THIS IS NOT A SOLICITATION OF ACCEPTANCES OR REJECTIONS OF THE PLAN. ACCEPTANCES OR REJECTIONS MAY NOT BE SOLICITED UNTIL A DISCLOSURE STATEMENT HAS BEEN APPROVED BY THE BANKRUPTCY COURT

Michael R. Rochelle
State Bar No. 17126700
Scott M. DeWolf
State Bar No. 24009990
ROCHELLE MCCULLOUGH LLP
325 N. St. Paul, Suite 4500
Dallas, Texas 75201
Telephone: (214) 953-0182
Fax: (214) 953-0185

Counsel for Debtors

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE NORTHERN DISTRICT OF TEXAS
DALLAS DIVISION

IN RE:	§	
	§	
HALLWOOD ENERGY, L.P.,	§	**CASE NO. 09-31253-11**
a Delaware Limited Partnership,	§	
	§	
Debtors.	§	**JOINTLY ADMINISTERED**
	§	

DISCLOSURE STATEMENT FOR DEBTORS' JOINT PLAN OF REORGANIZATION

NOTICE

THE BANKRUPTCY COURT HAS NOT YET APPROVED THIS DISCLOSURE STATEMENT PURSUANT TO 11 U.S.C. § 1125. THEREFORE, IT IS NOT TO BE RELIED UPON OR USED IN CONNECTION WITH THE SOLICITATION OF VOTES FOR OR AGAINST ANY CHAPTER 11 PLAN FILED IN THE BANKRUPTCY CASE.

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I.
INTRODUCTION

Hallwood Energy, L.P., Hallwood Energy Management, LLC, Hallwood Gathering, L.P., HG II Management, LLC, Hallwood Petroleum, LLC, and Hallwood SWD, LLC (each a "Debtor" and collectively referred to as the "Debtors"), the above-captioned debtors and debtors in possession, submit this Disclosure Statement for Debtors' Joint Plan of Reorganization (the "Disclosure Statement"). The Debtors are collectively referred to herein sometimes as the "Plan Proponents." This Disclosure Statement is to be used in connection with the solicitation of votes on the Joint Plan of Reorganization (the "Plan"), filed and proposed jointly by the Debtors. A copy of the Plan is attached here as Exhibit A. Unless otherwise defined in this document, capitalized terms have the meanings ascribed to them in the Plan (see Article I of the Plan entitled "Definitions, Construction and Interpretation").

For a summary of the proposed treatment of your Claim or Interest under the Plan, please see the chart on pages 8-10 below.

II.
NOTICE TO HOLDERS OF CLAIMS AND INTERESTS

The purpose of this Disclosure Statement is to enable creditors and shareholders with impaired Claims and Interests to make an informed decision in exercising their right to vote to accept or reject the Plan.

THIS DISCLOSURE STATEMENT CONTAINS INFORMATION THAT MAY BEAR UPON YOUR DECISION TO ACCEPT OR REJECT THE PLAN. PLEASE READ IT CAREFULLY.

On _____, 2009, the Bankruptcy Court held a hearing on the adequacy of the Disclosure Statement and subsequently entered an order under section 1125 of the Code approving the Disclosure Statement as containing adequate information of a kind, and in sufficient detail, to enable a hypothetical, reasonable investor, typical of the solicited holders of Claims against and Interests in the Debtors, to make an informed judgment as to acceptance or rejection of the Plan. A copy of this Order is included in the materials accompanying this Disclosure Statement. **APPROVAL OF THIS DISCLOSURE STATEMENT BY THE BANKRUPTCY COURT DOES NOT CONSTITUTE A DETERMINATION BY THE BANKRUPTCY COURT REGARDING THE FAIRNESS OR MERITS OF THE PLAN.**

THIS DISCLOSURE STATEMENT HAS NOT BEEN APPROVED OR DISAPPROVED BY THE SECURITIES AND EXCHANGE COMMISSION NOR HAS THE COMMISSION PASSED ON ITS ACCURACY OR ADEQUACY OF ITS STATEMENTS.

It is recommended that each Holder of a Claim or Interest entitled to vote on the Plan read this Disclosure Statement and the Plan in their entirety before voting. No solicitation of votes to accept or reject the Plan may be made except pursuant to this Disclosure Statement and section 1125 of the Code. No person has been authorized to use information, other than what is contained in this document, to solicit votes to accept

or reject the Plan. No Claimant should rely upon information relating to the Debtors, their business, or the Plan other than the information contained in this Disclosure Statement and the exhibits attached here. Unless otherwise indicated, the source of all information set forth herein is the Debtors and their professionals.

After carefully reviewing this Disclosure Statement, including the attached exhibits, indicate your acceptance or rejection of the Plan by voting for or against the Plan on the enclosed ballot and returning the same to the address set forth on the ballot, in the enclosed return envelope, in time for it to be received by Debtors' Counsel, Scott M. DeWolf, Rochelle McCullough, LLP, 325 N. St. Paul, Suite 4500, Dallas, Texas 75201, no later than 5:00 Central Time on _____, 2009.

If you do not vote to accept the Plan, or if you are the Holder of an unimpaired Claim, you may be bound by the Plan if it is accepted by the requisite Holders of Claims. *See* "Confirmation of the Plan – Solicitation of Votes; Voting Procedures," "Vote Required for Class Acceptance," (Section XI below).

TO BE SURE YOUR BALLOT IS COUNTED IT MUST BE RECEIVED NO LATER THAN 5:00 P.M. CENTRAL TIME, ON _____, 2009. For detailed voting instructions and the name, address, and phone number of the person you may contact if you have questions regarding the voting procedures, see "Confirmation of the Plan – Solicitation of Votes; Voting Procedures," "Parties In Interest Entitled to Vote." *See* Section XI below.

The Bankruptcy Court has scheduled a hearing to consider whether or not to confirm the Plan on _____, 2009, at _____ ___.m. Central Time, in the United States Bankruptcy Court for the Northern District of Texas, Dallas Division. **The Bankruptcy Court has directed that objections, if any, to confirmation of the Plan must be filed and served on or before _____, 2009.**

THE DEBTORS SUPPORT CONFIRMATION OF THE PLAN AND URGE ALL HOLDERS OF IMPAIRED CLAIMS TO ACCEPT THE PLAN.

III.
EXPLANATION OF CHAPTER 11

A. Overview of Chapter 11

Chapter 11 is the principal reorganization chapter of the Bankruptcy Code. Under Chapter 11, the debtor attempts to reorganize its business for the benefit of itself, its creditors and other parties in interest.

The filing of a Chapter 11 case creates an estate made up of all of the debtor's legal and equitable interests in property as of the date the bankruptcy petition is filed. Sections 1101, 1107, and 1108 of the Code provide that a debtor may continue to operate its business and remain in possession of its property as a "debtor in possession" unless

the bankruptcy court orders the appointment of a trustee. In the present case, the Debtors have remained in possession of their properties as debtors in possession.

The filing of a Chapter 11 petition triggers the automatic stay provisions of the Code, Section 362, which enjoins all attempts to collect prepetition claims from the debtor or otherwise interfere with its property or business. Except as otherwise ordered by the bankruptcy court, the automatic stay remains in force until the effective date of a confirmed plan of reorganization.

Devising a plan of reorganization acceptable to creditors is the principal purpose of a Chapter 11 case. The plan sets forth the means for satisfying the claims against and interests in the debtor. Only the debtor may file a plan during the first 120 days of a Chapter 11 case (the "Exclusive Period") unless a trustee is appointed. If the debtor files a plan the Exclusive Period extends an additional 60 days to allow the debtor to solicit acceptances of its plan. The Code also provides that the court may extend or reduce the Exclusive Period upon a showing of "cause." Any creditor or party in interest may file a plan if the Exclusive Period expires without a plan having been filed by the Debtor.

B. Purpose of Disclosure Statement

This Disclosure Statement is designed to provide sufficient information about the Debtors to enable the holders of impaired Claims to make an informed decision when voting on the Plan and it should be read in its entirety prior to voting. This Disclosure Statement describes the various transactions that must occur to effectuate the Plan. No solicitation of a vote for or against the Plan may be made unless consistent with this Disclosure Statement. No person has been authorized to distribute information concerning the Debtor or its business other than the information contained in this Disclosure Statement. Each creditor or other party in interest is urged to consider carefully the Plan and this Disclosure Statement in their entirety and to consult legal and/or other sources for advice, if necessary, to understand the Plan and its effects, including possible tax consequences, before voting and/or subscribing to any equity securities upon the exercise of the rights issued under to the Plan.

C. Plan of Reorganization

Although referred to as a "plan of reorganization," a plan may provide anything from a complex restructuring of a debtor's business and obligations to a simple liquidation of assets. After a plan of reorganization has been filed, the holders of claims against or interests in a debtor may vote to accept or reject the plan. Before soliciting acceptances of the proposed plan, section 1125 of the Code requires the debtor to prepare a disclosure statement containing adequate information of a kind, and in sufficient detail, to enable a hypothetical, reasonable investor to make an informed judgment about the plan. This Disclosure Statement is presented to holders of Claims against and Interests in the Debtors to satisfy the requirements of section 1125 of the Code.

