ 14,738                           | \$614,086 |

|   | As of December 31, 2015   |  |                                     |           |
|---|---|--|-------------------------------------|-----------|
|   | Quoted<br>Prices<br>in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level<br>1) | Other<br>Observable<br>Inputs<br>(Level 2) | Unobservable<br>Inputs<br>(Level 3) | Total     |
| U.S. Treasury securities and obligations of U.S. Government | \$-   | \$ 76,269                                  | \$ -                                | \$76,269  |
| Corporate bonds   | -   | 121,709                                    | -                                   | 121,709   |
| Collateralized corporate bank loans                         | -   | 81,596                                     | -                                   | 81,596    |
| Municipal bonds   | -   | 178,281                                    | 14,087                              | 192,368   |
| Mortgage-backed   | -   | 59,383                                     | -                                   | 59,383    |
| Total debt securities                                       | -   | 517,238                                    | 14,087                              | 531,325   |
| Total equity securities                                     | 47,504  | -  | -                                   | 47,504    |
| Total debt and equity securities                            | \$47,504  | \$ 517,238                                 | \$ 14,087                           | \$578,829 |

Due to significant unobservable inputs into the valuation model for certain municipal bonds and one equity security in illiquid markets, as of March 31, 2016, we classified these investments as Level 3 in the fair value hierarchy. We used an income approach in order to derive an estimated fair value of the municipal bonds classified as Level 3, which included inputs such as expected holding period, benchmark swap rate, benchmark discount rate and a discount rate premium for illiquidity. Significant changes in the unobservable inputs in the fair value measurement of these municipal bonds or equity security could result in a significant change in the fair value measurement.



The following table summarizes the changes in fair value for all financial assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) during the three months ended March 31, 2016 and 2015 (in thousands):

|  |           |
|--|-----------|
| Beginning balance as of January 1, 2016                | \$ 14,087 |
| Sales  | -         |
| Settlements  | -         |
| Purchases  | -         |
| Issuances  | -         |
| Total realized/unrealized gains included in net income | -         |
| Net gains included in other comprehensive income       | 29        |
| Transfers into Level 3                                 | 622       |
| Transfers out of Level 3                               | -         |
| Ending balance as of March 31, 2016                    | \$ 14,738 |
| Beginning balance as of January 1, 2015                | \$ 14,598 |
| Sales  | -         |
| Settlements  | (59 )     |
| Purchases  | -         |
| Issuances  | -         |
| Total realized/unrealized gains included in net income | -         |
| Net losses included in other comprehensive income      | (105 )    |
| Transfers into Level 3                                 | -         |
| Transfers out of Level 3                               | -         |
| Ending balance as of March 31, 2015                    | \$ 14,434 |

## 5. Investments

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

|   | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|---|-------------------|------------------------------|-------------------------------|---------------|
| As of March 31, 2016  |                   |                              |                               |               |
| U.S. Treasury securities and obligations of U.S. Government | \$ 74,338         | \$ 231                       | \$ -                          | \$ 74,569     |
| Corporate bonds   | 161,211           | 956                          | (1,472 )                      | 160,695       |
| Collateralized corporate bank loans                         | 81,062            | 116                          | (787 )                        | 80,391        |
| Municipal bonds   | 196,870           | 2,194                        | (6,384 )                      | 192,680       |
| Mortgage-backed   | 56,599            | 387                          | (563 )                        | 56,423        |
| Total debt securities                                       | 570,080           | 3,884                        | (9,206 )                      | 564,758       |
| Total equity securities                                     | 27,460            | 22,998                       | (1,130 )                      | 49,328        |
| Total debt and equity securities                            | \$ 597,540        | \$ 26,882                    | \$ (10,336 )                  | \$ 614,086    |
| As of December 31, 2015                                     |                   |                              |                               |               |
| U.S. Treasury securities and obligations of U.S. Government | \$ 76,323         | \$ 7                         | \$ (61 )                      | \$ 76,269     |
| Corporate bonds   | 122,894           | 637                          | (1,822 )                      | 121,709       |
| Collateralized corporate bank loans                         | 83,434            | 44                           | (1,882 )                      | 81,596        |
| Municipal bonds   | 196,446           | 1,888                        | (5,966 )                      | 192,368       |
| Mortgage-backed   | 59,532            | 155                          | (304 )                        | 59,383        |
| Total debt securities                                       | 538,629           | 2,731                        | (10,035 )                     | 531,325       |
| Total equity securities                                     | 24,951            | 23,391                       | (838 )                        | 47,504        |
| Total debt and equity securities                            | \$ 563,580        | \$ 26,122                    | \$ (10,873 )                  | \$ 578,829    |

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

|   | Three Months<br>Ended March<br>31, |       |
|---|------------------------------------|-------|
|   | 2016                               | 2015  |
| U.S. Treasury securities and obligations of U.S. Government | \$-                                | \$-   |
| Corporate bonds   | 80                                 | -     |
| Collateralized corporate bank loans                         | 18                                 | 18    |
| Municipal bonds   | (24 )                              | (26 ) |
| Mortgage-backed   | -                                  | 187   |
| Equity securities   | -                                  | 682   |
| Gain on investments   | 74                                 | 861   |
| Other-than-temporary impairments                            | (301)                              | (277) |
| Net realized (losses) gains                                 | \$(227)                            | \$584 |

We realized gross gains on investments of \$0.1 million and \$0.9 million during the three months ended March 31, 2016 and 2015, respectively. We realized gross losses on investments of \$23 thousand and \$28 thousand for the three months ended March 31, 2016 and 2015, respectively. We recorded proceeds from the sale of investment securities of \$4.8 million and \$1.6 million during the three months ended March 31, 2016 and 2015, respectively. Realized investment gains and losses are recognized in operations on the specific identification method.

The following schedules summarize the gross unrealized losses showing the length of time that investments have been continuously in an unrealized loss position as of March 31, 2016 and December 31, 2015 (in thousands):

|   | As of March 31, 2016 |                   |                       |                   |            |                   |
|---|----------------------|-------------------|-----------------------|-------------------|------------|-------------------|
|   | 12 months or less    |                   | Longer than 12 months |                   | Total      |                   |
|   | Fair Value           | Unrealized Losses | Fair Value            | Unrealized Losses | Fair Value | Unrealized Losses |
| U.S. Treasury securities and obligations of U.S. Government | \$-                  | \$ -              | \$-                   | \$ -              | \$-        | \$ -              |
| Corporate bonds   | 72,123               | (1,472 )          | -                     | -                 | 72,123     | (1,472 )          |
| Collateralized corporate bank loans                         | 45,414               | (691 )            | 5,314                 | (96 )             | 50,728     | (787 )            |
| Municipal bonds   | 16,565               | (279 )            | 20,798                | (6,105 )          | 37,363     | (6,384 )          |
| Mortgage-backed   | 29,780               | (561 )            | 44                    | (2 )              | 29,824     | (563 )            |
| Total debt securities                                       | 163,882              | (3,003 )          | 26,156                | (6,203 )          | 190,038    | (9,206 )          |
| Total equity securities                                     | 2,796                | (474 )            | 1,689                 | (656 )            | 4,485      | (1,130 )          |
| Total debt and equity securities                            | \$166,678            | \$ (3,477 )       | \$27,845              | \$ (6,859 )       | \$194,523  | \$ (10,336 )      |

|   | As of December 31, 2015 |                   |                       |                   |            |                   |
|---|-------------------------|-------------------|-----------------------|-------------------|------------|-------------------|
|   | 12 months or less       |                   | Longer than 12 months |                   | Total      |                   |
|   | Fair Value              | Unrealized Losses | Fair Value            | Unrealized Losses | Fair Value | Unrealized Losses |
| U.S. Treasury securities and obligations of U.S. Government | \$41,428                | \$ (61)           | \$-                   | \$ -              | \$41,428   | \$ (61)           |
| Corporate bonds   | 96,475                  | (1,822 )          | -                     | -                 | 96,475     | (1,822 )          |
| Collateralized corporate bank loans                         | 65,868                  | (1,758 )          | 3,532                 | (124 )            | 69,400     | (1,882 )          |
| Municipal bonds   | 44,525                  | (488 )            | 25,310                | (5,478 )          | 69,835     | (5,966 )          |
| Mortgage-backed   | 36,251                  | (302 )            | 48                    | (2 )              | 36,299     | (304 )            |
| Total debt securities                                       | 284,547                 | (4,431 )          | 28,890                | (5,604 )          | 313,437    | (10,035 )         |
| Total equity securities                                     | 6,584                   | (838 )            | -                     | -                 | 6,584      | (838 )            |
| Total debt and equity securities                            | \$291,131               | \$ (5,269 )       | \$28,890              | \$ (5,604 )       | \$320,021  | \$ (10,873 )      |

At March 31, 2016, the gross unrealized losses more than twelve months old were attributable to 33 debt security positions. At December 31, 2015, the gross unrealized losses more than twelve months old were attributable to 39 debt security positions. We consider these losses as a temporary decline in value as they are predominately on bonds that we do not intend to sell and do not believe we will be required to sell prior to recovery of our amortized cost basis. We see no other indications that the decline in values of these securities is other-than-temporary.

