

**HALLMARK FINANCIAL SERVICES, INC.**  
**777 Main Street, Suite 1000**  
**Fort Worth, Texas 76102**

**NOTICE OF ANNUAL MEETING OF SHAREHOLDERS**

**TO BE HELD MAY 28, 2009**

To Our Shareholders:

NOTICE IS HEREBY GIVEN that the 2009 Annual Meeting of Shareholders of Hallmark Financial Services, Inc. (the "Company") will be held in the 11<sup>th</sup> Floor Conference Room at Carter Burgess Plaza, 777 Main Street, Fort Worth, Texas, at 10:00 a.m., Central Daylight Time, on Thursday, May 28, 2009, for the following purposes:

1. To elect five directors to serve until the next annual meeting of shareholders or until their successors are duly elected and qualified;
2. To approve an amendment to the Company's 2005 Long Term Incentive Plan increasing the number of shares of Common Stock available for issuance thereunder from 1,500,000 shares to 2,000,000 shares; and
3. To transact such other business that may properly come before the meeting or any adjournment thereof.

Shareholders of record at the close of business on April 15, 2009, are entitled to notice of and to vote at the Annual Meeting or any adjournment thereof.

All shareholders of the Company are cordially invited to attend the Annual Meeting.

BY ORDER OF THE BOARD OF DIRECTORS



Cecil R. Wise, Secretary

Dated: April 28, 2009

**WHETHER OR NOT YOU PLAN TO ATTEND THE MEETING, PLEASE SIGN AND DATE THE ENCLOSED PROXY AND RETURN IT PROMPTLY IN THE ENCLOSED STAMPED ENVELOPE. IF YOU ATTEND THE MEETING, YOU MAY REVOKE YOUR PROXY AND VOTE IN PERSON.**



**HALLMARK FINANCIAL SERVICES, INC.**  
**777 Main Street, Suite 1000**  
**Fort Worth, Texas 76102**

**PROXY STATEMENT**  
**FOR**  
**ANNUAL MEETING OF SHAREHOLDERS**  
**TO BE HELD MAY 28, 2009**

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**SOLICITATION AND REVOCABILITY OF PROXIES**

This Proxy Statement is furnished in connection with the solicitation of proxies by the Board of Directors (the "Board") of Hallmark Financial Services, Inc., a Nevada corporation (the "Company"), to be voted at the 2009 Annual Meeting of Shareholders (the "Annual Meeting") to be held on Thursday, May 28, 2009, at the time and place and for the purposes set forth in the accompanying Notice of Annual Meeting of Shareholders (the "Notice"), and at any adjournment thereof. When proxies in the accompanying form are properly executed and received, the shares represented thereby will be voted at the Annual Meeting in accordance with the directions noted thereon. If no direction is indicated on the proxy, the shares represented thereby will be voted for the election of each of the nominees for director and in the discretion of the proxy holder on any other matter that may properly come before the meeting.

Submitting a proxy will not affect a shareholder's right to vote in person at the Annual Meeting. Any shareholder who gives a proxy may revoke it at any time before it is exercised by delivering written notice of revocation to the Company, by substituting a new proxy executed on a later date, or by making a written request in person at the Annual Meeting that the proxy be returned. However, mere attendance at the Annual Meeting will not revoke the proxy.

All expenses of preparing, assembling and mailing this Proxy Statement and the enclosed materials and all costs of soliciting proxies will be paid by the Company. In addition to solicitation by mail, proxies may be solicited by officers and regular employees of the Company by telephone or in person. Such officers and employees who solicit proxies will receive no compensation for their services other than their regular salaries. Arrangements will also be made with brokerage houses and other custodians, nominees and fiduciaries to forward solicitation materials to the beneficial owners of shares they hold, and the Company may reimburse them for reasonable out-of-pocket expenses they incur in forwarding these materials.

The principal executive offices of the Company are located at 777 Main Street, Suite 1000, Fort Worth, Texas 76102. The Company's mailing address is the same as that of its principal executive offices.

This Proxy Statement and the accompanying form of proxy are first being mailed or given to shareholders on or about April 28, 2009. A copy of the Company's Annual Report for the fiscal year ended December 31, 2008, is enclosed herewith. Such Annual Report does not constitute a part of the materials used for the solicitation of proxies.

## **PURPOSES OF THE MEETING**

At the Annual Meeting, the shareholders of the Company will consider and vote on the following matters:

1. Election of five directors to serve until the next annual meeting of shareholders or until their successors are duly elected and qualified;
2. Approval of an amendment to the Company's 2005 Long Term Incentive Plan increasing the number of shares of Common Stock available for issuance thereunder from 1,500,000 shares to 2,000,000 shares; and
3. Transaction of such other business as may properly come before the meeting or any adjournment thereof.

## **QUORUM AND VOTING**

The record date for the determination of shareholders entitled to notice of and to vote at the Annual Meeting was the close of business on April 15, 2009 (the "Record Date"). On the Record Date, there were 20,863,670 shares of common stock of the Company, par value \$0.18 per share (the "Common Stock"), issued and outstanding, each of which is entitled to one vote on all matters to be acted upon at the Annual Meeting. There are no cumulative voting rights. The presence, in person or by proxy, of holders of one-third of the outstanding shares of Common Stock entitled to vote at the meeting is necessary to constitute a quorum to transact business. Assuming the presence of a quorum, directors will be elected by a plurality of the votes cast. The affirmative vote of the holders of a majority of the shares of Common Stock actually voted will be required for the approval of all other matters to come before the Annual Meeting.

Abstentions and broker non-votes will be counted solely for purposes of determining whether a quorum is present at the Annual Meeting. Pursuant to the Bylaws of the Company, abstentions and broker non-votes will not be counted in determining the number of shares voted on any matter. Therefore, abstentions and broker non-votes will have no effect on the election of directors or the approval of any other proposal submitted to a vote of the shareholders at the Annual Meeting.

## **ELECTION OF DIRECTORS (Item 1)**

At the Annual Meeting, five directors will be elected for a term expiring at the 2010 annual meeting of the Company's shareholders or when their successors are elected and qualify. Directors will be elected by a plurality of the votes cast at the Annual Meeting. Cumulative voting is not permitted in the election of directors.

The Board has proposed the following slate of nominees for election as directors at the Annual Meeting. None of the nominees was selected on the basis of any special arrangement or understanding with any other person. None of the nominees bears any family relationship to any other nominee or to any executive officer of the Company. The Board has determined that all of its nominees other than Mark E. Schwarz meet the current independence requirements of The Nasdaq Stock Market ("Nasdaq").

In the absence of instructions to the contrary, shares represented by proxy will be voted for the election of each nominee named below. Each nominee has accepted nomination and agreed to serve if elected. If any

nominee becomes unable to serve before election, shares represented by proxy may be voted for the election of a substitute nominee designated by the Board.

**The Board recommends a vote FOR election of each nominee below.**

<u>Name</u>	<u>Age</u>	<u>Director Since</u>	<u>Current Position(s) with the Company</u>
Mark E. Schwarz	48	2001	Director and Executive Chairman
Scott T. Berlin	39	2001	Director
James H. Graves	60	1995	Director
Jim W. Henderson	62	---	---
George R. Manser	77	1995	Director

**Mark E. Schwarz** was elected Executive Chairman of the Company in August, 2006. He served as Chief Executive Officer of the Company from January, 2003 until August, 2006, and as President from November, 2003 through March, 2006. Since 1993, Mr. Schwarz has served, directly or indirectly through entities he controls, as the sole general partner of Newcastle Partners, L.P., a private investment firm. Since 2000, he has also served as the President and sole Managing Member of Newcastle Capital Group, L.L.C., the general partner of Newcastle Capital Management, L.P., a private investment management firm. From 1995 until 1999, Mr. Schwarz was also a Vice President of Sandera Capital Management, L.L.C. and, from 1993 until 1996, was a securities analyst and portfolio manager for SCM Advisors, L.L.C., both of which were private investment management firms associated with the Lamar Hunt family. Mr. Schwarz presently serves as Chairman of the boards of directors of Pizza Inn, Inc., an operator and franchisor of pizza restaurants; Bell Industries, Inc., a company primarily engaged in providing computer systems integration services; and Wilhelmina International, Inc., a model management company. Mr. Schwarz is also a director of MedQuist, Inc., a provider of clinical documentation workflow solutions in support of electronic health records; Nashua Corporation, a manufacturer of specialty papers, labels and printing supplies; and SL Industries, Inc., a developer of power systems used in a variety of aerospace, computer, datacom, industrial, medical, telecom, transportation and utility equipment applications.