If all classes of claims and interests accept a plan of reorganization, the bankruptcy court may nonetheless deny confirmation of the plan unless the court independently has determined that the requirements of section 1129 of the Code have been satisfied. Section 1129 requires that a plan meet the "best interests" test and be "feasible." The "best interests" test generally requires that the value of the consideration to be distributed to the holders of claims and interests under a plan may not be less than those parties would receive if the debtor were liquidated under Chapter 7 of the Code. Under the "feasibility" requirement, the court generally must find that there is a reasonable probability that the debtor will be able to meet its obligations under its plan without the need for further financial reorganization.

It is the opinion of the Debtors that the Plan satisfies all applicable requirements of Section 1129(a) of the Code, including, in particular, the "best interests of creditors" test and the "feasibility" requirement. The Debtors support confirmation of the Plan and urge all holders of impaired Claims and Interests to accept the Plan.

Chapter 11 does not require that every holder of a Claim vote in favor of a plan for the bankruptcy court to confirm the Plan. For a plan to be "accepted," however, it must receive the votes of a majority in number and two-thirds in amount of Claims actually voting in one impaired class. Only the holders of impaired Claims who actually vote will be counted as either accepting or rejecting the Plan. For example, if a hypothetical class has ten creditors that vote, and the total dollar amount of those ten creditors' claims is $1,000,000, then six or more must vote to accept the Plan (a simple majority), and the claims of the creditors voting to accept the Plan must total at least $666,667 (a two-thirds majority).

Classes of claims or interests that are not "impaired" under a plan of reorganization are conclusively presumed to have accepted the plan and therefore are not entitled to vote. Accordingly, acceptances of a plan generally will be solicited only from those persons who hold claims or interests in an impaired class. A class is "impaired" if the legal, equitable, or contractual rights attaching to the claims or equity interests of that class are modified in any way under the plan. Modification for purposes of determining impairment, however, does not include curing defaults and reinstating maturity or payment in full in cash. All Classes of Claims and Interests are impaired under the Plan. Administrative Expense Claims and Priority Tax Claims are unclassified; their treatment is prescribed by the Code, and the holders of such Claims are not entitled to vote on the Plan. Each Holder of a Claim or Interest in Classes 1-4 are entitled to vote. Each Holder of an Interest in Classes 5 and 6 will be deemed to have rejected the Plan and are not entitled to vote.

If fewer than all classes of impaired claims and interests vote to accept a plan it may still be confirmed if the proponent of the plan demonstrates, among other things, that the plan does not "discriminate unfairly" and is "fair and equitable" with respect to each impaired class of claims or interests rejecting the plan.

Under section 1129(b) of the Code, a plan is "fair and equitable" to a rejecting class if it provides: (a) to secured claims, property that has a value, as of the effective date of the plan, equal to the allowed amount of the claim; and (b) to unsecured claims the assurance that no class junior to it will receive anything unless the senior class is paid in full.

A plan does not "discriminate unfairly" against a rejecting class of claims if (a) the relative value of the recovery of such class under the plan does not differ materially from that of any class (or classes) of similarly situated claims, and (b) no senior class of claims is to receive more than 100% of the amount of the claims in such class.

In the opinion of the Debtors, the Plan has been structured so that it will satisfy these requirements as to any rejecting Class of Claims and can therefore be confirmed over the objection of any Class. The Debtors reserve the right to request confirmation of the Plan under the "cramdown" provisions of section 1129 of the Code.

IV
SUMMARY OF THE PLAN

A. General Overview

The Debtors' proposed Plan involves the Debtors raising up to $25 million to participate in a new limited partnership. Debtor Hallwood Energy, L.P. will serve as the general partner, and the new investors will be the limited partners.[1] The limited partners and the general partner will receive returns on an agreed formula. The returns to the general partner will be used to make distributions to holders of Allowed Claims and Interests.

The Debtors will retain all of their assets, including their existing producing properties. The revenue from their currently producing properties also will be utilized to make distributions to holders of Allowed Claims or Interests.

In considering whether to vote in favor of the Plan, a thorough examination of this Disclosure Statement is advisable, including the "Risk Factors" at ARTICLE XIV "Material Uncertainties and Risks."

B. Hallwood Penn Partners

As described above, the Plan contemplates the Debtors participating in a limited partnership, to be known as "Hallwood Penn Partners, L.P." ("Penn Partners"). Penn Partners will be funded by new investors investing up to $25 million in exchange for limited partnership interests in Penn Partners. The Debtors will serve as the general

[1] It is also possible that a different corporate form may be used, such as a Limited Liability Company or a joint venture. At the time of the drafting of this Disclosure Statement, this issue had not been finally determined.

partner and will contribute, among other things, certain acreage, seismic data, and leases to Penn Partners.

Penn Partners will develop leases currently held by the Debtors and acquire further acreage for exploration and development in the Arkansas Penn Sands play. The returns on the investment are on a defined formula under the limited partnership agreement and are projected over five years. Subject to various risk factors that must be taken into account, the projected net income generated for holders of Allowed Claims ranges between $33.8 million and $84.3 million. Again, Holders of Claims or Interests entitled to vote should carefully review the "Risk Factors" set forth in Article XIV "Material Risks and Uncertainties" of this Disclosure Statement in determining whether to vote in favor of the Plan.

C. Substantive Consolidation

To ensure fair treatment of creditors, the Bankruptcy Court may exercise its equitable powers under Code section 105(a) and order substantive consolidation. The Plan contemplates substantive consolidation.

As of the Effective Date, solely for the purposes of the Plan, the assets, claims and affairs of the Debtors and the Estates will be substantively consolidated pursuant to Bankruptcy Code section 105(a).

As a result of substantive consolidation, on the Effective Date all property, rights, and claims of the Debtors and the Estates, and all Claims against the Debtors and the Estates shall be deemed pooled for purposes of allowance, treatment, and distributions under the Plan. Multiple proofs of Claim on account of any Claim upon which any of the Debtors are co-obligors or guarantors or otherwise may be contingently liable, without necessity of objection by any party, shall be deemed to constitute a single proof of Clam entitled to a single satisfaction from the substantively consolidated Estates in accordance with the terms of the Plan and the duplicative Claims will be otherwise deemed disallowed. Further, as a result of this substantive consolidation, all Claims between and among the Debtors and the Estates will be canceled without their being entitled to any distribution under the Plan.

D. Classification and Treatment of Claims and Interests

The Plan divides into separate Classes the Claims[2] and Interests asserted in these cases and then describes the treatment to be provided to each such Class under the Plan. Sections 1122 and 1123 of the Code require such classification, with each Class to contain Claims or Equity Interests that are substantially similar to one another. The Plan Proponent has classified Claims and Interests into four (4) Classes for purposes of voting

[2] There are two exceptions to the classification of Claims. Because Administrative Claims and Priority Tax Claims are subject to mandatory treatment under the Code, they are not subject to classification.

on and distributions under the Plan. The treatment of the various Classes under the Plan is discussed in greater detail in later sections of this Disclosure Statement.

The following table sets out the Debtors' estimate of the number and dollar amount of Claims and Equity Interests by Class and a summary of the treatment afforded to each Class under the Plan. The information set forth within the table is subject to and qualified in its entirety by the more detailed information regarding the Plan set forth in this Disclosure Statement, the exhibits attached here (including the Plan itself), and the additional disclosures that follow the table.

SUMMARY OF TREATMENT OF CLASSES UNDER THE PLAN		
CLASS	**ESTIMATED AMOUNT OF CLAIMS AND EQUITY INTERESTS PER CLASS**	**TREATMENT UNDER PLAN**
Unclassified—Allowed Administrative Claims	Est. No. of Claimants: 3 Est. Amt. of Claims: $500,000.00 Est. Allowable Claims: *See* description of Plan treatment for Allowed Administrative Claims	Paid in full within 15 days of the later of the Effective Date or the date on which Allowed **Est. Recovery: 100%** **Unimpaired**
Unclassified—Allowed Priority Tax Claims	Est. No. of Claimants: 11 Est. Amt. of Claims: $45,000.00 Est. Allowable Claims: $45,000.00	Paid in full within 15 days of the later of the Effective Date or the date on which Allowed **Est. Recovery: 100%** **Unimpaired**
1--- Allowed Secured M&M Lien Claims	Est. No. of Claimants: 35 Est. Amt. of Claims: $6,600,000.00 Est. Allowable Claims: $6,600,000.00	Paid within 15 days of the later of the Effective Date or the date on which Allowed **Est. Recovery: 100%** **Impaired**
2---Allowed Priority Non-Tax Claims	Est. No. of Claimants: 20 Est. Amt. of Claims: $219,000.00 Est. Allowable Claims: $219,000.00	Paid within 15 days of the later of the Effective Date or the date on which Allowed **Est. Recovery: 100%** **Impaired**