We complete a detailed analysis each quarter to assess whether any decline in the fair value of any investment below cost is deemed other-than-temporary. All securities with an unrealized loss are reviewed. We recognize an impairment

loss when an investment's value declines below cost, adjusted for accretion, amortization and previous other-than-temporary impairments, and it is determined that the decline is other-than-temporary.

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

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

The amortized cost and estimated fair value of debt securities at March 31, 2016 by contractual maturity are as follows. Expected maturities may differ from contractual maturities because certain borrowers may have the right to call or prepay obligations with or without penalties.

|  | Amortized Fair |           |
|--|----------------|-----------|
|  | Cost           | Value     |
|  | (in thousands) |           |
| Due in one year or less                | \$76,399       | \$76,378  |
| Due after one year through five years  | 275,361        | 274,245   |
| Due after five years through ten years | 100,146        | 96,120    |
| Due after ten years                    | 61,575         | 61,592    |
| Mortgage-backed                        | 56,599         | 56,423    |
|  | \$570,080      | \$564,758 |

## 6. Pledged Investments

We have pledged certain of our securities for the benefit of various state insurance departments and reinsurers. These securities are included with our available-for-sale debt securities because we have the ability to trade these securities. We retain the interest earned on these securities. These securities had a carrying value of \$17.6 million at both March 31, 2016 and December 31, 2015.

## 7. Reserves for Unpaid Losses and Loss Adjustment Expenses

We recorded \$1.7 million of net favorable development in reserve estimates during the three months ended March 31, 2016. The \$1.7 million of net favorable development recognized during the first quarter of 2016 was attributable to \$3.6 million net favorable development on claims incurred in the 2015 accident years, \$0.2 million of net favorable development in the 2014 accident year and \$0.7 million in the 2011 and prior accident years, partially offset by \$1.7 million net unfavorable development in the 2013 accident year and \$1.1 million net unfavorable development in the 2012 accident year. Our MGA Commercial Products operating unit, Standard Commercial P&C operating unit, Workers Compensation operating unit and Specialty Commercial operating unit accounted for \$2.2 million, \$0.2 million, \$0.2 million and \$0.1 million, respectively, of the decrease in reserves recognized during the first quarter of 2016. These favorable developments were offset by \$1.0 million of net unfavorable development in our Personal Lines Segment.

The net favorable development of \$2.2 million for our MGA Commercial Products operating unit in the first quarter of 2016 was primarily driven by favorable claims development in both our general liability and commercial auto liability lines of business in the 2015, 2014 and 2011 and prior accident years, partially offset by net unfavorable development in the 2013 and 2012 accident years in both our general liability and commercial auto liability lines of business. The net favorable development of \$0.2 million in our Standard Commercial P&C operating unit consisted of \$0.8 million net favorable development in our commercial property and general liability lines of business, partially offset by \$0.6 million of net unfavorable development in our occupational accident line of business. The net favorable development of \$0.2 million in our Workers Compensation operating unit was primarily attributable to the 2015 accident year. The net favorable development of \$0.1 million in our Specialty Commercial operating unit was primarily attributable to our primary/excess & umbrella line of business. These net favorable developments were partially offset by net unfavorable development of \$1.0 million in our Specialty Personal Lines operating unit attributable to the 2015 and prior accident years.

We recorded \$1.1 million of net favorable development in reserve estimates during the three months ended March 31, 2015. The \$1.1 million of net favorable development recognized during the first quarter of 2015 was attributable to \$2.4 million net favorable development on claims incurred in the 2014 accident year and \$0.4 million of net favorable development in the 2011 accident year, partially offset by \$0.1 million of net unfavorable development in the 2013 accident year, \$0.2 million of net unfavorable development in the 2012 accident year and \$1.4 million of net unfavorable development in the 2010 and prior accident years. Our Standard Commercial P&C operating unit accounted for \$1.4 million of the net favorable development recognized during the first quarter of 2015. Our Specialty Commercial operating unit accounted for \$0.5 million of the net favorable development. These net favorable developments were offset by \$0.5 million of net unfavorable development in our Personal Lines Segment and \$0.3 million of net unfavorable development in our MGA Commercial Products operating unit.

The net favorable development of \$1.4 million for our Standard Commercial P&C operating unit in the first quarter of 2015 was primarily driven by net favorable claims development in our commercial property and general liability lines of business in the 2014 and 2013 accident years. The net favorable development of \$0.5 million in our Specialty Commercial operating unit was attributable to \$0.2 million in our general aviation line of business and \$0.3 million in our commercial excess liability line of business. The net unfavorable development of \$0.5 million in our Personal Lines Segment was primarily attributable to the 2014 accident year. The net unfavorable development of \$0.3 million in our MGA Commercial Products operating unit was attributable to the 2013, 2012 and the 2010 and prior accident years in both commercial auto liability and general liability lines of business, partially offset by net favorable development in the 2014 and 2011 accident years in the commercial auto liability line of business.

## **8. Share-Based Payment Arrangements**

Our 2005 Long Term Incentive Plan (“2005 LTIP”) is a stock compensation plan for key employees and non-employee directors that was initially approved by the shareholders on May 26, 2005 and expired by its terms on May 27, 2015. As of March 31, 2016, there were outstanding incentive stock options to purchase 539,240 shares of our common



stock, non-qualified stock options to purchase 304,157 shares of our common stock and restricted stock units representing the right to receive up to 177,755 shares of our common stock. 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.

A new equity compensation plan for our key employees and non-employee directors, the 2015 Long Term Incentive Plan ("2015 LTIP"), was approved by shareholders on May 29, 2015. There are 2,000,000 shares authorized for issuance under the 2015 LTIP. As of March 31, 2016, restricted stock units representing the right to receive up to 149,196 shares of our common stock were outstanding under the 2015 LTIP. There were no stock option awards granted under the 2015 LTIP as of March 31, 2016.

**Stock Options:**

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

A summary of the status of our stock options as of March 31, 2016 and changes during the three months then ended is presented below:

|                                | Number<br>of<br>Shares | Weighted<br>Average<br>Exercise<br>Price | Average<br>Remaining<br>Contractual<br>Term<br>(Years) | Aggregate<br>Intrinsic<br>Value<br>(\$000) |
|--------------------------------|------------------------|--|--|--|
| Outstanding at January 1, 2016 | 869,113                | \$ 9.51                                  |  |  |
| Granted                        | -                      | \$ -                                     |  |  |
| Exercised                      | -                      | \$ -                                     |  |  |
| Forfeited or expired           | (25,716 )              | \$ 11.93                                 |  |  |
| Outstanding at March 31, 2016  | 843,397                | \$ 9.43                                  | 2.3  | \$ 2,002                                   |
| Exercisable at March 31, 2016  | 792,326                | \$ 9.61                                  | 2.2  | \$ 1,752                                   |

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

|   | Three<br>Months<br>Ended<br>March 31,<br>2016 2015 |        |
|---|--|--------|
| Intrinsic value of options exercised                            | \$-  | \$ 114 |
| Cost of share-based payments (non-cash)                         | \$38   | \$39   |
| Income tax benefit of share-based payments recognized in income | \$8  | \$8    |

As of March 31, 2016, there was no unrecognized compensation cost related to non-vested stock options granted under our plans which is expected to be recognized in the future.