**Scott T. Berlin** is a Managing Director and principal of Brown, Gibbons, Lang & Company, an investment banking firm serving middle market companies. His professional activities are focused on the corporate finance and mergers/acquisitions practice. Prior to joining Brown, Gibbons, Lang & Company in 1997, Mr. Berlin was a lending officer in the Middle Market Group at The Northern Company.

**James H. Graves** is a Partner of Erwin, Graves & Associates, LP, a management consulting firm founded in 2002. He is also a Managing Director of Detwiler Fenton Group, Inc., a securities brokerage and research firm, and Vice President Financial Strategy of Device Fidelity, Inc., a credit card technology firm. Previously, Mr. Graves was a Managing Director of UBS Warburg, Inc., an international financial services firm which provides investment banking, underwriting and brokerage services. He was a Managing Director of Paine Webber Group Inc. prior to its acquisition by UBS Warburg in November, 2000, and was Chief Operating Officer and Head of Equity Capital Markets of J.C. Bradford & Co. at the time of its acquisition by Paine Webber Group Inc. in June, 2000. Mr. Graves had earlier served as Managing Director of J.C. Bradford & Co. and co-manager of its Corporate Finance Department. Prior to its acquisition by Paine Webber Group Inc., J.C. Bradford & Co. provided investment advisory services to the Company. Prior to joining J.C. Bradford & Co. in 1991, Mr. Graves had for 11 years been employed by Dean Witter Reynolds, where he completed his tenure as the head of the Special Industries Group in New York City. Mr. Graves

also serves as a director of Cash America International, Inc., a company operating pawn shops and jewelry stores; and BankCap Partners, LP, a private equity fund.

**Jim W. Henderson** is Vice Chairman and Chief Operating Officer of Brown & Brown, Inc., a diversified insurance agency and wholesale broker. He has served as a director of Brown & Brown since 1993 and also serves as an executive officer of several of its subsidiaries. Prior to assuming his current executive position in 2007, Mr. Henderson had served as Executive Vice President of Brown & Brown since 1995, as Senior Vice President from 1993 to 1995, as Senior Vice President of a predecessor corporation from 1989 to 1993, and as Chief Financial Officer of such predecessor from 1985 to 1989. Mr. Henderson is also Chairman of the Board of Trustees of Embry-Riddle Aeronautical University, and is a member of the Board of Directors of the School of Business Administration of Stetson University, the Council of Insurance Agents and Brokers, and the Florida Hurricane Catastrophe Fund. He previously served as Co-Chairman of the Insurance Accounting and Systems Association's Property & Casualty Committee, President of the Central Florida Chapter of Financial Executives International, and as a member of the Board of Directors of United Way of Volusia/Flagler Counties and the Ronald McDonald House.

**George R. Manser** is Chairman of Concorde Holding Co. and CAH, Inc. LLC, each a private investment management company. From 1991 to 2003, Mr. Manser served as a director of State Auto Financial Corp., an insurance holding company engaged primarily in the property and casualty insurance business. Prior to his retirement in 2000, Mr. Manser also served as Chairman of Uniglobe Travel (Capital Cities), Inc., a franchisor of travel agencies; as a director of CheckFree Corporation, a provider of financial electronic commerce services, software and related products; and as an advisory director of J.C. Bradford & Co. From 1995 to 1999, Mr. Manser served as the Director of Corporate Finance of Uniglobe Travel USA, L.L.C., a franchisor of travel agencies, and also served as a director of Cardinal Health, Inc. and AmerLink Corp. From 1984 to 1994, he also served as a director and Chairman of North American National Corporation and various of its insurance subsidiaries.

## **AMENDMENT OF 2005 LONG TERM INCENTIVE PLAN (Item 2)**

The Board proposes and recommends that the Company's 2005 Long Term Incentive Plan (the "2005 LTIP") be amended to increase the maximum aggregate number of shares of Common Stock which may be issued thereunder from 1,500,000 shares to 2,000,000 shares. The 2005 LTIP was originally approved by the shareholders on May 26, 2005. An amendment to the 2005 LTIP increasing the maximum number of shares of Common Stock available for issuance from 833,333 shares to 1,500,000 shares was approved by the shareholders on May 22, 2008. The Board has adopted a further amendment to the 2005 LTIP increasing the maximum number of shares of Common Stock available for issuance by 500,000 shares. This amendment is subject to shareholder approval and will not be effective unless shareholder approval is obtained at the Annual Meeting.

Stock options to purchase an aggregate of 987,499 shares of Common Stock reserved for issuance under the 2005 LTIP have been unconditionally granted. In addition, options to purchase 605,000 shares have been conditionally granted subject to approval of the proposed amendment to the 2005 LTIP by the shareholders at the Annual Meeting. The following table sets forth certain information concerning the persons to whom options were conditionally granted and the material terms of such options.

<u>Name</u>	<u>Conditional Grant Date</u>	<u>Common Stock Underlying Options (#)</u> <sup>1</sup>	<u>Exercise Price (\$/Sh)</u> <sup>2</sup>	<u>Expiration Date</u>
Mark J. Morrison President Chief Executive Officer	04/01/2009	75,000	6.61	04/01/2019
Kevin T. Kasitz Executive Vice President Chief Operating Officer President of Operating Unit	04/01/2009	55,000	6.61	04/01/2019
Brookland F. Davis Executive Vice President President of Operating Unit	04/01/2009	55,000	6.61	04/01/2019
All Current Executive Officers	04/01/2009	440,000	6.61	04/01/2019
All Current Directors (excluding Executive Officers)	04/01/2009	45,000	6.61	04/01/2019
All Other Employees (excluding Executive Officers)	04/01/2009	120,000	6.61	04/01/2019

<sup>1</sup> Options granted to non-employee directors vest in their entirety six months and one day from the date of conditional grant. All other options vest in seven equal annual installments commencing on the first anniversary of the date of conditional grant. Vesting of all grants is subject to acceleration upon death, disability, retirement or change in control of the Company.

<sup>2</sup> The exercise price is equal to the fair market value of the Common Stock on the date of conditional grant.

At the Annual Meeting, the proposed amendment to the 2005 LTIP will be submitted to the shareholders for approval. In order to approve the amendment of the 2005 LTIP, the number of votes cast in favor of the amendment must exceed the number of votes cast in opposition to the amendment. Abstentions and broker non-votes will not be counted as votes cast in favor of or in opposition to the approval of the amendment to the 2005 LTIP. Shares represented by proxies will be voted for the approval of the amendment to the 2005 LTIP unless authority to do so is withheld.

**The Board recommends a vote FOR the approval of the amendment to the 2005 LTIP.**

### **Description of the 2005 LTIP**

The description of the 2005 LTIP set forth below is a summary of its principal features. This summary, however, does not purport to be a complete description of all of the provisions of the 2005 LTIP and is qualified in its entirety by reference to the full text of the 2005 LTIP, a copy of which may be obtained, without cost, upon written request addressed to the Secretary at the principal executive offices of the Company.

Administration. The 2005 LTIP is administered by the Compensation Committee of the Board. The Compensation Committee has the authority to grant awards under the 2005 LTIP and to determine the terms and conditions of such awards.

Shares Available. The maximum aggregate number of shares of Common Stock with respect to which options and restricted shares, and rights granted without accompanying options, may be granted from time to time under the 2005 LTIP is presently 1,500,000 shares. Shares with respect to which awards are granted may be, in whole or in part, authorized and unissued shares of Common Stock or authorized and issued shares of Common Stock reacquired and held in treasury, as the Board from time to time determines. If for

any reason (other than the surrender of options or Deemed Options, as defined below, upon exercise of rights) any shares as to which an option has been granted cease to be subject to purchase under the option, or any restricted shares are forfeited, or any right issued without accompanying options terminates or expires without being exercised, then the shares in respect of which such option or right was granted, or which relate to such restricted shares, will become available for subsequent awards under the 2005 LTIP.

Eligibility. Awards under the 2005 LTIP are granted only to persons who are employed by the Company or who are non-employee directors. In determining the employees to whom awards are granted, the number of shares of Common Stock with respect to which each award is granted and the terms and conditions of each award, the Compensation Committee takes into account, among other things, the nature of the employee's duties and his or her present and potential contributions to the Company's growth and success.

Types of Awards. The following types of awards may be granted under the 2005 LTIP:

- incentive stock options under Section 422 of the Internal Revenue Code ("IRC");
- non-qualified stock options, which are stock options other than incentive stock options;
- restricted shares; and
- rights, either with or without accompanying options.