CLASS	ESTIMATED AMOUNT OF CLAIMS AND EQUITY INTERESTS PER CLASS	TREATMENT UNDER PLAN
3—Allowed General Unsecured Claims	Est No. of Claimants: 100 Est. Amt. of Claims: $8,000,000.00 Est. Allowable Claims: $8,000,000.00	Holders will receive their Pro Rata Share of 30% of available Cash within thirty days of the later of the Effective Date or the date on which Allowed; Holders will receive three additional distributions occurring at 120 day intervals thereafter with the final distribution paying the remaining balance of the Allowed Claim. Holders will not receive interest on their Allowed Claims. **Est. Recovery: 100%** **Impaired**
4—Allowed Equity Interests	Est. No. of Claimants: 50 Est. Amt. of Claims: $276,000,000 Est. Allowed Claims: $276,000,000	Allowed Equity Interests will receive their pro rata share of New Common Stock; Allowed Equity Interests will receive an initial pro rata distribution of 40% of available Cash within sixty days after the Claims in Classes 1-3 have been paid pursuant to the Plan. After the initial distribution to Class 4, Holders of Allowed Equity Interests will receive distributions on a pro rata basis not less than semi-annually **Est. Recovery: 10%-30%** **Impaired**

CLASS	ESTIMATED AMOUNT OF CLAIMS AND EQUITY INTERESTS PER CLASS	TREATMENT UNDER PLAN
5—Class A Equity Interests	Est. No. of Claimants: 50 Est. Amt. of Claims: $201,000,000.00 Est. Allowed Clams: $0.00	Class A Equity Interests will be cancelled and extinguished on the Effective Date, and such Holders will be deemed to have rejected the Plan. **Impaired (Not Entitled to Vote)**
6—Class B Equity Interests	Est. No. of Claimants: 8 Est. Amount of Claims: $1,000,000.00 Est. Allowed Claims: $0.00	Class B Equity Interests will be cancelled and extinguished on the Effective Date, and such Holders will be deemed to have rejected the Plan. **Impaired (Not Entitled to Vote)**

Factors and Assumptions Applied in Arriving at Estimates

The estimations in the foregoing table are derived from the Debtors' Schedules and proofs of claim filed in the Cases, the Debtors' books and records and Creditors' claim reconciliation information.

The distribution amounts are based on several significant assumptions: (1) the Debtors' equitably subordinate and/or recharacterize the Claims of HPI to Class 4 and thus the Debtors will have sufficient unencumbered Cash at the Effective Date to make Distributions to Holders of Claims, (2) FEI Shale pays the Debtors amounts due under several supplemental AFEs under the Farmout Agreement, and (3) the Debtors' net production proceeds remains constant at its current levels.

ARTICLE V
STRUCTURE AND HISTORY OF THE DEBTORS

A. Organizational Overview of the Debtors.

On December 31, 2005, four privately-held energy partnerships (Hallwood Energy, L.P., Hallwood Energy II, L.P., Hallwood Energy 4, L.P., and Hallwood Exploration, L.P) consolidated, with the surviving entity being Hallwood Energy, L.P. The boards and management of the partnerships recommended the consolidation to simplify their structure and operations, align all investors' interests, improve their operations, enhance potential financing opportunities, and facilitate future exit strategies. Following completion of the consolidation, all energy activities have been conducted by the Debtors from their corporate office located in Dallas, Texas, and from production offices in Searcy, Arkansas.

There are currently three classes of limited partnership interests in Hallwood Energy, L.P. Their payment priorities are as follows:

(1) "Class C Equity Interest" bear a 16% priority return which compounds monthly. The priority return is accrued and becomes payable when, if, and as declared by the general partner of Hallwood Energy, L.P.

(2) "Class A Equity Interest" have certain preferential voting rights and with the general partner receive 100% of the distributions of available cash and net proceeds from "terminating capital transactions" after:

(a) payment of all unpaid Class C priority return and

(b) payment of all Class C capital contributions until the unrecovered capital accounts of each Class A partner interest is reduced to zero.

Class A Interests thereafter share in all future distributions of available cash and net proceeds from terminating capital contributions with the holders of the Class B interests.

(3) "Class B Equity Interest" hold vested net profit interests awarded to key individuals in Hallwood Energy, L.P. At December 31, 2007 and 2006, outstanding Class B interests had rights to receive 18.6% and 18.8%, respectively, of distributions of defined available cash and net proceeds from terminating capital transactions after the unpaid Class C priority return and capital contributions and the unreturned Class A and general partner capital contributions have been reduced to zero.

In 2008, the Debtors also issued certain "Convertible Subordinated Notes and Warrants" (the "Convertible Notes"). The Convertible Notes were unsecured notes that contained an interest rate of between 14-16%, depending on the existence or non-existence of certain conditions, which was not paid current. Rather, interest continued to

accumulate during the life of the Convertible Notes. The Convertible Notes were convertible at the option of the noteholder into a Class C Equity Interest.

B. The Debtors' Business and Operations

The Debtors are headquartered in Dallas, Texas. Since the formation of Hallwood Energy, L.P., the Debtors have engaged in acquisition, development, exploration, production and sale of hydrocarbons with a primary focus on natural gas assets.

As explained in greater detail below, the Debtors in the past experienced significant losses. However, they now have discovered, defined and begun to exploit gas reserves of substantial value. In their opinion further development of the Arkansas Penn Sands can be accomplished at an attractive rate of return. All of the Debtors' properties are in areas where there is an established infrastructure for transporting gas to major markets. Main natural gas pipelines traverse, or are in close proximity to, Hallwood Energy's properties.

C. Events Leading to Chapter 11 Filing

In the summer of 2008, the Debtors sought to raise capital in the London equity markets to replace the funds provided by HPI. The process was far advanced and subscriptions for additional capital had been obtained, but before the transaction could close, the global financial markets crashed and the infusion of new equity became infeasible.

The market price for gas dropped in tandem with the financial markets from the Fall of 2008 through the Spring of 2009. At the Petition Date, gas prices were in the lowest range they had been in the previous six years. As a result, the Debtors' revenue declined and it was unable to service the HPI obligation pursuant to its terms.

D. Management of the Debtors

Throughout the course of the Bankruptcy Case, the Debtors have been operating as debtors in possession under the guidance and control of their officers and directors, and with the oversight of the Bankruptcy Court. As of the date of this Disclosure Statement the Debtors' primary remaining officers are:

William Guzzetti, President
Russell Meduna, Vice President
William Marble, Chief Technical Officer
Tony Strehlow, Chief Financial Officer, and
James R. Latimer, III, Chief Restructuring Officer.

The Debtors' Board members are William Guzzetti, Russ Meduna, Bill Marble, Parker Lee and Rob Raymond.

As described in greater detail below, the Plan contemplates the Debtors holding a general partnership interest in Penn Partners. The composition of the Debtors' board of directors after the Effective Date has not yet been determined. The Debtors will file as a Plan Supplement prior to the Confirmation Hearing with the composition of the Debtors' Board post-confirmation and any officers who will continue, if any, post-confirmation.

ARTICLE VI
SIGNIFICANT EVENTS DURING THE BANKRUPTCY CASE

During the course of the Bankruptcy Case, various pleadings have been filed with the Bankruptcy Court and several hearings have been conducted. For a comprehensive list of the pleadings filed in the Bankruptcy Case, the docket for the case should be reviewed. Relevant pleadings referenced there may be obtained from the Clerk's Office of the Bankruptcy Court or via the on-line PACER system.

The following is a description of the more significant events that have occurred during the case.

A. Debtors' Employment of Professionals

1. Bankruptcy Counsel

On the Petition Date, the Debtor filed an *Application for Order Authorizing Employment of Rochelle McCullough, LLP as Counsel for Debtors and Debtors-In-Possession.* On April 2, 2009, the Bankruptcy Court entered its order authorizing the Debtors to employ Rochelle McCullough LLP as Counsel for the Debtors *Nunc Pro Tunc* to the Petition Date.

2. Financial and Restructuring Advisor

On the Petition Date, the Debtors filed an *Application to Employ Blackhill Partners as Business Consultant and Chief Restructuring Officer* to request authority to employ Blackhill Partners and James R. Latimer, III as Chief Restructuring Officer for the Debtors. On March 12, 2009, the Debtors filed an *Amended Application to employ Blackhill Partners as Consultant Pursuant to Sections 105(a) and 363(b) of the Code for Authorization to (A) Employ and Retain Blackhill Partners, LLC to Provide the Debtors a Chief Restructuring Officer and Additional Personnel and (B) Designate James R. Latimer, III as the Chief Restructuring Officer for the Debtors Nunc Pro Tunc to the Petition Date.* On April 22, 2009, the Bankruptcy Court entered its Order Granting the Blackhill Application, as amended by the order.