The fair value of each stock option granted is estimated on the date of grant using the Black-Scholes option pricing model. Expected volatilities are based on the historical volatility of Hallmark's and similar companies' common stock for a period equal to the expected term. The risk-free interest rates for periods within the contractual term of the options are based on rates for U.S. Treasury Notes with maturity dates corresponding to the options' expected lives on the dates of grant. Expected term is determined based on the simplified method as we do not have sufficient historical exercise data to provide a basis for estimating the expected term. There were no stock options granted during the first three months of 2016 or 2015.

### **Restricted Stock Units:**

The 2005 LTIP was amended by the stockholders on May 30, 2013 to authorize the grant of restricted stock units, in addition to the other types of awards available thereunder. Restricted stock units awarded under the 2005 LTIP represent the right to receive shares of common stock upon the satisfaction of vesting requirements, performance criteria and other terms and conditions. On July 27, 2012 and April 10, 2013, an aggregate of 129,463 and 122,823 restricted stock units, respectively, were conditionally granted to certain of our employees subject to shareholder approval of the amendments to the 2005 LTIP at the May 30, 2013 shareholder meeting. One conditional grant of 9,280 restricted stock units was forfeited prior to approval at the shareholder meeting. Subsequently on September 8, 2014, an aggregate of 175,983 restricted stock units were granted to certain employees. On May 29, 2015, an aggregate of 103,351 restricted stock units were granted to certain employees under the 2015 LTIP.

The performance criteria for all restricted stock units require that we achieve certain compound average annual growth rates in book value per share over the vesting period in order to receive shares of common stock in amounts ranging from 50% to 150% of the number of restricted stock units granted. In addition, certain restricted stock units contain an

additional performance criteria related to the attainment of an average combined ratio percentage over the vesting period. Grantees of restricted stock units do not have any rights of a stockholder, and do not participate in any distributions to our common stockholders, until the award fully vests upon satisfaction of the vesting schedule, performance criteria and other conditions set forth in their award agreement. Therefore, unvested restricted stock units are not considered participating securities under ASC 260, "Earnings Per Share," and are not included in the calculation of basic or diluted earnings per share.

On April 1, 2016, 7,144 shares of common stock were issued with respect to 7,144 restricted stock units which were granted on April 10, 2013 and vested on March 31, 2016. On April 1, 2015, 8,616 shares of common stock were issued with respect to 8,616 restricted stock units which were granted on July 27, 2012 and vested on March 31, 2015. If and to the extent specified performance criteria have been achieved, the restricted stock units granted on September 8, 2014 (except for one grant) will vest on March 31, 2017, one grant of restricted stock units granted on September 8, 2014 will vest on March 31, 2018 and the restricted stock units granted on May 29, 2015 under the 2015 LTIP will vest on March 31, 2018.

Compensation cost is measured as an amount equal to the fair value of the restricted stock units on the date of grant and is expensed over the vesting period if achievement of the performance criteria is deemed probable, with the amount of the expense recognized based on our best estimate of the ultimate achievement level. The grant date fair value of the restricted stock units granted in 2012 and 2013 is \$9.20 per unit. The grant date fair value of the restricted stock units granted in 2014 is \$9.66 per unit. The grant date fair value of the restricted stock units granted in 2015 is \$11.10 per unit. We incurred compensation expense of \$101 thousand and \$332 thousand related to restricted stock units during the three months ended March 31, 2016 and 2015, respectively. We recorded an income tax benefit of \$35 thousand and \$116 thousand related to restricted stock units during the three months ended March 31, 2016 and 2015, respectively.

A summary of the status of our restricted stock units as of March 31, 2016 and changes during the three months then ended is presented below:

|                               | Number<br>of<br>Restricted<br>Stock<br>Units |
|-------------------------------|--|
| Non-vested at January 1, 2016 | 296,571                                      |
| Granted                       | -  |
| Vested                        | (7,144 )                                     |
| Forfeited                     | (71,460 )                                    |
| Non-vested at March 31, 2016  | 217,967                                      |

As of March 31, 2016, there was \$0.7 million of total unrecognized compensation cost related to unvested restricted stock units granted under our 2005 LTIP and 2015 LTIP, of which \$0.3 million is expected to be recognized during the remainder of 2016, \$0.3 million is expected to be recognized in 2017 and \$0.1 million is expected to be recognized in 2018.

**9. Segment Information**

The following is business segment information for the three months ended March 31, 2016 and 2015 (in thousands):

|                              | Three Months<br>Ended<br>March 31,<br>2016      2015 |          |
|------------------------------|--|----------|
| Revenues:                    |  |          |
| Specialty Commercial Segment | \$60,583   | \$62,257 |
| Standard Commercial Segment  | 17,992   | 20,381   |
| Personal Segment             | 12,090   | 8,653    |
| Corporate                    | (637 )   | 159      |
| Consolidated                 | \$90,028   | \$91,450 |
| Pre-tax income (loss):       |  |          |
| Specialty Commercial Segment | \$10,312   | \$9,721  |
| Standard Commercial Segment  | 1,416  | 1,886    |
| Personal Segment             | (1,083 )   | (296 )   |
| Corporate                    | (4,656 )   | (3,622 ) |
| Consolidated                 | \$5,989  | \$7,689  |

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

|                              | March 31,<br>2016 | December<br>31,<br>2015 |
|------------------------------|-------------------|-------------------------|
| Assets                       |                   |                         |
| Specialty Commercial Segment | \$673,102         | \$660,263               |
| Standard Commercial Segment  | 160,005           | 156,722                 |
| Personal Segment             | 236,025           | 239,632                 |
| Corporate                    | 20,917            | 19,983                  |
|                              | \$1,090,049       | \$1,076,600             |

**10. Reinsurance**

We reinsure a portion of the risk we underwrite in order to control the exposure to losses and to protect capital resources. We cede to reinsurers a portion of these risks and pay premiums based upon the risk and exposure of the policies subject to such reinsurance. Ceded reinsurance involves credit risk and is generally subject to aggregate loss limits. Although the reinsurer is liable to us to the extent of the reinsurance ceded, we are ultimately liable as the direct insurer on all risks reinsured. Reinsurance recoverables are reported after allowances for uncollectible amounts. We monitor the financial condition of reinsurers on an ongoing basis and review our reinsurance arrangements periodically. Reinsurers are selected based on their financial condition, business practices and the price of their product offerings. In order to mitigate credit risk to reinsurance companies, most of our reinsurance recoverable balance as of March 31, 2016 was with reinsurers that had an A.M. Best rating of “A-” or better.

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

|                        | Three Months<br>Ended<br>March 31,<br>2016      2015 |          |
|------------------------|--|----------|
| Ceded earned premiums  | \$38,980   | \$32,939 |
| Reinsurance recoveries | \$23,949   | \$19,358 |

## 11. Revolving Credit Facility

Our Second Restated Credit Agreement with The Frost National Bank (“Frost”) dated June 30, 2015, reinstated the credit facility with Frost which expired by its terms on April 30, 2015. The Second Restated Credit Agreement also amended certain provisions of the credit facility and restated the agreement with Frost in its entirety. The Second Restated Credit Agreement provides a \$15.0 million revolving credit facility, with a \$5.0 million letter of credit sub-facility. The outstanding balance of the revolving credit facility bears interest at a rate equal to the prime rate or LIBOR plus 2.5%, at our election. We pay an annual fee of 0.25% of the average daily unused balance of the credit facility and letter of credit fees at the rate of 1.00% per annum. The revolving credit facility contains covenants that, among other things, require us to maintain certain financial and operating ratios and restrict certain distributions, transactions and organizational changes. As of March 31, 2016 we were in compliance with all of our covenants and had no outstanding borrowings under this revolving credit facility.