Awards may be granted on the terms and conditions discussed below. In addition, the Compensation Committee may impose on any award or the exercise thereof such additional terms and conditions as they determine, including performance conditions, terms requiring forfeiture of awards in the event of termination of employment and terms permitting an award holder to make elections relating to his or her award. The Compensation Committee retains full power and discretion to accelerate or waive any term or condition of an award that is not mandatory under the 2005 LTIP. The term of each award is for such period as may be determined by the Compensation Committee, but not to exceed ten years.

Unless permitted by the Compensation Committee pursuant to the express terms of an award agreement, awards are generally not transferable other than by will or the laws of descent and distribution. The Compensation Committee may allow for the transfer of awards prior to an award holder's death pursuant to a qualified domestic relations order and to certain immediate family members or entities related to an immediate family member even in the absence of a qualified domestic relations order.

Prohibition on Repricing. No award may be repriced, replaced, regranted through cancellation or modified without shareholder approval, except in connection with a change in capitalization of the Company, if the effect would be to reduce the exercise price for shares of Common Stock underlying the award.

Terms and Conditions of Stock Options. The 2005 LTIP authorizes grants of incentive stock options and non-qualified stock options to eligible persons. The exercise price of each stock option granted under the 2005 LTIP may vary, but must not be less than the fair market value of the shares as of the grant date. Options may not be exercised as to less than 100 shares of Common Stock (or less than the number of full shares of Common Stock, if less than 100 shares). The Compensation Committee may determine the methods and form of payment for the exercise price of a stock option. Unless otherwise provided, all options become 100% vested when the grantee retires at or after retirement age, the grantee dies or becomes totally and permanently disabled, or a change in control occurs. Prior to 100% vesting, options become exercisable in cumulative installments and upon events as determined by the Compensation Committee.

Terms and Conditions of Restricted Shares. The 2005 LTIP authorizes grants of restricted shares. Restricted shares are shares of Common Stock subject to a restricted period of up to ten years, as determined by the Compensation Committee. Except to the extent set forth in a particular award, a person granted restricted shares will generally have all of the rights of a shareholder, including the right to vote the restricted shares. However, during any period that restricted shares are subject to restrictions imposed by the

Compensation Committee, the restricted shares may not be transferred or encumbered by an award holder. Upon termination of employment during the restricted period, restricted shares will be forfeited and reacquired by the Company. The Compensation Committee may determine the time or times at which, and the circumstances under which, any restrictions imposed on restricted shares will lapse and may shorten or waive a restricted period.

Terms and Conditions of Rights. The 2005 LTIP authorizes awards of primary rights with or without accompanying options or additional rights with accompanying options. A primary right granted without a corresponding option is deemed to have been accompanied by a “Deemed Option.” A Deemed Option serves only to establish the terms and conditions of the primary right, has no value, and cannot be exercised to obtain shares of Common Stock.

A right granted in connection with an option must be granted at the time the option is granted. Each right is subject to the same terms and conditions as the related option or Deemed Option, and is exercisable only to the extent the option or Deemed Option is exercisable. At the time of grant of a primary right not granted in connection with an option, the Compensation Committee will set forth the terms and conditions of the corresponding Deemed Option. The terms and conditions of such Deemed Option will include all terms and conditions that at the time of grant are required and, in the discretion of the Compensation Committee, may include any additional terms and conditions that at such time are permitted to be included in options granted under the 2005 LTIP.

A primary right entitles the holder to surrender unexercised the related option or Deemed Option (or any portion thereof) and to receive in exchange for each surrendered option, Deemed Option or portion thereof, subject to the provisions of the 2005 LTIP and regulations established by the Compensation Committee, a payment having an aggregate value equal to the excess of the fair market value per share of the Common Stock on the exercise date over the per share exercise price of the option or Deemed Option. Upon exercise of a primary right, payment may be made in the form of cash, shares of Common Stock, or a combination of both, as elected by the holder. Shares of Common Stock paid upon exercise of a primary right will be valued at the fair market value per share of the Common Stock on the exercise date. Cash will be paid in lieu of any fractional share based upon the fair market value per share of the Common Stock on the exercise date. Generally, no payment will be required from the holder upon exercise of a primary right. An additional right entitles the holder to receive, upon the exercise of a related option, a cash payment equal to a percentage of the product determined by multiplying the excess of the fair market value per share of the Common Stock on the date of exercise of the related option over the option price per share at which such option is exercisable, by the number of shares with respect to which the related option is being exercised.

Amendment and Termination. The Board has the right to amend, suspend or terminate the 2005 LTIP at any time, except that an amendment is subject to shareholder approval if such approval is required to comply with the IRC, the rules of any securities exchange or market system on which the Company’s securities are listed or admitted to trading at the time such amendment is adopted, or any other applicable laws. The Board may delegate to the Compensation Committee all or any portion of such authority. If the 2005 LTIP is terminated, the terms of the 2005 LTIP will, notwithstanding such termination, continue to apply to awards granted prior to such termination. In addition, no suspension, termination, modification or amendment of the 2005 LTIP may, without the consent of the grantee to whom an award was granted, adversely affect the rights of such grantee under such award.

Change in Control. Upon the occurrence of a change in control, with respect only to awards held by employees and directors (and their permitted transferees) at the occurrence of the change in control, (1) all outstanding rights and options will immediately become fully vested and exercisable in full, including that portion of any right or option that had not yet become exercisable; and (2) the restriction period of any restricted shares will immediately be accelerated and the restrictions will expire. A holder will not forfeit the

right to exercise the award during the remainder of the original term of the award because of a change in control or because the holder's employment is terminated for any reason following a change in control.

Section 16(b) Liability. The Company intends that the grant of any awards to or other transaction by an award recipient who is subject to Section 16(b) of the Securities Exchange Act of 1934, as amended, will be exempt from liability under Section 16(b) pursuant to an applicable exemption (except for transactions acknowledged in writing to be non-exempt by such award recipient). Accordingly, if a provision of the 2005 LTIP or any award agreement does not comply with the requirements of Rule 16b-3 promulgated under the Exchange Act, such provision will be deemed amended to the extent necessary to conform to Rule 16b-3 so that the award recipient avoids liability under Section 16(b) of the Exchange Act.

### **Federal Income Tax Consequences of Awards under the 2005 LTIP**

Set forth below is a summary of the federal income tax consequences to award recipients and to the Company as a result of the grant and exercise of awards under the 2005 LTIP. This summary is based on statutory provisions, Treasury regulations thereunder, judicial decisions, and IRS rulings in effect on the date hereof. This summary does not discuss any potential foreign, state, or local tax consequences.

Non-Qualified Stock Options and Incentive Stock Options. Option holders will not realize taxable income upon the grant of a non-qualified stock option. Upon the exercise of a non-qualified stock option, an option holder will recognize ordinary compensation income (subject to withholding by the Company or a subsidiary) in an amount equal to the excess of the amount of cash and the fair market value of the shares of Common Stock received over the exercise price paid for the shares. An option holder will generally have a tax basis in any shares received upon exercise of a non-qualified stock option that equals the fair market value of such shares on the date of exercise. Subject to the limitations on deductibility discussed below, the Company (or a subsidiary) will be entitled to a deduction for federal income tax purposes that corresponds as to timing and amount with the compensation income recognized by an option holder under the foregoing rules.

Recipients of incentive stock options will not have taxable income upon the grant or exercise of the incentive stock option. Upon exercise of an incentive stock option, the excess of the fair market value of the shares of Common Stock received over the exercise price will increase the alternative minimum taxable income of the option holder, which may cause the option holder to incur alternative minimum tax. The payment of any alternative minimum tax attributable to the exercise of an incentive stock option would be allowed as a credit against the option holder's regular tax liability in a later year to the extent that the option holder's regular tax liability is in excess of the alternative minimum tax for that year. Upon the disposition of shares of Common Stock acquired upon exercise of an incentive stock option that have been held for at least two years from the date of grant and one year from the date of exercise of the incentive stock option, an option holder will generally recognize capital gain (or loss) equal to the excess (or shortfall) of the amount received in the disposition over the exercise price paid by the option holder for the shares. However, if an option holder disposes of shares that have not been held for the requisite holding period (a "disqualifying disposition"), the option holder will recognize ordinary compensation income in the year of the disqualifying disposition in an amount equal to the amount by which the fair market value of the shares at the time of exercise of the incentive stock option (or, if less, the amount realized in an arm's-length disqualifying disposition to an unrelated party) exceeds the exercise price paid by the option holder for such shares. An option holder will also recognize capital gain to the extent the amount realized in the disqualifying disposition exceeds the fair market value of the shares on the exercise date.