3. Retention of STARR

On April 28, 2009, the Debtors filed their *Application to Employ State Tax Analysis, Research & Recovery, LLC as Consultant, or in the alternative, to Assume Service Agreement* (the "STARR Motion") seeking to retain State Tax Analysis,

Research & Recovery, LLC ("STARR") to pursue certain potential state tax refunds for the Debtors on a contingent fee basis. On April 28, 2009, the Debtors filed their *Motion to Shorten Time* seeking to have the STARR Application heard on May 14, 2009. On May 1, 2009, the Court granted the *Motion to Shorten Time.*

On May 14, 2009, the Court held a hearing on the STARR Motion and granted it.

B. Committee's Employment of Professionals

On March 12, 2009, the U.S. Trustee appointed an Official Committee of Unsecured Creditors (the "Committee") to serve in the Bankruptcy Case. The Committee is comprised of the following members: (a) Union Drilling, Inc.; (b) Premier Pipe, L.P.; (c) Oil Country Tubular Corporation; (d) Cimarex Energy, Co.; (e) W-B Supply Company; and (f) Chesapeake Operating, Inc.

1. Bankruptcy Counsel

On April 2, 2009, the Committee filed an *Application to Employ Okin Adams & Kilmer, LLP as Attorney for the Official Committee of Unsecured Creditors.* On May 1, 2009, the Court granted the Committee's application and employed Okin Adams & Kilmer, LLP as attorneys for the Official Committee of Unsecured Creditors *Nunc Pro Tunc* to March 12, 2009.

2. Financial Advisor

On April 15, 2009, the Committee filed an *Application to Employ LECG LLC as Financial Advisor to the Official Committee of Unsecured Creditors Nunc Pro Tunc to March 19, 2009* (the "LECG Application") seeking to employ LECG LLC as the Committee's financial advisor.

On May 14, 2009, the Court held a hearing on the LECG Application and denied the LECG Application without prejudice.

C. Cash Management System and Maintenance of Accounts

On the Petition Date, the Debtors filed their *Motion for Order Authorizing (1) Maintenance of Existing Bank Accounts and Business Forms and (2) Continued Use of Existing Cash Management System* to request authority to maintain and continue to utilize its existing cash management system and bank accounts, and to continue to utilize its existing business forms. On March 5, 2009, the Bankruptcy Court entered an *Order Authorizing Maintenance of Existing Bank Accounts and Business Forms and Continued Use of Cash Management System*, thereby granting the motion subject to certain modifications agreed upon among the Debtor and the U.S. Trustee.

D. Financing of Operations and Administration of the Estate

1. Authorization to Use Cash Collateral (FEI Shale)

On the Petition Date, the Debtors filed the *Debtors' Emergency Motion for Authority to Use Cash Collateral and Grant Adequate Protection* (the "FEI Shale Cash Collateral Motion") to seek authorization to use cash collateral in a certain "Project Account." On March 5, 2009, the Court entered its *Interim Order Temporarily Granting the Debtors' Emergency Motion for Authority to Use Cash Collateral and Grant Adequate Protection.*

On April 1, 2009, the Court conducted a final hearing on the FEI Shale Cash Collateral Motion. At the conclusion of the evidentiary hearing, the Court granted the FEI Shale Cash Collateral Motion and entered its final order granting the FEI Shale Cash Collateral Motion on April 7, 2009 (the "Final FEI Cash Collateral Order"). The Final FEI Shale Cash Collateral Order granted the Debtor use of the Project Account through June 4, 2009.

2. Authorization to Use Cash Collateral (HPI)

On April 15, 2009, the Debtors filed their *Emergency Motion to Use Cash Collateral* (the "HPI Cash Collateral Motion") seeking to use HPI's Cash Collateral to pay lease operating expenses from the Petition Date through June 4, 2009. On April 16, 2009, the Court held a hearing on the HPI Cash Collateral Motion and granted the HPI Cash Collateral Motion on an interim basis. The Court entered its interim order on the HPI Cash Collateral Motion on April 24, 2009.

On May 8, 2009, pursuant to an agreement between HPI and the Debtors, the Debtors were granted authority to use HPI's Cash Collateral to pay lease operating expenses pursuant to an agreed budget through May 31, 2009. The Court entered its final order on the HPI Cash Collateral Motion on May 12, 2009.

E. Authorization to Pay Royalty Interest Owners and Working Interest Owners

On the Petition Date, the Debtors filed the *Debtors' Emergency Motion for Authority to Honor Certain Pre-Petition Obligations to Working Interest Owners and Royalty Interest Owners and Continue Such Payments Post-Petition in the Ordinary Course of Business* (the "Royalty Owner Motion") seeking authority to pay certain pre-petition working interest and royalty interest payments and to pay such amounts post-petition in the ordinary course of business. The Debtors agreed to pass the Royalty Owner Motion to a hearing on March 24, 2009.

On March 24, 2009, the Court granted the Royalty Owner Motion and the Court entered its order on the Royalty Owner Motion on March 25, 2009. The Debtors paid working interest owners and royalty interest owners the requested pre-petition amounts

pursuant to the order and have continued to pay such amounts in the ordinary course of business post-petition.

F. Executory Contracts and Unexpired Leases

1. Motion to Reject Certain Executory Contracts

On April 15, 2009, the Debtors filed their *Motion to Reject Certain Executory Contracts*, seeking to reject two contracts with J-W Power for compressor units and to reject a contract with Crosstex for an amine unit.

On May 14, 2009, the Court held a hearing on the *Motion to Reject Certain Executory Contracts* and granted the motion subject to confirmation of proper service on J-W Power and Crosstex.

2. Motion to Reject Executory Contract with Anthony Gumbiner

On April 15, 2009, the Debtors filed their *Motion to Reject Consulting Agreement with Anthony Gumbiner* seeking to reject a certain consulting agreement between the Debtors and Anthony Gumbiner.

On May 14, 2009, the Court held a hearing on the *Motion to Reject Consulting Agreement with Anthony Gumbiner* and granted the motion pursuant to an order agreed to by the Debtors and HPI.

G. Automatic Stay Matters

1. HPI Motion to Lift Automatic Stay

On April 8, 2009, HPI filed its *Motion for Relief from the Automatic Stay* seeking to lift the automatic stay to foreclose on HPI's alleged security interests in the Debtors' property.

On May 8, 2009, the Court held a preliminary hearing on HPI's *Motion for Relief from the Automatic Stay*. The Court continued the automatic stay, found compelling circumstances existed to extend the thirty day period and set a final hearing on HPI's *Motion for Relief from Automatic Stay* on June 25, 2009 at 9:30 a.m.

2. FEI Shale Motion to Lift Automatic Stay

On April 13, 2009, FEI Shale filed its *Motion for Relief from the Automatic Stay* seeking to lift the automatic stay to (a) terminate the Farmout Agreement, (b) to seize the Project Account and (c) to remove Debtors as operators under certain operating agreements.

On May 8, 2009, the Court held a preliminary hearing on FEI Shale's *Motion for Relief from the Automatic Stay*. The Court continued the automatic stay, found compelling circumstances existed to extend the thirty day period and set a final hearing on FEI Shale's *Motion for Relief from Automatic Stay* on June 26, 2009 at 9:30 a.m.

3. Paschal Motion to Lift Automatic Stay

On April 29, 2009, Lavelle T. Paschal filed his *Motion for Relief from Automatic Stay* seeking to modify the automatic stay to permit him to pursue certain personal injury claims and seek recovery only from the Debtors' applicable insurance policies, if any.

A preliminary hearing on Mr. Paschal's *Motion for Relief from Automatic Stay* is set for May 28, 2009. The Debtors do not oppose the relief sought so long as it is clear Mr. Paschal will only seek to recover from the Debtors' applicable insurance policies, if any, and will not look to the Debtors' Estates for recovery.

H. Adversary Proceedings

1. HGI Adversary

On March 30, 2009, the Debtors filed an adversary proceeding against The Hallwood Group, Incorporated ("HGI"). The Debtors assert claims for breach of the "Equity Support Agreement" (the "ESA") dated June 9, 2008, in which HGI committed to provide up to $12,500,000.00 to the debt or equity capital of the Debtors. Prior to the Petition Date, the Debtors requested the remaining balance of $3,200,000.00 and HGI refused to fund. The funds had been set aside in a separate account and the Debtors, therefore, also assert a claim for turnover of those funds pursuant to 11 U.S.C. § 542.

On March 30, 2009, the Debtors moved for summary judgment on their claims against HGI. The Debtors also filed a Motion for Relief from Twenty Day Waiting Period and for Briefing Schedule. On April 16, 2009, the Court denied the Motion and set the Motion for Summary Judgment for hearing on June 22, 2009.

2. HPI Adversary

On May 7, 2009, the Debtors filed an adversary proceeding against Hall Phoenix/Inwood, Ltd., ("HPI"), Craig Hall, and Don Braun (the "HPI Adversary"). The Debtors assert claims for (a) equitable subordination, (b) recharacterization, (c) breach of fiduciary duty, (d) declaratory relief, and (e) claims objections regarding the HPI's claims in the bankruptcy. As described in more detail below, the Debtors allege that the HPI transactions are in fact equity contributions and therefore should either be equitably subordinated or recharacterized as equity. The Debtors further assert claims for breach of fiduciary duty against Craig Hall and Don Braun, former directors of the Debtors' general partner.