On December 17, 2015, we entered into a First Amendment to Second Restated Credit Agreement (the “First Amendment”) and a Revolving Facility B Agreement (the “Facility B Agreement”) with Frost. The First Amendment amended the existing Second Restated Credit Agreement with Frost to incorporate the additional credit facility reflected by the Facility B Agreement.

The Facility B Agreement provides a new \$30.0 million revolving credit facility (“Facility B”), in addition to the existing \$15.0 million revolving credit facility with Frost. We may use Facility B loan proceeds solely for the purpose of making capital contributions to AHIC and HIC. We may borrow, repay and reborrow under the Facility B until December 17, 2017, at which time all amounts outstanding under the Facility B are converted to a term loan. In connection with Facility B, we paid Frost a one-time commitment fee of \$75,000 and will pay Frost an additional quarterly fee through December 17, 2017 of 0.25% per annum of the average daily unused balance of Facility B. Facility B bears interest at a rate equal to the prime rate or LIBOR plus 3.00%, at our election. Until December 17, 2017, interest only on amounts from time to time outstanding under Facility B are payable quarterly. Any amounts outstanding on Facility B as of December 17, 2017 are converted to a term loan payable in quarterly installments over



five years based on a seven year amortization of principal plus accrued interest. All remaining principal and accrued interest become due and payable on December 17, 2022. The obligations under Facility B are secured by the same collateral as the existing credit facility, being a security interest in the capital stock of AHIC and HIC. Facility B is subject to the same covenants as the existing credit facility. As of March 31, 2016, we had \$30.0 million outstanding under Facility B.

## 12. Subordinated Debt Securities

On June 21, 2005, we entered into a trust preferred securities transaction pursuant to which we issued \$30.9 million aggregate principal amount of subordinated debt securities due in 2035. To effect the transaction, we formed Trust I as a Delaware statutory trust. Trust I issued \$30.0 million of preferred securities to investors and \$0.9 million of common securities to us. Trust I used the proceeds from these issuances to purchase the subordinated debt securities. The initial interest rate on our Trust I subordinated debt securities was 7.725% until June 15, 2015, after which interest adjusts quarterly to the three-month LIBOR rate plus 3.25 percentage points. Trust I pays dividends on its preferred securities at the same rate. Under the terms of our Trust I subordinated debt securities, we pay interest only each quarter and the principal of the note at maturity. The subordinated debt securities are uncollateralized and do not require maintenance of minimum financial covenants. As of March 31, 2016, the balance of our Trust I subordinated debt was \$30.9 million and the interest rate was 3.88% per annum.

On August 23, 2007, we entered into a trust preferred securities transaction pursuant to which we issued \$25.8 million aggregate principal amount of subordinated debt securities due in 2037. To effect the transaction, we formed Trust II as a Delaware statutory trust. Trust II issued \$25.0 million of preferred securities to investors and \$0.8 million of common securities to us. Trust II used the proceeds from these issuances to purchase the subordinated debt securities. Our Trust II subordinated debt securities bear an initial interest rate of 8.28% until September 15, 2017, at which time interest will adjust quarterly to the three-month LIBOR rate plus 2.90 percentage points. Trust II pays dividends on its preferred securities at the same rate. Under the terms of our Trust II subordinated debt securities, we pay interest only each quarter and the principal of the note at maturity. The subordinated debt securities are uncollateralized and do not require maintenance of minimum financial covenants. As of March 31, 2016, the balance of our Trust II subordinated debt was \$25.8 million.

## 13. Deferred Policy Acquisition Costs

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

|           | Three Months<br>Ended<br>March 31,<br>2016 |  | 2015      |
|-----------|--|--|-----------|
| Deferred  | \$(13,738)                                 |  | \$(3,718) |
| Amortized | 13,367                                     |  | 3,334     |
| Net       | \$(371)                                    |  | \$(384)   |



**14. Earnings per Share**

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

|   | Three Months<br>Ended<br>March 31,<br>2016      2015 |        |
|---|--|--------|
| Weighted average shares - basic             | 19,013   | 19,227 |
| Effect of dilutive securities               | 175  | 202    |
| Weighted average shares - assuming dilution | 19,188   | 19,429 |

For the three months ended March 31, 2016, 421,666 shares of common stock potentially issuable upon the exercise of employee stock options were excluded from the weighted average number of shares outstanding on a diluted basis because the effect of such options would be anti-dilutive. For the three months ended March 31, 2015, 504,999 shares of common stock potentially issuable upon the exercise of employee stock options were excluded from the weighted average number of shares outstanding on a diluted basis because the effect of such options would be anti-dilutive.

**15. Net Periodic Pension Cost**

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

|                                | Three Months<br>Ended<br>March 31, |         |
|--------------------------------|------------------------------------|---------|
|                                | 2016                               | 2015    |
| Interest cost                  | \$128                              | \$129   |
| Amortization of net loss       | 28                                 | 26      |
| Expected return on plan assets | (161)                              | (175)   |
| Net periodic pension cost      | \$(5 )                             | \$(20 ) |
| Contributed amount             | \$-                                | \$-     |

Refer to Note 14 to the consolidated financial statements in our Annual Report on Form 10-K for the year ended December 31, 2015 for more discussion of our retirement plans.

**16. Income Taxes**

Our effective income tax rate for the first three months ended March 31, 2016 and 2015 was 32.0% and 30.5%, respectively. The rates varied from the statutory tax rate primarily due to the amount of tax exempt income in relation to pre-tax income.

**17. Commitments and Contingencies**

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

During the third quarter of 2015 we paid \$1.2 million to the sellers of the subsidiaries comprising our Workers Compensation operating unit in fulfillment of the contingent purchase price. The sellers have disputed the calculation

of the amount paid and assert that an additional \$1.8 million is due. We disagree with this assertion and believe that our calculation of the contingent purchase price was substantially correct. Pursuant to the terms of the acquisition agreement, an independent actuary has been engaged to resolve this matter.

In November 2015, HSU was informed by the Texas Comptroller of Public Accounts that a surplus lines tax audit covering the period January 1, 2010 through December 31, 2013 was complete. HSU frequently acts as a managing general underwriter (“MGU”) authorized to underwrite policies on behalf of Republic Vanguard Insurance Company and HSIC, both Texas eligible surplus lines insurance carriers. In its role as the MGU, HSU underwrites policies on behalf of these carriers while other agencies located in Texas (generally referred to as “producing agents”) deliver the policies to the insureds and collect all premiums due from the insureds. During the period under audit, the producing agents also collected the surplus lines premium taxes due on the policies from the insureds, held them in trust, and timely remitted those taxes to the Comptroller. We believe this system for collecting and paying the required surplus lines premium taxes complies in all respects with the Texas Insurance Code and other regulations, which clearly require that the same party who delivers the policies and collects the premiums will also collect premium taxes, hold premium taxes in trust, and pay premium taxes to the Comptroller. It also complies with long standing industry practice. In addition, effective January 1, 2012 the Texas Legislators enacted House Bill 3410 (HB3410) which allows an MGU to contractually pass the collection, payment and administration of surplus lines taxes down to another Texas licensed surplus line agent.

The Comptroller asserts that HSU is liable for the surplus lines premium taxes related to policy transactions and premiums collected from surplus lines insureds during January 1, 2010 through December 31, 2011, the period prior to the passage of HB3410, and that HSU therefore owes \$2.5 million in premium taxes, as well as \$0.7 million in penalties and interest for the audit period.

We disagree with the Comptroller and intend to vigorously fight their assertion that HSU is liable for the surplus lines premium taxes. We are currently in negotiations with the Comptroller to settle the matter. However, we are presently unable to reasonably estimate the possible loss or legal costs that are likely to arise out of the surplus lines tax audit or any future proceedings relating to this matter. Therefore we have not accrued any amount as of March 31, 2016 related to this matter.