The Company and its subsidiaries will generally not be entitled to any federal income tax deduction upon the grant or exercise of an incentive stock option, unless an option holder makes a disqualifying disposition of the shares of Common Stock. If an option holder makes a disqualifying disposition, the Company (or a subsidiary) will then, subject to the limitations on deductibility discussed below, be entitled

to a tax deduction that corresponds as to timing and amount with the compensation income recognized by an option holder under the rules described in the preceding paragraph.

Under current rulings, if an option holder transfers previously held shares of Common Stock (other than shares acquired by exercise of an incentive stock option that have not been held for the requisite holding period) in satisfaction of part or all of the exercise price of a non-qualified stock option or incentive stock option, no additional gain will be recognized on the transfer of such previously held shares in satisfaction of the non-qualified stock option or incentive stock option exercise price (although an option holder would still recognize ordinary compensation income upon exercise of a non-qualified stock option in the manner described above). Moreover, that number of shares received upon exercise which equals the number of shares of previously held shares of Common Stock surrendered in satisfaction of the non-qualified stock option or incentive stock option exercise price will have a tax basis that equals, and a holding period that includes, the tax basis and holding period of the previously held shares surrendered in satisfaction of the non-qualified stock option or incentive stock option exercise price. Any additional shares of Common Stock received upon exercise will have a tax basis that equals the amount of cash (if any) paid by the option holder, plus the amount of compensation income recognized by the option holder under the rules described above.

Restricted Shares. Generally, a recipient of restricted shares will recognize ordinary compensation income as a result of the receipt of restricted shares in an amount equal to the fair market value of the shares of Common Stock when such shares first cease to be subject to a prohibition on transfer or to a substantial risk of forfeiture. The amount of income realized will be the value of the shares at the date the shares first become transferable or cease to be subject to substantial risk of forfeiture. However, if such a recipient makes a valid election under IRC Section 83(b), the restricted shares will be taxable at the date of receipt of the shares and the recipient will realize ordinary income upon the grant of the restricted shares in an amount equal to the value of the shares without regard to the restrictions on transferability and the risk of forfeiture.

Rights. A holder of a right will not recognize taxable income upon the grant of a right. Upon the exercise of a right, the holder will recognize ordinary compensation income (subject to withholding by the Company or a subsidiary) in an amount equal to the excess of the amount of cash and the fair market value of the shares of Common Stock received over the exercise price (if any). A right holder will generally have a tax basis in any shares received pursuant to the exercise of a right that equals the fair market value of such shares on the date of exercise. Subject to the limitations on deductibility discussed below, the Company (or a subsidiary) will be entitled to a deduction for federal income tax purposes that corresponds as to timing and amount with the compensation income recognized by a right holder.

An award recipient will be subject to withholding for federal, and any applicable state and local, income taxes at the time the award recipient recognizes income under the rules described above. Subject to the limitations on deductibility discussed below, the Company (or a subsidiary) will be entitled to a deduction for federal income tax purposes that corresponds as to timing and amount with the compensation income recognized by an award recipient under the foregoing rules.

Limitations on Deductibility. In order for the amounts described above to be deductible by the Company (or a subsidiary), such amounts must constitute reasonable compensation for services rendered or to be rendered and must be ordinary and necessary business expenses. The ability of the Company (or a subsidiary) to obtain a deduction for future payments under the 2005 LTIP could also in some circumstances be limited by the golden parachute payment rules of IRC Section 280G, which prevent the deductibility of certain excess parachute payments made in connection with a change in control of a corporation. Finally, IRC Section 162(m) limits to \$1.0 million the deductibility of most compensation paid during a taxable year of the Company to certain executive officers of the Company.

## **OTHER BUSINESS (Item 3)**

The Board knows of no other business to be brought before the Annual Meeting. If, however, any other business should properly come before the Annual Meeting, the persons named in the accompanying proxy will vote the proxy as they in their discretion may deem appropriate, unless they are directed by the proxy to do otherwise.

## **BOARD OF DIRECTORS**

### **Board Committees**

Standing committees of the Board of the Company include the Audit Committee, the Nomination and Governance Committee, the Compensation Committee and the Stock Option Committee. Scott T. Berlin, James H. Graves and George R. Manser presently serve on each of these standing committees. Mark E. Schwarz does not presently serve on any of these standing committees.

Audit Committee. George R. Manser currently serves as chairman of the Audit Committee. The Board has determined that all members of the Audit Committee satisfy the current independence and experience requirements of Nasdaq and the Securities and Exchange Commission ("SEC"). The Board has also determined that Mr. Manser satisfies the requirements for an "audit committee financial expert" under applicable rules of the SEC and has designated Mr. Manser as its "audit committee financial expert."

The Audit Committee oversees the conduct of the financial reporting processes of the Company, including (i) reviewing with management and the outside auditors the audited financial statements included in the Company's Annual Report, (ii) reviewing with management and the outside auditors the interim financial results included in the Company's quarterly reports filed with the SEC, (iii) discussing with management and the outside auditors the quality and adequacy of internal controls, and (iv) reviewing the independence of the outside auditors. (See, **Audit Committee Report.**) A copy of the Amended and Restated Audit Committee Charter is available for review on the Company's website at [www.hallmarkgrp.com](http://www.hallmarkgrp.com). The Audit Committee held eight meetings during 2008.

Nomination and Governance Committee. Scott T. Berlin currently serves as chairman of the Nomination and Governance Committee. The Nomination and Governance Committee is responsible for advising the Board about the appropriate composition of the Board and its committees, identifying and evaluating candidates for Board service, recommending director nominees for election at annual meetings of shareholders or for appointment to fill vacancies, and recommending the directors to serve on each committee of the Board. The Nomination and Governance Committee is also responsible for periodically reviewing and making recommendations to the Board regarding corporate governance policies and responses to shareholder proposals. A copy of the Nomination and Governance Committee Charter is available for review on the Company's website at [www.hallmarkgrp.com](http://www.hallmarkgrp.com). The Nomination and Governance Committee met twice during 2008.

The Nomination and Governance Committee strives to identify and attract director nominees with a variety of experience who have the business background and personal integrity to represent the interests of all shareholders. Although the Nomination and Governance Committee has not established any specific minimum qualifications that must be met by a director nominee, factors considered in evaluating potential candidates include educational achievement, managerial experience, business acumen, financial sophistication, insurance industry expertise and strategic planning and policy-making skills. Depending upon the current needs of the Board, some factors may be weighed more or less heavily than others in the deliberations. The Nomination and Governance Committee evaluates the suitability of a potential director

nominee on the basis of written information concerning the candidate, discussions with persons familiar with the background and character of the candidate and personal interviews with the candidate.

The Nomination and Governance Committee will consider candidates for nomination to the Board from any reasonable source, including shareholder recommendations. The Nomination and Governance Committee does not evaluate candidates differently based on the source of the proposal. The Nomination and Governance Committee has not, and has no present intention to, use consultants or search firms to assist in the process of identifying and evaluating director candidates.

Shareholders may recommend director candidates for consideration by the Nomination and Governance Committee by writing to its chairman in care of the Company's headquarters in Fort Worth, Texas, giving the candidate's name, contact information, biographical data and qualifications. A written statement from the candidate consenting to be named as a candidate and, if nominated and elected, to serve as a director should accompany any such recommendation. The Nomination and Governance Committee has not implemented any formal procedures for consideration of director nominees submitted by shareholders of the Company. The Nomination and Governance Committee has not received any recommendations of nominees for election to the Board at the Annual Meeting from any person or group beneficially owning more than five percent of the Common Stock of the Company. The Company's Executive Chairman and Chief Executive Officer recommended Jim W. Henderson as a potential nominee for election to the Board at the Annual Meeting.

Compensation Committee and Stock Option Committee. James H. Graves currently serves as chairman of the Compensation Committee and the Stock Option Committee. The Compensation Committee reviews, evaluates and recommends to the Board compensation policies of the Company with respect to directors, executive officers and senior management. The Compensation Committee also administers the 2005 LTIP. The Stock Option Committee administers the Company's 1994 Key Employee Long Term Incentive Plan (the "1994 Employee Plan") and 1994 Non-Employee Director Stock Option Plan (the "1994 Director Plan"), both of which expired during 2004 but have unexpired options outstanding. Neither the Compensation Committee nor the Stock Option Committee has a charter. The Compensation Committee and Stock Option Committee each met once during 2008.

The Compensation Committee has the authority to approve the compensation of the directors, executive officers and senior management of the Company. The Compensation Committee also has the authority to grant stock options and other equity awards under the 2005 LTIP. The Compensation Committee does not delegate any of its authority to any other person. The Executive Chairman and Chief Executive Officer of the Company provide recommendations to the Compensation Committee concerning most of these compensation decisions. Neither the Company nor the Compensation Committee currently engages any consultant to assist in the review of director or executive officer compensation.