ARTICLE VII
EQUITABLE SUBORDINATION AND/OR
RECHARACTERIZATION OF HPI'S CLAIMS AND CONVERTIBLE DEBT

A. Introduction

If the Plan is confirmed, Hall Phoenix's claims will be equitably subordinated and/or recharacterized as Equity and be treated in Class 4. An understanding of the doctrines of equitable subordination and recharacterization is essential in order to understand the structure of the Plan.

B. Standards for Equitable Subordination

Section 510(c) of the Code provides as follows:

Notwithstanding subsections (a) [relating to inter-creditor subordination agreements] and (b) [relating to certain securities based claims] of this section, after notice and a hearing, the court may –

> (1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim . . . ; or
>
> (2) order that any lien securing such a subordinated claim be transferred to the estate.

11 U.S.C. § 510(c). Ordinarily, a request for equitable subordination is adjudicated in the context of an adversary proceeding. However, an exception exists "when chapter 11 ... plan provides for subordination." Fed. R. Bankr. P. 7001(8); *see also* Fed. R. Bankr. P. 3020(b)(1) (providing that an objection to confirmation is governed by Bankruptcy Rule 9014).

Substantively, the Code does not specify the "principles of equitable subordination" applicable under Section 510(c), but it "clearly indicates congressional intent at least to start with existing [judicial] doctrine."[3] Based upon such direction, the most widely-recognized[4] summary of applicable "principles of equitable subordination" was provided by the Fifth Circuit in the *Mobile Steel* case:[5]

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[3] *United States v. Noland*, 517 U.S. 537, 538 (1996); *see also Fabricators*, 926 F.2d at 1464 ("The legislative history indicates that equitable subordination is to be invoked according to case law at the time of codification [of the Code], with development of the concept being left to the courts"); *Summit Coffee Co. v. Herby's Foods, Inc. (In re Herby's Foods, Inc.)*, 2 F.3d 128, 131 (5th Cir. 1993) (same).

[4] *See e.g., Noland*, 517 U.S. at 538 (describing the *Mobile Steel* opinion as an "influential opinion" on the principles of equitable subordination); *Merrimac Paper Co., Inc. v. Harrison (In re Merrimac Paper Co., Inc.)*, 420 F.3d 53, 59 (1st Cir. 2005) (citing *Mobile Steel* test with approval); *Sender v. Bronze Group, Ltd. (In re Hedged-Investments Assocs., Inc.)*, 380 F.3d 1292, 1300 (10th Cir. 2004) (recognizing adoption of *Mobile Steel* test).

> "[B]ankruptcy courts have traditionally been regarded as courts of equity, and it is settled that they possess the power 'to prevent the consummation of a course of conduct by [a] claimant which ... would be fraudulent or otherwise inequitable' by subordinating his claim to the ethically superior claims asserted by other creditors.
>
> ***
>
> Three conditions must be satisfied before the exercise of the power of equitable subordination is appropriate.
>
> (i) The claimant must have engaged in some type of inequitable conduct.
>
> (ii) The misconduct must have resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant.
>
> (iii) Equitable subordination of the claim must not be inconsistent with the provisions of the Bankruptcy Act [now Code]."

Focusing on the first condition, inequitable conduct includes (a) fraud, illegality or breach of fiduciary duties; and (b) a claimant's use of the debtor as a mere instrumentality or alter ego."[6] As for the third condition, the Fifth Circuit merely intended to ensure that subordination decisions are not made on the basis of generalized or categorical equitable considerations. Instead, subordination must be considered and justified on the particular facts of the case.[7]

As reflected by the above principles, a creditor's use of the debtor as a mere instrumentality to achieve an unfair advantage is one form of inequitable conduct that warrants equitable subordination of the creditor's claim. In the context of a lender-borrower relationship, the Fifth Circuit has explained:[8]

> "Through its loan agreement, every lender effectively exercises 'control' over its borrower to some degree....The purpose of equitable subordination is to distinguish between unilateral remedies that a creditor may properly enforce pursuant to its agreements with the debtor and other inequitable conduct such as fraud, misrepresentation, or the exercise of such total control over the debtor as to have essentially replaced its decision-making

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5 *Mobile Steel*, 563 F.2d at 698-701 (citations omitted).

6 *Clark Pipe & Supply Co.*, 893 F.2d at 699; *see also Wilson v. Huffman (In re Missionary Baptist Found. Of America, Inc.)*, 818 F.2d 1135, 1142 (5th Cir. 1987).

7 *See Noland*, 517 U.S. at 1527; *Merrimac Paper Co.*, 420 F.3d at 60-62.

8 *Clark Pipe & Supply Co.*, 893 F.2d at 701 (quoting *Comstock v. Group of Institutional Investors*, 335 U.S. 211, 229 (1948)).

capacity with that of the lender. The crucial distinction between what is inequitable and what a lender can reasonably and legitimately do to protect its interests is the distinction between the exercise of 'control' and the exercise of that 'control' to direct the activities of the debtor. 'It is not the mere existence of the opportunity to do wrong that brings that rule into play; it is the unconscionable use of the opportunity afforded by the domination of advantage itself at the injury of the subsidiary that deprives the wrongdoer of the fruits of his wrong.'"

C. Application of Standards to HPI's Claims

1. Factual Background of HPI's Claims

In February 2006, the Debtors entered into a $65 million loan facility with J. Aron and Company (the "J. Aron Facility") and immediately drew down $40 million from the J. Aron Facility. The J. Aron Facility was secured by the Debtors' oil and gas leases, matured on January 31, 2009, and bore an interest rate of London Interbank Offer Rate ("LIBOR") plus 8.75% per annum. As of December 31, 2006, the interest rate was 14.12%.

The J. Aron Facility contained a prepayment provision requiring the Debtors to "make whole" the lender by paying the present value of interest from the date of prepayment through the end of the loan term.

As of December 31, 2006, the Debtors were not in compliance with the proved collateral coverage ratio. In March 2007, the Debtors were still out of compliance with various J. Aron loan covenants and needed additional funding to continue their ongoing operations. To that end the Debtors had to access the remaining $25 million under the J. Aron Facility. The Debtors, however, were required to obtain from the existing equity holders their commitment to contribute an additional $25 million before J. Aron would agree to provide the balance of its credit. Put simply, if the Debtors committed to a $25 million capital contribution, J. Aron would release the remaining $25 million under the J. Aron Facility.

In March 2007, Craig Hall, one of the directors of Hallwood Energy Management, LLC, the general partner of Hallwood Energy, L.P., met with Anthony Gumbiner and advised him that he, Hall, would not participate in any future capital calls as an equity holder if the Debtors continued under the J. Aron Facility. At the time, Mr. Hall, through a separately wholly-controlled limited partnership, was one of the Debtors' largest equity holders. As a practical matter, the Debtors would be unable to commit to raising the equity needed to continue operations if Mr. Hall refused to respond to a capital call.

Rather than committing to a portion of the requested capital call, Mr. Hall insisted that the Debtors enter into a "loan" facility with his affiliated company, HPI. Some

directors of the Debtors were not in favor of the HPI transaction because it required the Debtors, among other things, to pay the "make whole" fee to J. Aron, which in March 2007, was approximately $9.8 million.

However, the reality was that the directors were left with no choice. Mr. Hall's refusal to fund his portion of the $25 million capital call left the Debtors unable to raise the additional $25 million of equity required by the J. Aron Facility. Because Mr. Hall persisted in his refusal to contribute capital the Debtors could not continue to operate and were forced to capitulate and accede to Hall's demands. On or about April 19, 2007, the Debtors entered into a $100 Million Advancing Term Loan (the "HPI $100MM Facility").

At the time of closing of the HPI $100MM Facility, the Debtors were undercapitalized. Its records and the "Transaction Documents" executed in connection with the HPI $100MM Facility evidence that the Debtors needed an additional $80 million in capital to continue in existence and acquire new properties.

Further, the HPI $100MM Facility was not immediately made available in the full amount but only in proportion to new equity contributions by existing equity holders. At the closing of the HPI $100MM Facility, $63MM was drawn immediately. Approximately $9.8 million of the amount drawn was used to pay the "make whole" fee for which the Debtors received no benefit. Further, the Debtors paid HPI and its Counsel approximately $425,000.00 in commitment and legal fees.

Two additional agreements were executed in connection with the HPI $100MM Facility and designated as "Transaction Documents." The first Transaction Document was an agreement by the Debtors to raise an additional $60 million of equity capital in 2007. As a result, HPI required the Debtors to raise $35 million beyond the $25 million in capital that J. Aron requested in early 2007. If the Debtors failed to raise the additional $60 million, the remaining monies (approximately $35 million) under the HPI $100MM Facility would not be available for borrowing.