**18. Changes in Accumulated Other Comprehensive Income Balances**

The changes in accumulated other comprehensive income balances as of March 31, 2016 and 2015 were as follows (in thousands):

|  | Minimum<br>Pension<br>Liability | Unrealized<br>Gains<br>(Loss) | Accumulated<br>Other<br>Comprehensive<br>Income |
|--|---------------------------------|-------------------------------|---|
| Balance at December 31, 2014   | \$ (2,600 )                     | \$ 20,401                     | \$ 17,801                                       |
| Other comprehensive income :   |                                 |                               |   |
| Change in net actuarial gain   | 26                              | -                             | 26  |
| Tax effect on change in net actuarial gain   | (9 )                            | -                             | (9 )  |
| Net unrealized holding gains arising during the period                             | -                               | 7,069                         | 7,069   |
| Tax effect on unrealized gains arising during the period                           | -                               | (2,474 )                      | (2,474 )  |
| Reclassification adjustment for gains included in net realized gains               | -                               | (861 )                        | (861 )  |
| Tax effect on reclassification adjustment for gains included in income tax expense | -                               | 301                           | 301   |
| Other comprehensive income, net of tax   | 17                              | 4,035                         | 4,052   |
| Balance at March 31, 2015  | \$ (2,583 )                     | \$ 24,436                     | \$ 21,853                                       |
| Balance at December 31, 2015   | \$ (2,572 )                     | \$ 9,990                      | \$ 7,418  |
| Other comprehensive income :   |                                 |                               |   |
| Change in net actuarial gain   | 28                              | -                             | 28  |
| Tax effect on change in net actuarial gain   | (10 )                           | -                             | (10 )   |
| Net unrealized holding gains arising during the period                             | -                               | 1,371                         | 1,371   |
| Tax effect on unrealized gains arising during the period                           | -                               | (480 )                        | (480 )  |
| Reclassification adjustment for gains included in net realized gains               | -                               | (74 )                         | (74 )   |
| Tax effect on reclassification adjustment for gains included in income tax expense | -                               | 26                            | 26  |
| Other comprehensive income, net of tax   | 18                              | 843                           | 861   |
| Balance at March 31, 2016  | \$ (2,554 )                     | \$ 10,833                     | \$ 8,279  |



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

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

### Introduction

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

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

***Specialty Commercial Segment.*** Our Specialty Commercial Segment includes the excess and surplus lines commercial property/casualty insurance products and services handled by our MGA Commercial Products operating unit and the general aviation, satellite launch, commercial umbrella and primary/excess liability, medical professional liability and primary/excess commercial property insurance products and services handled by our Specialty Commercial operating unit, as well as certain specialty risk programs which are managed at the parent level.

***Standard Commercial Segment.*** Our Standard Commercial Segment includes the standard lines commercial property/casualty and occupational accident insurance products and services handled by our Standard Commercial P&C operating unit and the workers compensation insurance products handled by our Workers Compensation operating unit. Effective July 1, 2015, the Workers Compensation operating unit no longer retains any risk on new or renewal policies.

***Personal Segment.*** Our Personal Segment includes the non-standard personal automobile and renters insurance products and services handled by our Specialty Personal Lines operating unit.

The retained premium produced by these reportable segments is supported by our American Hallmark Insurance Company of Texas (“AHIC”), Hallmark Specialty Insurance Company (“HSIC”), Hallmark Insurance Company (“HIC”), Hallmark National Insurance Company (“HNIC”) and Texas Builders Insurance Company (“TBIC”) insurance subsidiaries. In addition, control and management of Hallmark County Mutual (“HCM”) is maintained through our wholly owned subsidiary, CYR Insurance Management Company (“CYR”). CYR has as its primary asset a management agreement with HCM which provides for CYR to have management and control of HCM. HCM is used to front certain lines of business in our Specialty Commercial and Personal Segments in Texas. HCM does not retain any business.

AHIC, HIC, HSIC and HNIC have entered into a pooling arrangement pursuant to which AHIC retains 34% of the total net premiums written by any of them, HIC retains 32% of our total net premiums written by any of them, HSIC retains 24% of our total net premiums written by any of them and HNIC retains 10% of our total net premiums written by any of them. Neither HCM nor TBIC is a party to the intercompany pooling arrangement.

## Results of Operations

**Management overview.** During the three months ended March 31, 2016, our total revenues were \$90.0 million, representing a decrease of 2% from the \$91.5 million in total revenues for the same period of 2015. This decrease in revenue was primarily attributable to lower net premiums earned and realized losses recognized on our investment portfolio during the three months ended March 31, 2016, partially offset by higher net investment income and favorable profit share commission revenue adjustment in our Standard Commercial Segment. The decreased net earned premiums were due primarily to lower premiums written in our Workers Compensation operating unit due to a renewal rights agreement entered into during the second quarter of 2015 and subsequently amended during the third quarter of 2015 to cede 100% of the unearned premium effective July 1, 2015, as well as the impact on net premiums earned of lower net premiums written in our Specialty Commercial Segment during the fourth quarter of 2015, partially offset by increased retained premium under a renewed quota share reinsurance agreement effective October 1, 2014 in our Personal Segment.

The decrease in revenue for the three months ended March 31, 2016 was partially offset by lower loss and loss adjustment expenses (“LAE”) of \$0.7 million as compared to the same period in 2015. The decrease in loss and LAE was primarily the result of favorable prior year loss reserve development of \$1.7 million for the three months ended March 31, 2016 as compared to \$1.1 million of favorable prior year development for the same period of 2015, partially offset by higher current accident year loss trends in our Personal Segment. Other operating expenses increased due mostly to increased salary and related expenses, partially offset by lower production related expenses, in our Specialty Commercial Segment.

We reported net income of \$4.1 million for the three months ended March 31, 2016 as compared to net income of \$5.3 million for the same period of 2015. On a diluted basis per share, we reported net income of \$0.21 per share for the three months ended March 31, 2016, as compared to net income of \$0.28 per share for the same period in 2015.

**First Quarter 2016 as Compared to First Quarter 2015**

The following is additional business segment information for the three months ended March 31, 2016 and 2015 (in thousands):

|  | Three Months Ended March 31 |          |                             |          |                  |          |
|--|-----------------------------|----------|-----------------------------|----------|------------------|----------|
|  | Specialty                   |          | Standard Commercial Segment |          | Personal Segment |          |
|  | 2016                        | 2015     | 2016                        | 2015     | 2016             | 2015     |
| Gross premiums written                             | \$87,400                    | \$81,766 | \$20,098                    | \$22,309 | \$20,949         | \$20,984 |
| Ceded premiums written                             | (28,663)                    | (23,090) | (2,352)                     | (1,960)  | (9,806)          | (9,635)  |
| Net premiums written                               | 58,737                      | 58,676   | 17,746                      | 20,349   | 11,143           | 11,349   |
| Change in unearned premiums                        | (1,484)                     | 1,211    | (1,096)                     | (785)    | (719)            | (4,104)  |
| Net premiums earned                                | 57,253                      | 59,887   | 16,650                      | 19,564   | 10,424           | 7,245    |
| Total revenues                                     | 60,583                      | 62,257   | 17,992                      | 20,381   | 12,090           | 8,653    |
| Losses and loss adjustment expenses                | 34,413                      | 37,333   | 11,069                      | 12,470   | 9,913            | 6,287    |
| Pre-tax income (loss)                              | 10,312                      | 9,721    | 1,416                       | 1,886    | (1,083)          | (296)    |
| Net loss ratio (1)                                 | 60.1 %                      | 62.3 %   | 66.5 %                      | 63.7 %   | 95.1 %           | 86.8 %   |
| Net expense ratio (1)                              | 27.7 %                      | 25.5 %   | 34.2 %                      | 31.8 %   | 19.1 %           | 21.1 %   |
| Net combined ratio (1)                             | 87.8 %                      | 87.8 %   | 100.7 %                     | 95.5 %   | 114.2 %          | 107.9 %  |
| Net Favorable (Unfavorable) Prior Year Development | 2,347                       | 211      | 358                         | 1,362    | (988)            | (512)    |

(1) The net loss ratio is calculated as incurred losses and LAE divided by net premiums earned, each determined in accordance with GAAP. The net expense ratio is calculated as total underwriting expenses offset by agency fee income divided by net premiums earned, each determined in accordance with GAAP. Net combined ratio is calculated as the sum of the net loss ratio and the net expense ratio.