### **Attendance at Meetings**

The Board held five meetings during 2008. Various matters were also approved by the unanimous written consent of the directors during the last fiscal year. Each director attended at least 75% of the aggregate of (i) the total number of meetings of the Board, and (ii) the total number of meetings held by all committees of the Board on which such director served. The Company has no formal policy with respect to the attendance of Board members at the Annual Meeting, but encourages all incumbent directors and all director nominees to attend each annual meeting of shareholders. All incumbent directors and all director nominees attended the Company's last annual meeting of shareholders held on May 22, 2008.

## Compensation of Directors in 2008 Fiscal Year

The Company's standard compensation arrangement for each non-employee director is a \$12,000 annual retainer plus a fee of \$1,500 for each Board meeting attended in person or telephonically and a fee of \$750 for each committee meeting attended in person or telephonically. The chairman of the Audit Committee also receives an additional \$5,000 annual retainer. No other cash compensation was paid to any non-employee director during 2008.

The Compensation Committee also periodically grants stock options to the directors of the Company. In 2008, all directors of the Company received grants of non-qualified options to purchase 5,000 shares of Common Stock pursuant to the 2005 LTIP. Such options are exercisable at the grant date fair market value of the Company's common stock of \$11.46 per share, vested in their entirety six months and one day from the date of grant and will expire ten years from the date of grant.

The following table sets forth information concerning the compensation of the directors of the Company for the fiscal year ended December 31, 2008.

<u>Name</u>	<u>Fees Earned or Paid in Cash (\$)</u>	<u>Option Awards (\$)<sup>1</sup></u>	<u>All Other Compensation (\$)</u>	<u>Total (\$)</u>
Mark E. Schwarz	195,000 <sup>2</sup>	21,300	9,615 <sup>2</sup>	225,915
Scott T. Berlin	27,750	21,300	---	49,050
James H. Graves	27,750	21,300	---	49,050
George R. Manser	29,750	21,300	---	51,050

<sup>1</sup> Reflects the amount recognized for financial statement purposes in accordance with Financial Accounting Standards Board Statement No. 123R. Assumptions used in calculating this amount are included in Note 13 to the Company's audited financial statements included in its Annual Report on Form 10-K for the year ended December 31, 2008. As of December 31, 2008, fully exercisable options to purchase 19,167, 31,667, 15,000 and 23,333 shares of Common Stock were outstanding to Messrs. Schwarz, Berlin, Graves and Manser, respectively.

<sup>2</sup> Represents compensation received as an executive officer of the Company. "All Other Compensation" represents the employee portion of medical coverage paid by the Company and the Company's matching contributions to employee 401(k) account.

## Shareholder Communications

The Board believes that, in light of the accessibility of its directors to informal communications, a formal process for shareholders to communicate with directors is unnecessary. Any shareholder communication sent to the Board, either generally or in care of the Executive Chairman, will be forwarded to members of the Board without screening. Any shareholder communication to the Board should be addressed in care of the Executive Chairman and transmitted to the Company's headquarters in Fort Worth, Texas. In order to assure proper handling, the transmittal envelope should include a notation indicating "Board Communication" or "Director Communication." All such correspondence should identify the author as a shareholder and clearly state whether the intended recipients are all members of the Board or only specified directors. The Executive Chairman will circulate all such correspondence to the appropriate directors.

## EXECUTIVE OFFICERS

The following persons are currently the only executive officers of the Company:

<u>Name</u>	<u>Age</u>	<u>Position(s) with the Company</u>
Mark E. Schwarz	48	Executive Chairman and Director
Mark J. Morrison	49	President and Chief Executive Officer
Kevin T. Kasitz	46	Executive Vice President, Chief Operating Officer and President of AHIS Operating Unit
Brookland F. Davis	45	Executive Vice President and President of Personal Lines Operating Unit
Jeffrey R. Passmore	41	Senior Vice President and Chief Accounting Officer
Donald E. Meyer	53	President of TGA Operating Unit
Christopher C. Jones	60	President of Aerospace Operating Unit
Jeffrey L. Heath	57	President of Heath XS Operating Unit

No executive officer bears any family relationship to any other executive officer or to any director or nominee for director of the Company. No director, nominee for director or executive officer of the Company has been involved in any legal proceedings that would be material to an evaluation of the management of the Company. Information concerning the business experience of Mark E. Schwarz is provided under **Election of Directors**.

**Mark J. Morrison** was named President of the Company in April, 2006 and became Chief Executive Officer in August, 2006. He joined the Company in March, 2004, as Executive Vice President and Chief Financial Officer and was appointed to the additional position of Chief Operating Officer in April, 2005. Mr. Morrison has been employed in the property and casualty insurance industry since 1993. Prior to joining the Company, he had since 2001 served as President of Associates Insurance Group, a subsidiary of The Travelers Companies, Inc. From 1996 through 2000, he served as Senior Vice President and Chief Financial Officer of Associates Insurance Group, the insurance division of Associates First Capital Corporation. From 1995 to 1996, Mr. Morrison served as Vice President and Controller of American Eagle Insurance Group, and from 1993 to 1995 was Director of Corporate Accounting for Republic Insurance Group. From 1991 to 1993, he served as Director of Strategic Planning and Analysis at Anthem, Inc. Mr. Morrison began his career as a public accountant with Ernst & Young, LLP from 1982 to 1991, where he completed his tenure as a Senior Manager.

**Kevin T. Kasitz** was named an Executive Vice President of the Company effective April, 2006, and became Chief Operating Officer in December, 2006. He has served as the President of the AHIS Operating Unit, a functional division of the Company handling standard lines commercial insurance, since April, 2003. Prior to joining the Company, Mr. Kasitz had since 1991 been employed by Benfield Blanch Inc., a reinsurance intermediary, where he served as a Senior Vice President in the Program Services division (2000 to 2003) and Alternative Distribution division (1999 to 2000), a Vice President in the Alternative Distribution division (1994 to 1999) and a Manager in the Wholesale Insurance Services division (1991 to 1994). From 1989 to 1991, he was a personal lines underwriter for Continental Insurance Company and from 1986 to 1989 was an internal auditor for National County Mutual Insurance Company, a regional non-standard automobile insurer.

**Brookland F. Davis** was named an Executive Vice President of the Company in December, 2006, and has served as the President of the Personal Lines Operating Unit, a functional division of the Company handling non-standard personal automobile insurance, since January, 2003. Since 2001, Mr. Davis had previously been employed by Bankers Insurance Group, Inc., a property/casualty and life insurance group of companies, where he began as the Chief Accounting Officer and was ultimately promoted to President of their Texas managing general agency and head of their nationwide non-standard personal automobile operations. From 1998 to 2000, he served as Executive Vice President and Chief Financial Officer of Paragon Insurance Holdings, LLC, a multi-state personal lines managing general agency offering non-standard personal automobile and homeowners insurance, which Mr. Davis co-founded. During 1997, Mr. Davis was a Senior Manager with KPMG Peat Marwick focusing on the financial services practice area. From 1993 to 1997, he served as Vice President and Treasurer of Midland Financial Group, Inc., a multi-state property/casualty insurance company focused on non-standard automobile insurance. Mr. Davis began his professional career in 1986 in public accounting with first Coopers & Lybrand and later KPMG Peat Marwick, where he ended his tenure in 1992 as a Supervising Senior Tax Specialist. Mr. Davis is a certified public accountant licensed in Texas and Tennessee.

**Jeffrey R. Passmore** has served as Senior Vice President and Chief Accounting Officer of the Company since June, 2003, and previously served as Vice President of Business Development for the Company. Prior to joining the Company in November, 2002, Mr. Passmore had since 2000 served as Vice President and Controller of Benfield Blanch, Inc. and its predecessor E.W. Blanch Holdings, Inc., a reinsurance intermediary. From 1998 to 1999, he served E.W. Blanch Holdings, Inc. as Assistant Vice President of Financial Reporting. From 1994 to 1998, he was a senior financial analyst with TIG Holdings, Inc., a property and casualty insurance holding company. Mr. Passmore began his career as an accountant for Gulf Insurance Group from 1990 to 1993. Mr. Passmore is a certified public accountant licensed in Texas.