The second Transaction Document acknowledged that the Debtors needed an additional $20 million, separate and apart from the $60MM described above, in order to fund drilling on its Arkansas leases during 2007.

Mr. Hall's refusal to participate in the $25 million capital call requested by J. Aron allowed him to improve his position relative to other equity holders and all of the Debtors' unsecured creditors. Rather than raising an additional $50 million (the remaining $25 million J. Aron loan proceeds plus a $25 million equity contribution), Hall forced the Debtors to pay J. Aron's $9.8 million "make whole fee" and then would only advance funds equal to the amount put up by other equity holders. Hall thus put himself in a hedged position: if the Debtors succeeded he would be paid a high rate of interest and an additional "make whole fee," and if they failed, Hall would have a purported lien on all their assets and he could foreclose, while all other equity holders would lose their entire investment.

The proportionate ratio between the advances by HPI and other equity holders are evidence of an equity contribution rather than an actual "loan." Further, the additional equity required was funded pursuant to a newly created preferred "Class C Partnership Interest" that carried a 16% coupon to mimic or mirror the interest rate under the HPI transaction.

Paying the "make whole fee" gave the Debtors no benefit, but only served to further weaken their financial position and improve Hall's position, through the HPI $100MM Facility, as an ostensible secured creditor rather than as an equity holder. At the time of the HPI $100MM Facility the Debtors had no other way to obtain outside financing—further evidence of the Debtors' inadequate capitalization and true character of the HPI $100MM Facility as an equity contribution.

The Debtors' financial condition deteriorated further in 2007. By December 31, 2007, the Debtors were out of covenant compliance under the HPI $100MM Facility. The Debtors attempted to raise additional capital through the summer of 2008 to fund operations, and needed at least $30 million of new capital.

In January 2008, in exchange for an agreement of the existing equity holders to provide $15 million, HPI agreed to advance another $15 million under a second facility (the "HPI $15MM Facility"). HPI's advances continued in direct proportion to existing equity, consistent with a capital contribution rather than a loan.

Again, the Debtors had no other outside lending source, and no reasonably prudent lender would advance an additional $15 million to a borrower who owed $100 million, whose assets were worth substantially less than $100 million and whose auditor had recently given it a going-concern qualification.

In addition, upon information and belief, HPI is owned and controlled by Craig Hall, who at the time of the HPI $100MM Facility, was a director of Hallwood Energy Management, LLC, the general partner of Hallwood Energy, L.P.—the board that controls the Debtors. Further, HPI acknowledged in a letter agreement dated October 17, 2007, that it was a "partner" of Hallwood Energy, L.P.

Because the HPI transactions were dealings with insiders, they are subject to rigorous scrutiny.

In the October 17, 2007 letter agreement, HPI agreed to contribute $4,500,000.00 in exchange for Class C Equity Interests. On January 3, 2008, HPI defaulted on those obligations and refused to contribute the $4,500,000.00 it had committed to less than three months before. Instead of putting up the money, HPI insisted that this claim be released in exchange for making the HPI $15MM Facility. Thus, instead of contributing the agreed $4,500,000.00 of equity capital, HPI forced the Debtors to incur $15 million of purported "secured debt" and waive a $4,500,000.00 contractual claim.

Upon information and belief, Craig Hall and Don Braun, in connection with the HPI $100MM Facility and during the same time period when they were negotiating the HPI $100MM Facility with the Debtors, were negotiating a separate loan from a group of banks so that they could fund the HPI $100MM Facility.

Undisclosed to the Debtors and the HEM Board of Directors, Craig Hall and Don Braun were negotiating a separate facility in which they would pledge the security they obtained under the HPI $100MM Facility in exchange for a loan of $65 million (i.e., the amount of the initial funding under the HPI $100MM Facility).

According to Mr. Hall's sworn testimony, the loan they negotiated was on much more favorable terms and at a much more favorable interest rate. Thus, while the Debtors were paying HPI LIBOR plus 10.75%, HPI's effective interest rate was considerably lower. According to Hall, HPI, Hall and Braun, were making as much as $1 million profit *each month* on the "spread" between HPI's cost of funds and the amount paid by the Debtors.

In the Debtors' opinion, these and other related facts establish a good faith basis for the Court either to equitably subordinate or to recharacterize the HPI $100MM Facility and the HPI $15MM Facility as equity.

As shown above, HPI engaged in inequitable conduct. The unfair advantage obtained from this conduct and the damage caused to creditors and the Debtors justifies subordination of HPI's Claims to all General Unsecured Creditors for the purposes of distribution under the Plan and further justifies a transfer of HPI's Liens to the Estate in connection with such subordination. Accordingly, the Debtors pray that the Bankruptcy Court order the subordination, lien transfers recharacterization as equity, and other necessary relief to compensate injured creditors as part of the Court's order confirming the Plan.

D. Application of Standards to Convertible Notes

In 2008, the Debtors entered into two convertible debt offerings (the "Convertible Notes"). The Convertible Notes were entered into in January, 2008 and May, 2008. The Convertible Notes were unsecured notes that contained an interest rate of between 14-16%, depending on the existence or non-existence of certain conditions, which was not paid current. Rather, interest continued to accumulate during the life of the notes. Further, the Convertible Notes holders had the option to convert their holdings to Class C Limited Partnership Interests.

The Debtors believe these Convertible Notes should be recharacterized as equity, rather than debt. At the time of the issuance of the Convertible Notes, the Debtors financial condition was poor. The Debtors were undercapitalized, out of compliance with covenants in its Hall Phoenix arrangements and had received a going concern opinion from its auditors. Further, the Convertible Notes were raised at a time when the Debtors

needed additional capital contributions. The reality of the situation makes it appear the Convertible Notes are more properly treated as an "equity contribution" than a "loan."

Under the Plan, the Convertible Notes are recharacterized as equity and subordinated to true unsecured creditors. The Debtors believe that the recharacterization issues related to the Convertible Notes can be tried in connection with the Confirmation Hearing and confirmation of the Plan.[9] As such, the Debtors do not intend, at this time, to file an adversary proceeding to recharacterize the Convertible Notes. Confirmation of the Plan shall be deemed a recharacterization of the Convertible Notes to equity in Class 4.

ARTICLE VIII
SUMMARY OF THE PLAN OF REORGANIZATION

THIS SECTION PROVIDES A SUMMARY OF THE PLAN AND IS QUALIFIED IN ITS ENTIRETY BY REFERENCE TO THE PLAN.

THE REPRESENTATIONS CONTAINED IN THIS DISCLOSURE STATEMENT INCLUDE SUMMARIES OF THE PROVISIONS CONTAINED IN THE PLAN AND IN DOCUMENTS REFERRED TO THERE. THE REPRESENTATIONS CONTAINED IN THIS DISCLOSURE STATEMENT DO NOT PURPORT TO BE PRECISE OR COMPLETE REPRESENTATIONS OF ALL THE TERMS AND PROVISIONS OF THE PLAN OR DOCUMENTS REFERRRED TO THERE, AND REFERENCE IS MADE TO THE PLAN AND SUCH DOCUMENTS FOR THE FULL AND COMPLETE STATEMENTS OF SUCH TERMS AND PROVISIONS.

THE PLAN AND THE DOCUMENTS REFERRED TO THERE WILL CONTROL THE TREATMENT OF A HOLDER OF A CLAIM OR EQUITY INTEREST UNDER THE PLAN AND SHALL, UPON THE EFFECTIVE DATE, BE BINDING UPON A HOLDER OF A CLAIM AGAINST, OR AN EQUITY INTEREST IN, THE DEBTOR AND OTHER PARTIES IN INTEREST.

A. General Concept of the Plan.

The Plan proposes to (i) pay, with Cash on hand on the Effective Date, all Holders of Allowed Administrative Claims and Priority Tax Claims, and (ii) to pay, with Cash, the Holders of Allowed Claims in Classes 1-4 distributions over time as set forth for each Class of Claim or Interest.

The Plan provides for equitable subordination and/or recharacterization of the Claims of HPI to equity in Class 4 and for equitable subordination and/or recharacterization of the Claims of Convertible Debt Holders to equity in Class 4.

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[9] *See* FED. R. BANKR. P. 7001(8); *see also* FED. R. BANKR. P. 3020(b)(1) (providing that an objection to confirmation is governed by Bankruptcy Rule 9014).

The Debtors believe the Plan provides the best and most prompt possible recovery to Holders of Claims and Interests. For purposes of this Disclosure Statement, the term Holder refers to the holder of a Claim or Interest in a particular Class under the Plan. If the Plan is confirmed by the Bankruptcy Court and consummated, then on the Effective Date or as soon as practicable thereafter, the Reorganized Debtor will make distributions as provided in the Plan as more fully described below.

B. Classification of Claims and Equity Interests

Code § 1122 requires that a plan classify the claims of a debtor's creditors and the interests of its equity holders. The Code provides that except for certain claims classified for administrative convenience, a plan may place a claim or an equity interest in a particular class only if such claim or equity interest is substantially similar to the other claims or equity interests of such class. The Code further provides that a plan offer the same treatment for each claim or equity interest of a particular class unless the holder of a particular claim or equity interest agrees to less favorable treatment of its claim or equity interest.