***Specialty Commercial Segment***

Gross premiums written for the Specialty Commercial Segment were \$87.4 million for the three months ended March 31, 2016, which was \$5.6 million, or 7%, more than the \$81.8 million reported for the same period of 2015. The increase in gross premium was primarily due to increased production in both our MGA Commercial Products and

Specialty Commercial operating units. Net premiums written were \$58.7 million for both the three months ended March 31, 2016 and 2015, due to a change in mix towards business with higher ceded premium as a percent of the gross premium.

The \$60.6 million of total revenue for the three months ended March 31, 2016 was \$1.7 million less than the \$62.3 million reported by the Specialty Commercial Segment for the same period in 2015. This decrease in revenue was primarily due to lower net premiums earned of \$2.6 million due primarily to the impact on net premiums earned of lower net premiums written in our Specialty Commercial Segment during the fourth quarter of 2015, partially offset by higher net investment income of \$0.8 million and higher commission and fees of \$0.1 million.

Pre-tax income for the Specialty Commercial Segment of \$10.3 million for the first quarter of 2016 was \$0.6 million higher than the \$9.7 million reported for the same period in 2015. The increase in pre-tax income was primarily the result of lower loss and LAE expenses of \$2.9 million, partially offset by higher operating expenses of \$0.6 million and the decreased revenue discussed above.

Our MGA Commercial Products operating unit reported a \$3.7 million decrease in loss and LAE due primarily to \$2.2 million favorable prior year loss reserve development recognized during the three months ended March 31, 2016 as compared to \$0.4 million unfavorable prior year loss reserve development during the same period during 2015. Our Specialty Commercial operating unit reported a \$0.8 million increase in loss and LAE which consisted of (a) a \$0.2 million increase in loss and LAE due primarily to \$0.1 million of favorable loss reserve development recognized during the three months ended March 31, 2016 as compared to \$0.3 million favorable prior year loss development during the same period of 2015 in our commercial umbrella and primary/excess liability line of business (b) a \$0.1 million increase in loss and LAE attributable to our general aviation line of business due primarily to \$0.2 million favorable loss reserve development recognized during the three months ended March 31, 2015 compared to no prior year loss reserve development recognized during the three months ended March 31, 2016 (c) a \$0.4 million increase in loss and LAE attributable to our medical professional liability insurance products due to higher current accident year loss trends and (d) a \$0.1 million increase in loss and LAE attributable to our primary/excess property insurance products. The increase of \$0.6 million in operating expense was the combined result of increased salary and related expenses of \$1.4 million, partially offset by lower production related expenses of \$0.8 million.

The Specialty Commercial Segment reported a net loss ratio of 60.1% for the three months ended March 31, 2016 as compared to 62.3% for the same period during 2015. The gross loss ratio before reinsurance was 58.3% for the three months ended March 31, 2016 as compared to 62.2% for the same period in 2015. The lower gross and net loss ratios were primarily the result of \$2.3 million favorable prior year loss reserve development recognized for the three months ended March 31, 2016 as compared to \$0.2 million favorable prior year loss reserve development for the same period of 2015. The Specialty Commercial Segment reported a net expense ratio of 27.7% for the first quarter of 2016 as compared to 25.5% for the same period of 2015. The increase in the expense ratio was due predominately to the impact of lower net premiums earned as well as increased operating expenses referenced above.

### ***Standard Commercial Segment***

Gross premiums written for the Standard Commercial Segment were \$20.1 million for the three months ended March 31, 2016, which was \$2.2 million, or 10%, less than the \$22.3 million reported for the same period in 2015. The decrease in gross premium was primarily due to lower premium production in our Workers Compensation operating unit due to the renewal rights agreement entered into during the second quarter of 2015 and subsequently amended during the third quarter of 2015 to cede 100% of the unearned premium effective July 1, 2015. Net premiums written were \$17.7 million for the three months ended March 31, 2016 as compared to \$20.3 million reported for the same period in 2015. The lower net premiums written were primarily due to the workers compensation renewal rights agreement.

Total revenue for the Standard Commercial Segment of \$18.0 million for the three months ended March 31, 2016, was \$2.4 million, or 12%, less than the \$20.4 million reported for the same period in 2015. This decrease in total revenue was due to a \$2.9 million decrease in net premiums earned primarily as a result of the workers compensation renewal rights agreement, partially offset by higher net investment income of \$0.1 million and higher commission and fees of

\$0.4 million.

Our Standard Commercial Segment reported pre-tax income of \$1.4 million for the three months ended March 31, 2016 which was \$0.5 million, or 25%, less than the \$1.9 million reported for the same period of 2015. The decrease in pre-tax income was the result of the decreased revenue discussed above, partially offset by lower loss and LAE of \$1.4 million and lower operating expenses of \$0.5 million.

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The Standard Commercial Segment reported a net loss ratio of 66.5% for the three months ended March 31, 2016 as compared to 63.7% for the same period of 2015. The gross loss ratio before reinsurance for the three months ended March 31, 2016 was 65.8% as compared to the 57.2% reported for the same period of 2015. The increase in the gross and net loss ratios was driven by favorable prior year reserve development of \$0.4 million recognized during the three months ended March 31, 2016 as compared to favorable prior year reserve development of \$1.4 million during the same period of 2015. The Standard Commercial Segment reported a net expense ratio of 34.2% for the first quarter of 2016 as compared to 31.8% for the same period of 2015. The increase in the expense ratio is primarily due to the decreased earned premium partially offset by lower operating expenses.

### *Personal Segment*

Gross premiums written for the Personal Segment were \$20.9 million for the three months ended March 31, 2016 as compared to \$21.0 million for the same period in the prior year. Net premiums written for our Personal Segment were \$11.1 million in the first quarter of 2016, which was a decrease of \$0.2 million, or 2%, from the \$11.3 million reported for the first quarter of 2015.

Total revenue for the Personal Segment increased 40% to \$12.1 million for the first quarter of 2016 from \$8.7 million for the first quarter of 2015. The increase in revenue was primarily due to higher net premiums earned of \$3.2 million due mostly to increased retained premium under a renewed quota share reinsurance agreement effective October 1, 2014, increased finance charges of \$0.1 million and increased net investment income of \$0.1 million.

Pre-tax loss for the Personal Segment was \$1.1 million for the three months ended March 31, 2016 as compared to pre-tax loss of \$0.3 million for the same period of 2015. The increase in the pre-tax loss was the result of increased losses and LAE of \$3.6 million and increased operating expenses of \$0.6 million for the three months ended March 31, 2016 as compared to the same period during 2015, partially offset by the increased revenue discussed above.

The Personal Segment reported a net loss ratio of 95.1% for the three months ended March 31, 2016 as compared to 86.8% for the same period of 2015. The gross loss ratio before reinsurance was 90.2% for the three months ended March 31, 2016 as compared to 77.9% for the same period in 2015. The higher gross and net loss ratios were primarily the result of higher current accident year loss trends as well as \$1.0 million of unfavorable prior year net loss reserve development for the three months ended March 31, 2016 as compared to \$0.5 million of unfavorable development for the same period in the prior year. The Personal Segment reported a net expense ratio of 19.1% for the first quarter of 2016 as compared to 21.1% for the same period of 2015. The decrease in the expense ratio was due predominately to the impact of the change in terms of the quota share reinsurance agreement referenced above.



*Corporate*

Total revenue for Corporate decreased by \$0.8 million for the three months ended March 31, 2016 as compared to the same period the prior year. This decrease in total revenue was due to net realized losses recognized on our investment portfolio of \$0.2 million for the three months ended March 31, 2016 as compared to the net realized gains of \$0.6 million for the same period of 2015.

Corporate pre-tax loss was \$4.7 million for the three months ended March 31, 2016 as compared to pre-tax loss of \$3.6 million for the same period of 2015. The increase in pre-tax loss was primarily due to the decreased revenue discussed above and higher operating expenses of \$0.3 million due primarily as a result of higher salary and related expenses of \$0.2 million and higher other operating expenses of \$0.1 million.