**Donald E. Meyer** was named President of the TGA Operating Unit, a functional division of the Company handling primarily excess and surplus lines commercial insurance, after the acquisition of the subsidiaries comprising this operating unit in January, 2006. Mr. Meyer has served as the Vice President of the primary subsidiary within the TGA Operating Unit, TGA Insurance Managers, Inc., since 1981. He has since 1986 also served as the President of Hallmark Specialty Insurance Company, which was also acquired by the Company in January, 2006. Mr. Meyer served on the board of directors of the Texas Surplus Lines Association, an industry trade group, from 2002 through 2004. He had previously served on the board of directors of this organization from 1991 through 1996 and served as its President during 1995 and 1996. In 1999, Mr. Meyer was appointed by the Texas Insurance Commissioner to serve a three year term on the board of directors of the Surplus Lines Stamping Office of Texas, a surplus lines self-regulatory organization, where he served as chairman in 2001.

**Christopher C. Jones** was named President of the Aerospace Operating Unit, a functional division of the Company handling general aviation property/casualty insurance, effective January 1, 2009. Since 2006, Mr. Jones had served as Executive Vice President and Chief Operating Officer of the primary subsidiary within the Aerospace Operating Unit, Aerospace Insurance Managers, Inc., where he had also served as the Executive Vice President of Underwriting since its formation in 1999. Previously, Mr. Jones was a Vice President for the aviation division of Great American Insurance Company, and held a similar position with American Eagle Group, Inc. from 1993 until the acquisition of certain of its assets and employees by Great American Insurance Company in 1997. Mr. Jones was a Vice President at J. Smith Lanier & Company from 1990 to 1993, was an agent for Nation Air Insurance Company from 1989 to 1990, and served as a Vice President of Aviation Office of America, Inc. from 1982 to 1989. He began his insurance career in 1978 as an aviation claims adjuster and later moved into underwriting at CTH Aviation Underwriters. Mr. Jones has been an active pilot since 1974 and holds a commercial pilot certificate with airplane, single engine and multi-engine land and instrument-airplane ratings.

**Jeffrey L. Heath** was named President of the Heath XS Operating Unit, a functional division of the Company offering excess commercial automobile and commercial umbrella insurance in certain niche markets, after the Company's acquisition of a majority interest in the subsidiaries comprising this operating unit in August, 2008. He had served as founder and President of these and predecessor entities since inception in August 1991. Previously Mr. Heath had served as Vice President and casualty reinsurance broker with Sten-Re Cole, Inc., as a wholesale insurance broker and division manager with DIA Brokers and as a broker/participant on The New York Insurance Exchange. From 1980 to 1986, he served as an Executive Vice President of G.F.F., Inc., a managing general agent for umbrella and excess coverages. Mr. Heath has also held other positions as a broker or underwriter in the insurance and reinsurance markets. Mr. Heath began his career in 1976 as a casualty facultative underwriter with General Reinsurance Corp.

## EXECUTIVE COMPENSATION

### Summary Compensation Table

The following table sets forth information concerning the compensation of the Chief Executive Officer and the next two most highly compensated executive officers of the Company (the "Named Executive Officers") for the fiscal years ended December 31, 2008 and 2007.

<u>Name and Current Principal Position</u>	<u>Year</u>	<u>Salary (\$)</u>	<u>Bonus (\$)<sup>1</sup></u>	<u>Option Awards (\$)<sup>2</sup></u>	<u>All Other Compensation (\$)<sup>3</sup></u>	<u>Total (\$)</u>
Mark J. Morrison President Chief Executive Officer	2008	361,250	85,000	260,386	9,959	716,595
	2007	350,000	210,000	75,682	11,011	646,693
Kevin T. Kasitz Executive Vice President Chief Operating Officer President of Operating Unit	2008	242,500	50,000	203,448	12,743	508,691
	2007	235,000	105,000	64,752	13,397	418,149
Brookland F. Davis Executive Vice President President of Operating Unit	2008	225,000	70,000	203,448	12,527	510,975
	2007	210,000	125,000	64,752	15,245	414,997

<sup>1</sup> Bonuses earned for each fiscal year were awarded in the following fiscal year. Of the total bonus amount, 75% was paid when awarded and the remaining 25% is payable in two equal annual installments of cash, without interest, on the first and second anniversaries of the initial payment. Receipt of the deferred payments is conditioned upon continued employment with the Company.

<sup>2</sup> Reflects the amount recognized for financial statement purposes in accordance with Financial Accounting Standards Board Statement No. 123R. Assumptions used in calculating this amount are included in Note 13 to the Company's audited financial statements included in its Annual Report on Form 10-K for the year ended December 31, 2007. Information concerning material terms of stock option grants is provided under **Executive Compensation – Outstanding Equity Awards at 2008 Fiscal Year-End**.

<sup>3</sup> Represents the employee portion of medical coverage paid by the Company and the Company's matching contributions to employee 401(k) accounts.

## Outstanding Equity Awards at 2008 Fiscal Year-End

The following table sets forth information concerning all equity awards to the Named Executive Officers which were outstanding as of December 31, 2008, consisting solely of unexercised stock options granted under the 1994 Employee Plan or the 2005 LTIP.

<u>Name</u>	<u>Number of Securities</u> <u>Underlying Unexercised Options</u>		<u>Option Exercise</u> <u>Price (\$)</u>	<u>Option</u> <u>Expiration Date</u>
	<u>Exercisable (#)</u>	<u>Unexercisable (#)</u>		
Mark J. Morrison	15,000	---	3.90	01/26/2009
	10,000	6,667 <sup>1</sup>	7.14	05/27/2015
	6,250	14,583 <sup>1</sup>	11.34	05/25/2016
	10,000	90,000 <sup>1</sup>	12.52	05/24/2017
	---	50,000 <sup>1</sup>	11.46	05/22/2018
Kevin T. Kasitz	10,000	6,667 <sup>2</sup>	7.14	05/27/2015
	5,000	11,667 <sup>2</sup>	11.34	05/25/2016
	7,500	67,500 <sup>2</sup>	12.52	05/24/2017
	---	37,500 <sup>2</sup>	11.46	05/22/2008
Brookland F. Davis	10,000	6,667 <sup>3</sup>	7.14	05/27/2015
	5,000	11,667 <sup>3</sup>	11.34	05/25/2016
	7,500	67,500 <sup>3</sup>	12.52	05/24/2017
	---	37,500 <sup>3</sup>	11.46	05/22/2018

<sup>1</sup> Unexercisable options expiring May 27, 2015, vest on May 27, 2009. Unexercisable options expiring May 25, 2016, vest as to 6,250 and 8,333 shares on May 25, 2009 and 2010, respectively. Unexercisable options expiring May 24, 2017, vest as to 20,000, 30,000 and 40,000 shares on May 24, 2009, 2010 and 2011, respectively. Unexercisable options expiring May 22, 2018, vest as to 5,000, 10,000, 15,000 and 20,000 shares on May 22, 2009, 2010, 2011 and 2012, respectively.

<sup>2</sup> Unexercisable options expiring May 27, 2015, vest on May 27, 2009. Unexercisable options expiring May 25, 2016, vest as to 5,000 and 6,667 shares on May 25, 2009 and 2010, respectively. Unexercisable options expiring May 24, 2017, vest as to 15,000, 22,500 and 30,000 shares on May 24, 2009, 2010 and 2011, respectively. Unexercisable options expiring May 22, 2018, vest as to 3,750, 7,500, 11,250 and 15,000 shares on May 22, 2009, 2010, 2011 and 2012, respectively.

<sup>3</sup> Unexercisable options expiring May 27, 2015, vest on May 27, 2009. Unexercisable options expiring May 25, 2016, vest as to 5,000 and 6,667 shares on May 25, 2009 and 2010, respectively. Unexercisable options expiring May 24, 2017, vest as to 15,000, 22,500 and 30,000 shares on May 24, 2009, 2010 and 2011, respectively. Unexercisable options expiring May 22, 2018, vest as to 3,750, 7,500, 11,250 and 15,000 shares on May 22, 2009, 2010, 2011 and 2012, respectively.

## Equity Compensation Plan Information

The following table sets forth information regarding shares of the Common Stock authorized for issuance under the Company's equity compensation plans as of December 31, 2008.

<u>Plan Category</u>	<b>Number of securities to be issued upon exercise of outstanding options, warrants and rights</b>	<b>Weighted-average exercise price of outstanding options, warrants and rights</b>	<b>Number of securities remaining available for future issuance under equity compensation plans [excluding securities reflected in column (a)]</b>
	(a)	(b)	(c)
Equity compensation plans approved by security holders <sup>1</sup>	1,043,965	\$11.19	512,501
Equity compensation plans not approved by security holders <sup>2</sup>	8,333	\$ 2.25	- 0 -
Total	<u>1,052,298</u>	<u>\$11.12</u>	<u>512,501</u>

<sup>1</sup> Includes shares of Common Stock authorized for issuance under the 2005 LTIP, as well as shares of Common Stock issuable upon exercise of options outstanding under the 1994 Employee Plan and the 1994 Director Plan, both of which terminated in accordance with their terms in 2004.