Certain Classes of Creditors have not been classified in the Plan because they will be paid in full and are not impaired. Such Claimants include those holding Allowed Administrative Claims, Allowed Professional Fee Claims, and Claims relating to U.S. Trustee Fees.

C. Treatment of Claims and Equity Interests

The following is an overview of the treatment to be afforded to each Class of Creditors or holders of Equity Interests as provided under the Plan. It is provided for convenience only and is specifically qualified by the Plan itself.

Notwithstanding anything to the contrary herein, no distributions will be made and no rights will be retained on account of any Claim (or Interest) that is not an Allowed Claim (or Allowed Interest).

The treatment in the Plan is in full and complete satisfaction of the legal, contractual and equitable rights that each entity holding a Claim or an Interest may have in or against any Debtor, any Estate, or their respective property. This treatment supersedes and replaces any agreements or rights those entities have in or against any Debtor, any Estate, the Reorganized Debtors, or their respective property. Except as otherwise specifically provided in the Plan, all distributions under the Plan will be tendered to the entity holding the Allowed Claim or Allowed Interest.

D. Allowance and Treatment of Unclassified Claims (Administrative Claims, Priority Tax Claims)

1. Administrative Claims

The Holder of any Administrative Claim that is incurred, accrued, or in existence prior to the Effective Date, other than (i) a Fee Claim, (ii) and Allowed Administrative Claim, or (iii) a liability in the Ordinary Course of Business must file and serve on all parties required to receive such notice a request for the allowance of such Administrative Claim on or before thirty (30) days after the Effective Date. Such request must include at a minimum (i) the name of the Holder of the Claim (ii) the amount of the Claim and (iii) the basis of the Claim. Failure to timely and properly file and serve the request under this Section shall result in the Administrative Claim being forever barred and discharged. Objections to such requests must be filed and served pursuant to the Bankruptcy Rules on the requesting party and the Debtors within twenty (20) days after the filing of the applicable request for payment of an Administrative Claim.

2. Priority Tax Claims

Except to the extent that a Holder of an Allowed Priority Tax Claim has been paid prior to the Effective Date, or agrees to a different treatment, each Holder of an Allowed Priority Tax Claim, in full satisfaction, release and discharge of and exchange for such Claim, shall receive Cash from the Reorganized Debtor equal to the Allowed amount of such Priority Tax Claim within 15 days of the later of the Effective Date or date on which Allowed. Notwithstanding the foregoing, the Holder of an Allowed Priority Tax Claim shall not be entitled to receive any payment on account of any penalty arising with respect to or in connection with the Allowed Priority Tax Claim.

3. U.S. Trustee Fees

The Debtors shall be responsible for timely payment of United States Trustee quarterly fees incurred pursuant to 28 U.S.C. § 1930(a)(6). Any fees due as of the most recent quarterly invoice prior to the Confirmation Date will be paid in full within thirty (30) days after the Effective Date. After the Effective Date, the Reorganized Debtor shall pay the United States Trustee quarterly fees as they accrue until the Bankruptcy Case is closed. The Reorganized Debtor shall serve on the United States Trustee a quarterly financial report for each quarter (or portion thereof) that the Bankruptcy Case remains open.

E. Class 1: Allowed M&M Lien Claims (Impaired)

Class 1 consists of all Claims held by entities that have valid Claims for which the Holder is entitled to, as of the Petition Date, a mechanics and materialman's lien ("M&M Lien") under applicable non-bankruptcy law.

Unless the holder of a Class 1 Claim agrees to other treatment, such holder shall receive cash in the allowed amount of such holder's Class 1 Allowed Claim on the latest of (i) 15 days after the Effective Date; (ii) 15 days after the date on which the M&M Lien Claim becomes an Allowed M&M Lien Claim.

F. Class 2: Allowed Priority Non-Tax Claims (Impaired)

Class 2 consists of all Claims held by entities that are properly deemed to be priority non-tax claims (the "Priority Non-Tax Claims").

Unless the holder of a Class 2 Claim agrees to other treatment, such holder shall receive Cash within 15 days of the later of the Effective Date or the date on which their Claim is Allowed.

G. Class 3: Allowed General Unsecured Claims (Impaired)

Class 3 consists of all Claims held by entities that are properly deemed to be general unsecured creditors (the "General Unsecured Claims").

Unless the holder of a Class 3 Claim agrees to other treatment, such holder will be paid in full, without interest, as follows: (i) the Reorganized Debtor will make an initial distribution consisting of 30% of available cash within 30 days of the later of the Effective Date, or the date on which Allowed, and Holders of Allowed Class 3 Claims will receive a Pro Rata Share (the "Initial Distribution"); (ii) 120 days after the Initial Distribution, the Reorganized Debtor will make a second distribution consisting of 30% of available cash and Holders of Class 3 Claims will receive a Pro Rata Share (the "Second Distribution"); (iii) 120 days after the Second Distribution, the Reorganized Debtor will make a third distribution consisting of 30% of available cash and Holders of Allowed Class 3 Claims will receive a Pro Rata Share (the "Third Distribution"); and (iv) 120 days after the Third Distribution, the Reorganized Debtor will make a distribution consisting of the remaining balance due on Allowed Class 3 Claims (the "Final Distribution"). Holders of Allowed Class 3 Claims will not receive interest on the amount of their Allowed Claims.

H. Class 4: Allowed Equity Interests (Impaired)

Class 4 consists of all (i) Interests held by Class C Equity Interest Holders; (ii) Claims of Convertible Debt Holders; and (iii) HPI (collectively the "Allowed Equity Interests").

Holders of Allowed Equity Interests will have all of their interests cancelled and extinguished on the Effective Date and in exchange will receive an equity interest in the Reorganized Debtor (the "New Common Stock") on a Pro Rata Basis of the total amount of Allowed Equity Interests; provided, however, no holder will receive New Common Stock unless and until such holder agrees in writing to be bound by the Equity Agreement of the Reorganized Debtor. The New Common Stock will have the attributes described

in the Equity Agreement of the Reorganized Debtor which will be filed as a Plan Supplement.

Holders of Allowed Class 4 Claims will receive distributions after all amounts due under the Plan to Unclassified Claims and Classes 1-3 have been satisfied.

I. Class 5: Class A Equity Interests (Impaired)

Class 5 consists of interest holders of Class A Limited Partnership Interests of the Debtors. Holders of Class A Equity Interests are not entitled to receive or retain any interest under the Plan. Class A Equity Interests will be cancelled and extinguished upon the Effective Date. Class A Equity Interests are deemed to reject the Plan and are not entitled to vote.

J. Class 6: Class B Equity Interests (Impaired)

Class 6 consists of interest holders of Class B Limited Partnership Interests of the Debtors. Holders of Class B Equity Interests are not entitled to receive or retain any interest under the Plan. Class B Equity Interests will be cancelled and extinguished upon the Effective Date. Class B Equity Interests are deemed to reject the Plan and are not entitled to vote.

ARTICLE IX
LEGAL PROCEEDINGS AFFECTING THE DEBTOR AND THE ESTATE

A. Litigation Pending as of the Petition Date

As of the Petition Date, certain of the Debtors were parties to the following actions. The status of each of the actions is noted below:

Cause No.	Plaintiff(s)	Defendant(s)	Court	Nature of Suit
08-3546	Oil Country Tubular Corporation	Hallwood Petroleum, LLC	U.S.D.C. E.D. Louisiana	Collection/ Breach of Warranty
08-13582	Cimarex Energy Co.	Hallwood Energy, L.P.	298th Dist. Ct (Dallas County, Texas)	Breach of Contract

Cause No.	Plaintiff(s)	Defendant(s)	Court	Nature of Suit
2008-57060	Premier Pipe, LLC	J.D. Fields & Co., Hallwood Energy, L.P.	189th Dist. Ct. (Harris County, Texas)	Collection/ Breach of warranty
07-01209	Eagle Drilling, LLC	Hallwood Energy, L.P., Hallwood Petroleum, LLC	U.S. Bankr. Ct. W.D. Okla.	Breach of Contract
07-30424-H4-11	Eagle Drilling Domestic Drilling Operations, LLC	Hallwood Energy, L.P., Hallwood Petroleum, LLC	U.S. Bankr. Ct. S.D. Texas	Breach of Contract
09-1113	James R. Usery and Rhonda S. Usery as Trustees for the Jim and Rhonda Usery Revocable Trust	Anadarko Petroleum Corp., Hallwood Energy, L.P.	U.S. Court of Appeals for the Eighth Circuit	Dispute over oil and gas interests

B. Post-Petition Litigation

During the course of the Bankruptcy Case, certain litigation has been initiated by the Debtors. The Debtors have initiated an adversary proceeding against The Hallwood Group Incorporated, Adv. Case No. 09-03082-SGJ (the "HGI Adversary"). The HGI Adversary is discussed in more detail at Article VI, H(1) *infra*. The Debtors have also initiated an adversary proceeding against HPI, Craig Hall and Don Braun, Adv. No. 09-03120-SGJ (the "HPI Adversary"). The HPI Adversary is described in more detail at Articles VI, H(2) and VII, C, *infra*.