## **Financial Condition and Liquidity**

### ***Sources and Uses of Funds***

Our sources of funds are from insurance-related operations, financing activities and investing activities. Major sources of funds from operations include premiums collected (net of policy cancellations and premiums ceded), commissions, and processing and service fees. As a holding company, Hallmark is dependent on dividend payments and management fees from its subsidiaries to meet operating expenses and debt obligations. As of March 31, 2016, Hallmark had \$8.7 million in unrestricted cash and cash equivalents at the holding company. Unrestricted cash and cash equivalents of our non-insurance subsidiaries were \$7.2 million as of March 31, 2016. As of that date, our insurance subsidiaries held \$71.6 million of unrestricted cash and cash equivalents as well as \$564.8 million in debt securities with an average modified duration of 2.9 years. Accordingly, we do not anticipate selling long-term debt instruments to meet any liquidity needs.

AHIC and TBIC, domiciled in Texas, are limited in the payment of dividends to their stockholders in any 12-month period, without the prior written consent of the Texas Department of Insurance, to the greater of statutory net income for the prior calendar year or 10% of statutory policyholders' surplus as of the prior year end. Dividends may only be paid from unassigned surplus funds. HIC and HNIC, both domiciled in Arizona, are limited in the payment of dividends to the lesser of 10% of prior year policyholders' surplus or prior year's net investment income, without prior written approval from the Arizona Department of Insurance. HSIC, domiciled in Oklahoma, is limited in the payment of dividends to the greater of 10% of prior year policyholders' surplus or prior year's statutory net income, not including realized capital gains, without prior written approval from the Oklahoma Insurance Department. During 2016, the aggregate ordinary dividend capacity of these subsidiaries is \$27.6 million, of which \$18.5 million is available to Hallmark. As a county mutual, dividends from HCM are payable to policyholders. During the first three months of 2016 and 2015, our insurance company subsidiaries paid \$2.3 million and \$2.0 million in dividends to Hallmark, respectively.

### ***Comparison of March 31, 2016 to December 31, 2015***

On a consolidated basis, our cash (excluding restricted cash) and investments at March 31, 2016 were \$701.6 million compared to \$693.3 million at December 31, 2015. The primary reason for this increase in unrestricted cash and investments was the collection of an unsettled investment disposal during the first quarter of 2016.

### ***Comparison of Three Months Ended March 31, 2016 and March 31, 2015***

Net cash used in our consolidated operating activities was \$1.3 million for the first three months of 2016 as compared to net cash provided of \$3.7 million for the first three months of 2015. The decrease in operating cash flow was primarily due to increased paid losses including timing of reinsurance claim settlements, partially offset by lower net paid operating expenses and increased net collected premiums.

Net cash used in investing activities during the first three months of 2016 was \$24.4 million as compared to \$4.2 million during the first three months of 2015. The increase in cash used by investing activities during the first three months of 2016 was comprised of an increase in purchases of debt and equity securities of \$31.6 million and a decrease in transfers from restricted cash of \$2.3 million, partially offset by a \$13.5 million increase in maturities, sales and redemptions of investment securities and a decrease in purchases of property and equipment of \$0.2 million.

Cash used in financing activities during the first three months of 2016 was \$1.3 million as a result of the repurchase of our common stock. Cash used in financing activities during the first three months of 2015 was \$0.1 million as a result of \$0.3 million related to the repurchase of our common stock, partially offset by \$0.2 million related to proceeds from the exercise of employee stock options

### *Credit Facilities*

Our Second Restated Credit Agreement with The Frost National Bank (“Frost”) dated June 30, 2015, reinstated the credit facility with Frost which expired by its terms on April 30, 2015. The Second Restated Credit Agreement also amended certain provisions of the credit facility and restated the agreement with Frost in its entirety. The Second Restated Credit Agreement provides a \$15.0 million revolving credit facility, with a \$5.0 million letter of credit sub-facility. The outstanding balance of the revolving credit facility bears interest at a rate equal to the prime rate or LIBOR plus 2.5%, at our election. We pay an annual fee of 0.25% of the average daily unused balance of the credit facility and letter of credit fees at the rate of 1.00% per annum. The revolving credit facility contains covenants that, among other things, require us to maintain certain financial and operating ratios and restrict certain distributions, transactions and organizational changes. As of March 31, 2016, we were in compliance with all of our covenants and had no outstanding borrowings under this revolving credit facility.

On December 17, 2015, we entered into a First Amendment to Second Restated Credit Agreement (the “First Amendment”) and a Revolving Facility B Agreement (the “Facility B Agreement”) with Frost. The First Amendment amended the existing Second Restated Credit Agreement with Frost to incorporate the additional credit facility reflected by the Facility B Agreement.

The Facility B Agreement provides a new \$30.0 million revolving credit facility (“Facility B”), in addition to the existing \$15.0 million revolving credit facility with Frost. We may use Facility B loan proceeds solely for the purpose of making capital contributions to AHIC and HIC. We may borrow, repay and reborrow under the Facility B until

December 17, 2017, at which time all amounts outstanding under the Facility B are converted to a term loan. In connection with Facility B, we paid Frost a one-time commitment fee of \$75,000 and will pay Frost an additional quarterly fee through December 17, 2017 of 0.25% per annum of the average daily unused balance of Facility B. Facility B bears interest at a rate equal to the prime rate or LIBOR plus 3.00%, at our election. Until December 17, 2017, interest only on amounts from time to time outstanding under Facility B are payable quarterly. Any amounts outstanding on Facility B as of December 17, 2017 are converted to a term loan payable in quarterly installments over five years based on a seven year amortization of principal plus accrued interest. All remaining principal and accrued interest become due and payable on December 17, 2022. The obligations under Facility B are secured by the same collateral as the existing credit facility, being a security interest in the capital stock of AHIC and HIC. Facility B is subject to the same covenants as the existing credit facility. As of March 31, 2016, we had \$30.0 million outstanding under Facility B.

### *Subordinated Debt Securities*

On June 21, 2005, we entered into a trust preferred securities transaction pursuant to which we issued \$30.9 million aggregate principal amount of subordinated debt securities due in 2035. To effect the transaction, we formed a Delaware statutory trust, Hallmark Statutory Trust I ("Trust I"). Trust I issued \$30.0 million of preferred securities to investors and \$0.9 million of common securities to us. Trust I used the proceeds from these issuances to purchase the subordinated debt securities. The initial interest rate on our Trust I subordinated debt securities was 7.725% until June 15, 2015, after which interest adjusts quarterly to the three-month LIBOR rate plus 3.25 percentage points. Trust I pays dividends on its preferred securities at the same rate. Under the terms of our Trust I subordinated debt securities, we pay interest only each quarter and the principal of the note at maturity. The subordinated debt securities are uncollateralized and do not require maintenance of minimum financial covenants. As of March 31, 2016, the balance of our Trust I subordinated debt was \$30.9 million and the interest rate was 3.88% per annum.

On August 23, 2007, we entered into a trust preferred securities transaction pursuant to which we issued \$25.8 million aggregate principal amount of subordinated debt securities due in 2037. To effect the transaction, we formed a Delaware statutory trust, Hallmark Statutory Trust II (“Trust II”). Trust II issued \$25.0 million of preferred securities to investors and \$0.8 million of common securities to us. Trust II used the proceeds from these issuances to purchase the subordinated debt securities. Our Trust II subordinated debt securities bear an initial interest rate of 8.28% until September 15, 2017, at which time interest will adjust quarterly to the three-month LIBOR rate plus 2.90 percentage points. Trust II pays dividends on its preferred securities at the same rate. Under the terms of our Trust II subordinated debt securities, we pay interest only each quarter and the principal of the note at maturity. The subordinated debt securities are uncollateralized and do not require maintenance of minimum financial covenants. As of March 31, 2016, the balance of our Trust II subordinated debt was \$25.8 million.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk.**

There have been no material changes to the market risks discussed in Item 7A to Part II of our Form 10-K for the fiscal year ended December 31, 2015.