<sup>2</sup> Represents shares of Common Stock issuable upon exercise of non-qualified stock options granted to non-employee directors in lieu of cash compensation for their service on the Board during fiscal 1999. The options became fully exercisable on August 16, 2000, and terminate on March 15, 2010, to the extent not previously exercised.

## TRANSACTIONS WITH RELATED PERSONS

### Certain Relationships

The Executive Chairman of the Company, Mark E. Schwarz, is the managing member of Newcastle Capital Group, L.L.C. (“NCG”), which entity is the sole general partner of Newcastle Capital Management, L.P. (“NCM”), which entity is the sole general partner of Newcastle Partners, L.P., Newcastle Special Opportunity Fund I, L.P., Newcastle Special Opportunity Fund II, L.P. and Newcastle Focus Fund II, L.P. (collectively, the “Newcastle Funds”). In addition, Mr. Schwarz and NCG are the sole shareholders of DSC Services, Inc., which in turn is the sole shareholder of Detroit Stoker Company (“Detroit Stoker”). As a result of these relationships, Mr. Schwarz has sole investment and voting control over the shares of Common Stock beneficially owned by NCM, the Newcastle Funds and Detroit Stoker, which collectively are the largest holders of the Common Stock. (See, **Principal Shareholders and Stock Ownership of Management.**)

Curtis R. Donnell, who retired as President of the Aerospace Operating Unit effective December 31, 2008, was one of the sellers, and controlled the other seller, from whom the Company acquired the subsidiaries now comprising the Aerospace Operating Unit in January, 2006. Donald E. Meyer was one of the sellers, and is related by marriage to the other sellers, from whom the Company acquired the subsidiaries now comprising the TGA Operating Unit in January, 2006. Jeffrey L. Heath was the seller from whom the Company acquired its majority interests in the subsidiaries now comprising the Heath XS Operating Unit. At the time of these transactions, there was no material relationship between any of the sellers and the Company.

### Acquisition of Aerospace Operating Unit

In January, 2006, the Company completed the acquisition of Aerospace Holdings, LLC from Donnell Children Revocable Trust and Curtis R. Donnell. Mr. Donnell was the settlor and sole trustee of the Donnell Children Revocable Trust. Aerospace Holdings, LLC and its subsidiaries now comprise the Company’s Aerospace Operating Unit. The Company acquired these subsidiaries for initial consideration of \$12.5

million paid in cash at closing. Such initial consideration was allocated \$11.9 million to the purchase price and \$0.6 million to the sellers' compliance with certain restrictive covenants, including a covenant not to compete for a period of five years after closing. The acquisition agreement also required the Company to pay additional contingent consideration of up to \$2.5 million conditioned on the sellers complying with their restrictive covenants and the Aerospace Operating Unit achieving certain operational objectives related to premium production and loss ratios. However, the Aerospace Operating Unit did not achieve the operational objectives necessary to earn such additional consideration.

#### **Lease with Donnell Investments, L.L.C.**

Prior to the Company's acquisition of the subsidiaries now comprising the Aerospace Operating Unit in January, 2006, the primary such subsidiary entered into an agreement to lease office space from Donnell Investments, L.L.C., an entity wholly owned and controlled by Curtis R. Donnell. The lease pertains to an approximately 8,925 square foot suite in a low-rise office building and expires September 30, 2010. The rent is currently \$13,666 per month. The aggregate amount of all scheduled periodic payments under the lease from January 1, 2006, through the termination date is \$0.8 million.

#### **Acquisition of TGA Operating Unit**

In January, 2006, the Company consummated the acquisition of Texas General Agency, Inc. ("TGA") and TGA Special Risk, Inc. ("TGASRI") from Samuel M. Cangelosi, Donate A. Cangelosi and Donald E. Meyer (collectively, the "TGA Sellers"). The Company simultaneously consummated the acquisition of Pan American Acceptance Corporation ("PAAC") from Samuel M. Cangelosi, Donate A. Cangelosi and Carol A. Meyer (collectively, the "PAAC Sellers"). Donald E. Meyer is the brother-in-law of Samuel M. Cangelosi and Donate A. Cangelosi and the husband of Carol A. Meyer. TGA, TGASRI and PAAC now comprise the Company's TGA Operating Unit. TGA also had a wholly-owned insurance company subsidiary which is now an indirect subsidiary of the Company.

The Company acquired PAAC for consideration of \$0.7 million paid in cash at closing. The Company acquired TGA and TGASRI for consideration of \$13.1 million paid in cash at closing, plus the delivery of promissory notes in the aggregate principal amount of \$23.8 million which have now been fully repaid. Aggregate principal of \$14.3 million and \$9.5 million on such promissory notes were paid on January 2, 2007 and 2008, respectively. In addition to the purchase price, the Company paid the TGA Sellers \$0.8 million at closing and \$0.7 million and \$0.5 million on January 2, 2007 and 2008, respectively, in consideration of their compliance with certain restrictive covenants, including a covenant not to compete for a period of five years after closing. The Company secured payment of the future installments of both the purchase price and the restrictive covenant consideration by depositing \$25.0 million in a trust account for the benefit of the TGA Sellers. The trust account deposit has now been released.

The acquisition agreement also required the Company to pay additional contingent consideration of up to \$8.0 million conditioned on the TGA Sellers complying with their restrictive covenants and TGA achieving certain operational objectives related to premium production and loss ratios. Effective December 18, 2008, the Company and the TGA Sellers amended the acquisition agreement to remove all further contingencies and compromise the additional consideration payable to the TGA Sellers at \$4.0 million, which amount was paid to the TGA Sellers in January, 2009.

Pursuant to the respective acquisition agreements, TGA and PAAC distributed to the TGA Sellers, PAAC Sellers and certain employees aggregate cash of approximately \$3.25 million prior to closing. Prior to closing, TGA also assigned to the TGA Sellers any sliding scale contingent commissions attributable to business produced on or before December 31, 2005, which might subsequently become due to TGA under certain reinsurance agreements.

Donald E. Meyer owned a 33.3% interest in TGA and TGASRI and his wife owned a 33.0% interest in PAAC. All amounts payable to the TGA Sellers and the PAAC Sellers were in proportion to their respective ownership interests.

### **Acquisition of Heath XS Operating Unit**

In August, 2008, the Company acquired from Jeffrey L. Heath 80% of the issued and outstanding membership interests in Heath XS, LLC and Hardscrabble Data Solutions, LLC, each a New Jersey limited liability company (collectively, the "Heath Group"), for aggregate cash consideration of \$15.0 million. In connection with the acquisition, the Company executed an Amended and Restated Operating Agreement for each of Heath XS, LLC and Hardscrabble Data Solutions, LLC (collectively, the "Operating Agreements"). The Operating Agreements provide for management of the Heath Group by three managers, two of whom are appointed by the Company and one of whom is appointed by Heath Holdings, LLC ("Heath Holdings"), which is controlled by Mr. Heath. Although most matters may be approved by a majority of the managers, the Operating Agreements specify certain matters requiring unanimous approval of the managers. The Operating Agreements also grant certain preemptive rights, provide for allocation of profits and losses and distributions of available cash, restrict transfers of membership interests and specify certain co-sale and "drag-along" rights.

In addition, the Operating Agreements grant to the Company the right to purchase the remaining 20% membership interests in the Heath Group and grant to Heath Holdings the right to require the Company to purchase such remaining membership interests (the "Put/Call Option"). The Put/Call Option becomes exercisable by either the Company or Heath Holdings upon the earlier of August 29, 2012, the termination of the employment of Mr. Heath by the Heath Group or a change of control of the Company. If the Put/Call Option is exercised, the Company would have the right or obligation to purchase the remaining 20% membership interests in the Heath Group for an amount equal to nine times the average Pre-Tax Income (as defined in the Operating Agreements) for the previous 12 fiscal quarters.

## **CODE OF ETHICS**

The Board has adopted a Code of Ethics applicable to all of the Company's employees, officers and directors. The Code of Ethics covers compliance with law; fair and honest dealings with the Company, its competitors and others; full, fair and accurate disclosure to the public; and procedures for compliance with the Code of Ethics. This Code of Ethics is posted on the Company's website at [www.hallmarkgrp.com](http://www.hallmarkgrp.com).

### **SECTION 16(a) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE**

The Company's executive officers, directors and beneficial owners of more than 10% of the Company's Common Stock are required to file reports of ownership and changes in ownership of the Common Stock with the SEC. Based solely upon information provided to the Company by individual directors, executive officers and beneficial owners, the Company believes that all such reports were timely filed during and with respect to the fiscal year ended December 31, 2008, except that James H. Graves was late filing one Form 4 reporting the exercise of stock options.

### **PRINCIPAL SHAREHOLDERS AND STOCK OWNERSHIP OF MANAGEMENT**

The following table and the notes thereto set forth certain information regarding the beneficial ownership of the Common Stock as of the Record Date by (i) the Named Executive Officers, (ii) each current director and nominee for director of the Company, (iii) all current executive officers and current directors of the Company as a group; and (iv) each other person known to the Company to own beneficially more than

five percent of the presently outstanding Common Stock. Except as otherwise indicated, (a) the persons identified in the table have sole voting and dispositive power with respect to the shares shown as beneficially owned by them, (b) the mailing address for all persons is the same as that of the Company, and (c) the current directors and executive officers have not pledged any of such shares as security.

<u>Shareholder</u>	<u>No. of Shares Beneficially Owned</u>	<u>Percent of Class Beneficially Owned</u>
Mark E. Schwarz <sup>1</sup>	11,059,957	53.0
Mark J. Morrison <sup>2</sup>	139,167	*
Kevin T. Kasitz <sup>3</sup>	79,343	*
Brookland F. Davis <sup>4</sup>	135,328	*
Scott T. Berlin <sup>5</sup>	41,667	*
James H. Graves <sup>6</sup>	133,086	*
Jim W. Henderson	---	---
George R. Manser <sup>7</sup>	71,247	*
All executive officers and current directors, as a group (11 persons) <sup>8</sup>	11,728,865	55.4
Newcastle Capital Management, L.P. <sup>9</sup>	1,515,151	7.3
Newcastle Partners, L.P. <sup>10</sup>	5,901,615	28.3
Newcastle Special Opportunity Fund I, L.P. <sup>10</sup>	1,643,965	7.9
Newcastle Special Opportunity Fund II, L.P. <sup>10</sup>	1,630,865	7.8

\* Represents less than 1%.

<sup>1</sup> Includes 19,167 shares which may be acquired by Mr. Schwarz pursuant to stock options exercisable on or within 60 days after the Record Date, 1,515,151 shares beneficially owned by NCM, 9,178,845 shares owned by the Newcastle Funds and 295,268 shares owned by Detroit Stoker. (See **Transactions with Related Persons – Certain Relationships** and Notes 9 and 10, below.)

<sup>2</sup> Includes 64,167 shares which may be acquired pursuant to stock options exercisable on or within 60 days after the Record Date.

<sup>3</sup> Includes 52,917 shares which may be acquired pursuant to stock options exercisable on or within 60 days after the Record Date.

<sup>4</sup> Includes 52,917 shares which may be acquired pursuant to stock options exercisable on or within 60 days after the Record Date.

<sup>5</sup> Includes 31,667 shares which may be acquired pursuant to stock options exercisable on or within 60 days after the Record Date.

<sup>6</sup> Includes 15,000 shares which may be acquired pursuant to stock options exercisable on or within 60 days after the Record Date and 66,894 shares owned by a limited partnership indirectly controlled by Mr. Graves.

<sup>7</sup> Includes 23,333 shares which may be acquired pursuant to stock options exercisable on or within 60 days after the Record Date and 5,096 shares held by Mr. Manser's spouse, over which shares Mr. Manser shares voting and dispositive power.

<sup>8</sup> Includes 310,501 shares which may be acquired pursuant to stock options exercisable on or within 60 days after the Record Date.

<sup>9</sup> NCM has shared voting and dispositive power over such shares pursuant to an account management agreement. Does not include shares owned by Mark E. Schwarz, the Newcastle Funds or Detroit Stoker. (See **Transactions with Related Persons – Certain Relationships**.)

<sup>10</sup> Does not include shares beneficially owned by Mark E. Schwarz, NCM, Detroit Stoker or the other Newcastle Funds. (See **Transactions with Related Persons – Certain Relationships**.)

## **AUDIT COMMITTEE REPORT**

The Audit Committee is composed of three independent directors and operates under a written charter adopted by the Board in accordance with applicable rules of the SEC and Nasdaq. A copy of the Amended and Restated Audit Committee Charter is posted on the Company's website at [www.hallmarkgrp.com](http://www.hallmarkgrp.com).

The primary purpose of the Audit Committee is to assist the Board in fulfilling its responsibility to oversee management's conduct of the Company's financial reporting process. In discharging its oversight role, the Audit Committee is empowered to investigate any matter brought to its attention with full access to all books, records, facilities and personnel of the Company and is authorized to retain outside counsel, auditors or other experts for this purpose. Subject to any action that may be taken by the full Board, the Audit Committee also has the authority and responsibility to select, evaluate and, where appropriate, replace the Company's independent registered public accountants.

The Company's management is responsible for preparing the Company's financial statements and the independent registered public accountants are responsible for auditing those financial statements. The role of the Audit Committee is to monitor and oversee these processes.

In this context, the Audit Committee has reviewed and discussed the consolidated financial statements with both management and the independent registered public accountants. The Audit Committee also discussed with the independent registered public accountants the matters required to be discussed by Statement on Auditing Standards No. 61 (Communication with Audit Committees). The Audit Committee received from the independent registered public accountants the written disclosures required by applicable requirements of the Public Company Accounting Oversight Board regarding the independent registered public accountants' communications with the Audit Committee concerning independence, and the Audit Committee discussed with the independent registered public accountants their independence.

Based on the Audit Committee's review and discussions with management and the independent registered public accountants, the Audit Committee recommended to the Board that the audited financial statements be included in the Company's Annual Report on Form 10-K filed with the SEC for the year ended December 31, 2008.

Respectfully submitted by the Audit Committee:

George R. Manser (chairman)  
Scott T. Berlin  
James H. Graves

## **INDEPENDENT REGISTERED PUBLIC ACCOUNTANTS**

The Audit Committee has selected KPMG LLP ("KPMG") as the independent registered public accounting firm to audit the consolidated financial statements of the Company for the 2009 fiscal year. KPMG also reported on the Company's consolidated financial statements for the fiscal years ended December 31, 2008 and 2007. Representatives of KPMG are expected to be present at the Annual Meeting, will have the opportunity to make a statement if they so desire and are expected to be available to respond to appropriate questions from shareholders.

The following table presents fees for professional services rendered by KPMG for the audit of the Company's consolidated financial statements for the fiscal years ended December 31, 2008 and 2007, as well as fees billed for other services rendered by the independent registered public accountants during those periods.

	<u>Fiscal 2008</u>	<u>Fiscal 2007</u>
Audit Fees <sup>1</sup>	\$689,682	\$722,672
Audit-Related Fees <sup>2</sup>	---	\$ 10,400
Tax Fees	---	---
All Other Fees	---	---

<sup>1</sup> Reflects fees for services attributable to the indicated fiscal year, a portion of which fees were paid in the subsequent fiscal year.

<sup>2</sup> Audit-related fees in 2007 pertained to services in connection with the Company's filing of registration statements on Form S-3 and Form S-8.

The current policy of the Audit Committee is to review and approve all proposed audit and non-audit services prior to the engagement of independent registered public accountants to perform such services. Therefore, the Audit Committee does not presently have any pre-approval policy or procedures. Review and approval of such services generally occur at the Audit Committee's regularly scheduled quarterly meetings. In situations where it is impractical to wait until the next regularly scheduled quarterly meeting, the Audit Committee has delegated to its chairman the authority to approve audit and non-audit services up to a pre-determined level set by the Audit Committee. Any audit or non-audit services approved pursuant to such delegation of authority must be reported to the full Audit Committee at its next regularly scheduled meeting. During fiscal 2008 and 2007, all audit and non-audit services performed by the Company's independent registered public accountants were approved in advance by the Audit Committee.

#### **SHAREHOLDER PROPOSALS FOR 2010 ANNUAL MEETING**

Any shareholder desiring to submit a proposal for inclusion in the proxy material relating to the 2010 annual meeting of shareholders must do so in writing. The proposal must be received at the Company's principal executive offices by December 29, 2009. In addition, with respect to any matter proposed by a shareholder at the 2010 annual meeting but not included in the Company's proxy materials, the proxy holders designated by the Company may exercise discretionary voting authority if appropriate notice of the shareholder proposal is not received by the Company at its principal executive office by March 14, 2010.

By Order of the Board of Directors,



Cecil R. Wise, Secretary

April 28, 2009  
Fort Worth, Texas