### **Item 4. Controls and Procedures.**

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

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

This Form 10-Q contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, which are intended to be covered by the safe harbors created thereby. These statements include the plans and objectives of management for future operations, including plans and objectives relating to future growth of our business activities and availability of funds. The forward-looking

statements included herein are based on current expectations that involve numerous risks and uncertainties. Assumptions relating to the foregoing involve judgments with respect to, among other things, future economic, competitive and market conditions, regulatory framework, weather-related events and future business decisions, all of which are difficult or impossible to predict accurately and many of which are beyond our control. Although we believe that the assumptions underlying the forward-looking statements are reasonable, any of the assumptions could be inaccurate and, therefore, there can be no assurance that the forward-looking statements included in this Form 10-Q will prove to be accurate. In light of the significant uncertainties inherent in the forward-looking statements included herein, the inclusion of such information should not be regarded as a representation by us or any other person that our objectives and plans will be achieved.

## **PART II**

### **OTHER INFORMATION**

#### **Item 1. Legal Proceedings.**

During the third quarter of 2015, we paid \$1.2 million to the sellers of the subsidiaries comprising our Workers Compensation operating unit in fulfillment of the contingent purchase price. The sellers have disputed the calculation of the amount paid and assert that an additional \$1.8 million is due. We disagree with this assertion and believe that our calculation of the contingent purchase price was substantially correct. Pursuant to the terms of the acquisition agreement, an independent actuary has been engaged to resolve this matter.

In November 2015, HSU was informed by the Texas Comptroller of Public Accounts that a surplus lines tax audit covering the period January 1, 2010 through December 31, 2013 was complete. HSU frequently acts as a managing general underwriter (“MGU”) authorized to underwrite policies on behalf of Republic Vanguard Insurance Company and HSIC, both Texas eligible surplus lines insurance carriers. In its role as the MGU, HSU underwrites policies on behalf of these carriers while other agencies located in Texas (generally referred to as “producing agents”) deliver the policies to the insureds and collect all premiums due from the insureds. During the period under audit, the producing agents also collected the surplus lines premium taxes due on the policies from the insureds, held them in trust, and timely remitted those taxes to the Comptroller. We believe this system for collecting and paying the required surplus lines premium taxes complies in all respects with the Texas Insurance Code and other regulations, which clearly require that the same party who delivers the policies and collects the premiums will also collect premium taxes, hold premium taxes in trust, and pay premium taxes to the Comptroller. It also complies with long standing industry practice. In addition, effective January 1, 2012 the Texas Legislators enacted House Bill 3410 (HB3410) which allows an MGU to contractually pass the collection, payment and administration of surplus lines taxes down to another Texas licensed surplus line agent.

The Comptroller asserts that HSU is liable for the surplus lines premium taxes related to policy transactions and premiums collected from surplus lines insureds during January 1, 2010 through December 31, 2011, the period prior to the passage of HB3410, and that HSU therefore owes \$2.5 million in premium taxes, as well as \$0.7 million in penalties and interest for the audit period.

We disagree with the Comptroller and intend to vigorously fight their assertion that HSU is liable for the surplus lines premium taxes. We are currently in negotiations with the Comptroller to settle the matter. However, we are presently unable to reasonably estimate the possible loss or legal costs that are likely to arise out of the surplus lines tax audit or any future proceedings relating to this matter. Therefore we have not accrued any amount as of March 31, 2016 related to this matter.

We are engaged in various legal proceedings that are routine in nature and incidental to our business. None of these proceedings, either individually or in the aggregate, are believed, in our opinion, to have a material adverse effect on our consolidated financial position or our results of operations.



**Item 1A. Risk Factors.**

There have been no material changes to the risk factors discussed in Item 1A to Part I of our Form 10-K for the fiscal year ended December 31, 2015.

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

Our stock buyback program initially announced on April 18, 2008, authorized the repurchase of up to 1,000,000 shares of our common stock in the open market or in privately negotiated transactions (the “Stock Repurchase Plan”). On January 24, 2011, we announced an increased authorization to repurchase up to an additional 3,000,000 shares. The Stock Repurchase Plan does not have an expiration date.

The following table furnishes information for purchases made pursuant to the Stock Repurchase Plan during the quarter ended March 31, 2016:

| Period              | Total<br>Number of<br>Shares<br>Purchased | Average<br>Price<br>Paid<br>Per<br>Share | Cumulative<br>Number<br>of Shares<br>Purchased<br>as Part of<br>Publicly<br>Announced<br>Plan | Maximum<br>Number of<br>Shares that<br>May Yet<br>Be<br>Purchased<br>Under<br>the Plan |
|---------------------|---|--|---|--|
| January 1-31, 2016  | 89,592                                    | \$ 11.12                                 | 2,117,244   | 1,882,756  |
| February 1-29, 2016 | -   | \$ -                                     | 2,117,244   | 1,882,756  |
| March 1-31, 2016    | 28,187                                    | \$ 10.55                                 | 2,145,431   | 1,854,569  |

**Item 3. Defaults Upon Senior Securities.**

None.

**Item 4. Mine Safety Disclosures.**

None.

**Item 5. Other Information.**

None.

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**Item 6. Exhibits.**

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

Exhibit

Number Description

- 3(a) Restated Articles of Incorporation of the registrant, as amended (incorporated by reference to Exhibit 3.1 to the registrant's Registration Statement on Form S-1 [Registration No. 333-136414] filed September 8, 2006).
- 3(b) Amended and Restated By-Laws of the registrant (incorporated by reference to Exhibit 3.1 to the registrant's Current Report on Form 8-K filed October 1, 2007).
- 10(a) Assignment and Assumption of Lease Agreement and Bill of Sale between Equitymetrix, LLC and Hallmark Financial Services, Inc. dated to be effective March 1, 2016 (incorporated by reference to Exhibit 10.1 to the registrant's Current Report on Form 8-K filed March 2, 2016).
- 10(b) Lease between Musref 13727 Noel, L.P. and Equitymetrix, LLC dated March 25, 2009, as amended by First Amendment to Lease between Musref 13727 Noel, L.P. and Equitymetrix, LLC dated February 3, 2010, Second Amendment to Lease between Musref 13727 Noel, L.P. and Equitymetrix, LLC dated July 2, 2013, and Third Amendment to Lease between Musref 13727 Noel, L.P. and Equitymetrix, LLC dated February 25, 2014 (incorporated by reference to Exhibit 10.2 to the registrant's Current Report on Form 8-K filed March 2, 2016).
- 31(a) Certification of principal executive officer required by Rule 13a-14(a) or Rule 15d-14(a).
- 31(b) Certification of principal financial officer required by Rule 13a-14(a) or Rule 15d-14(a).
- 32(a) Certification of principal executive officer Pursuant to 18 U.S.C. § 1350.
- 32(b) Certification of principal financial officer Pursuant to 18 U.S.C. § 1350.
- 101  
INS+ XBRL Instance Document.
- 101  
SCH+ XBRL Taxonomy Extension Schema Document.
- 101  
CAL+ XBRL Taxonomy Extension Calculation Linkbase Document.
- 101  
LAB+ XBRL Taxonomy Extension Label Linkbase Document.

101  
PRE+ XBRL Taxonomy Extension Presentation Linkbase Document.

101  
DEF+ XBRL Taxonomy Extension Definition Linkbase Document.

+ Filed with this Quarterly Report on Form 10-Q and included in Exhibit 101 to this report are the following documents formatted in XBRL (Extensible Business Reporting Language): (i) Consolidated Balance Sheets as of March 31, 2016 and December 31, 2015, (ii) Consolidated Statements of Operations for the three months ended March 31, 2016 and 2015, (iii) Consolidated Statements of Comprehensive Income for the three months ended March 31, 2016 and 2015, (iv) Consolidated Statements of Stockholder's Equity for the three months ended March 31, 2016 and 2015, (v) Consolidated Statements of Cash Flows for the three months ended March 31, 2016 and 2015 and (vi) related notes.

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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 5, 2016 /s/ Naveen Anand  
Naveen Anand, Chief Executive Officer and President

Date: May 5, 2016 /s/ Jeffrey R. Passmore  
Jeffrey R. Passmore, Chief Accounting Officer and Senior Vice President