C. Potential Litigation

The Plan preserves all Causes of Action, unless expressly provided otherwise, and provides for them to be transferred to the Reorganized Debtor on the Effective Date of the Plan. The Reorganized Debtor shall have the full authority to prosecute any and all Causes of Action. In addition to the Causes of Action which have already been asserted

by the Debtors (discussed in prior sections of the Disclosure Statement), the Estates do or may hold, other possible Causes of Action.

1. Avoidance Causes of Action

Pursuant to Sections 547 and 550 of the Code, a trustee (or debtor in possession pursuant to Section 1107 of the Code) may avoid and recover any transfer of an interest of the debtor in property to or for the benefit of a creditor if such transfer (i) was for or on the account of an antecedent debt owed by the debtor before the transfer was made, (ii) was made while the debtor was insolvent, (iii) was made within ninety (90) days of the bankruptcy filing, and (iv) resulted in the creditor receiving more on account of the debt than if the transfer had not been made, the debtor were liquidated under Chapter 7 of the Code, and the creditor were limited to recovery on the debt through the Chapter 7 process. Causes of Action pursuant to Sections 547 and 550 of the Code are referred to as "Preference Causes of Action."

The Estate does or may hold Preference Causes of Action against each of the recipients of payments reflected on Exhibit 3(b) to the Debtors' Statement of Financial Affairs filed in the Bankruptcy Case on March 30, 2009 (the "90-Day Payment Listing"). The 90-Day Payment Listing is incorporated here by reference, for all intents and purposes.

Under Section 548 and 550 of the Code, a trustee or debtor in possession may also seek to avoid and recover what are generally termed "fraudulent transfers." There are two sets of statutes dealing with fraudulent transfers, one state and the other federal. The largest difference between the two is that the statute of limitations in most states on this cause of action is four years, while the federal statute on fraudulent transfers reaches back only two years. These transfers are of two types: those made with actual fraudulent intent, and those which are "constructive fraudulent transfers," and do not involve intent to defraud. To recover a transfer made with actual intent, one must demonstrate that the transfer from the debtor to another party was made with actual intent to hinder, delay, or defraud the debtor's other creditors. Typically, this sort of conveyance is encountered when a debtor is trying to put its assets beyond the reach of creditors. The second type, the "constructively fraudulent transfer," requires that (1) the debtor transferred property for less than reasonably equivalent value to another, and was either (2a) insolvent or (2b) became insolvent because of the transfer. This second sort of fraudulent transfer is more common in the business setting because distressed debtors sometimes find it expedient to convey away property for far less than its fair value. It is at least possible that such causes of action exist for the Debtors here, and they do not waive them.

2. Subordination Causes of Action

Pursuant to Section 510(c) of the Code, after notice and hearing, a bankruptcy court may, under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim. Causes of Action under Section 510(c) of the Code are referred to as "Subordination Causes of

Action." The Estate does or may hold Subordination Causes of Action against (a) HPI, and (b) Holders of Convertible Debt.

3. Collection Causes of Action

a. Collection Causes of Action Generally

As of the date hereof, parties owe amounts to the Debtors. To the extent that amounts owing to the Debtors are currently past due or may hereafter become due, the Estates may hold various claims against such parties for collection of amounts owing. Any claims arising from such obligations shall constitute part of the Causes of Action preserved under the Plan.

b. Amounts Due from FEI Shale

On or about June 9, 2008, the Debtors entered into a certain agreement entitled "Acquisition and Farmout Agreement" (the "Farmout Agreement") with FEI Shale, L.P. ("FEI Shale"). In connection with the Farmout Agreement, FEI Shale agreed to fund up to $125 million in exchange for earning up to a one-third interest in the Debtors' oil and gas properties.

Prior to the Petition Date, FEI Shale agreed to fund certain projects pursuant to "Investment Invoices" under the Farmout Agreement. Under those Investment Invoices, FEI Shale is responsible for and still owes the Debtors approximately $6.6 million. The Debtors have submitted the amounts due pursuant to certain Supplemental AFE's and invoices. To date, FEI Shale has approved approximately $2.0 million of the Supplemental AFE's.

FEI Shale has sought to intervene in the HGI Adversary. The Debtors have consented to this intervention. In the event that FEI Shale does not pay the amounts due of approximately $6.6 million, the Debtors will seek to collect those amounts in the HGI Adversary in the event FEI Shale is permitted to intervene.

PLEASE TAKE NOTICE: WITH THE EXCEPTION OF THOSE CAUSES OF ACTION THAT ARE EXPRESSLY RELEASED OR WAIVED UNDER THE TERMS OF THE PLAN, ALL CAUSES OF ACTION OF THE DEBTORS AND THEIR ESTATES, WHETHER OR NOT SPECIFIED HERE, WILL BE PRESERVED PURSUANT TO THE PLAN. THE LACK OF DISCLOSURE OF ANY PARTICULAR CAUSE OF ACTION SHALL NOT CONSTITUTE, NOR BE DEEMED TO CONSTITUTE, A RELEASE OR WAIVER OF SUCH CAUSE OF ACTION, IT BEING THE INTENTION OF THE PLAN PROPONENTS FOR THE PLAN TO PRESERVE ANY AND ALL CAUSES OF ACTION HELD BY THE DEBTORS AND THEIR ESTATES AS OF THE EFFECTIVE DATE OF THE PLAN.

ARTICLE X
OTHER SIGNIFICANT PLAN PROVISIONS

A. Treatment of Executory Contracts and Unexpired Leases

Section 365 of the Code sets out various provisions regarding executory contracts and unexpired leases. Pursuant to the Plan, all contracts and leases constituting executory contracts or unexpired leases under the provisions of Section 365 of the Code as of the Effective Date of the Plan which (a) have not been assumed or rejected by the Effective Date, or (b) have not been made the subject of a motion to assume which is pending as of the first date set for the hearing on confirmation of the Plan, will be deemed rejected as of the Effective Date in accordance with the provisions of Section 365 of the Code.

The Plan further provides that any Claim arising from the rejection of an executory contract or unexpired lease under the terms of the Plan must be evidenced by a proof of claim filed with the Bankruptcy Court and served on the Debtors by no later than 20 days following the Effective Date of the Plan. **Any holder of such a rejection damages Claim that fails to file and serve such proof of claim on or before said deadline shall be deemed to have waived such Claim in full, and such Claim shall be deemed Disallowed and discharged.**

Notwithstanding the foregoing, the Debtors anticipate filing prior to the Effective Date a certain omnibus motion to assume certain executory contracts and unexpired leases (the "Omnibus Assumption Motion"). The Omnibus Assumption Motion will seek to assume certain agreements necessary for the operations of the Reorganized Debtor, including, but not limited to, (a) farmout agreements, (b) operating agreements, (c) equipment leases for oil and gas properties, and (d) leases (to the extent such leases are not or may not be fee simple determinable under applicable law).

B. Distributions Under the Plan

Pursuant to the Plan, distributions will be made to the holders of Allowed Claims under the following parameters.

1. Distributions Made to Holders as of Distribution Record Date

Pursuant to the Plan, all distributions under the Plan on account of Allowed Claims will be made to (or in the case of Disputed Claims, reserved on behalf of) the holders of such Claims as determined as of the Distribution Date. The "Distribution Date" is defined under the Plan as the "the later of the Effective Date or (b) the Allowance Date."

2. Conditions to Distributions, Warranty of Entitlement and Withholding

No holder of an Allowed Claim will be entitled to a distribution under the Plan until it has provided the Reorganized Debtor with its taxpayer identification number. Additionally, every Creditor accepting distribution under the Plan on account of an Allowed Claim will be deemed to have warranted that such Creditor is the lawful holder of the Allowed Claim, is authorized to receive the distribution, and there are no outstanding commitments, agreements or understandings, express or implied, that may or can, in any way, defeat or modify the right of the Creditor to receive the distribution.

Pursuant to the Plan, any federal, state or local withholding taxes or other amounts required to be withheld under applicable law in relation to a distribution under the Plan will be deducted from the distribution and remitted to the applicable taxing authority(ies). To the extent that such provision of the Plan affects the holder of a particular Allowed Claim, such holder will be required to provide all such information required to comply with such law(s), and no distribution will be made to such holder unless and until such information is provided.

3. Setoffs

Pursuant to the Plan, except as otherwise provided therein pursuant to Section 502(d) or 553 of the Code or any applicable non-bankruptcy law, upon application and approval by the Bankruptcy Court, setoff against any distribution to be made pursuant to the Plan on account of an Allowed Claim any claims, rights or Causes of Action held by the Debtors or their Estates against the holder of the Allowed Claim or in relation to the Allowed Claim; *provided, however*, that neither the failure to effect such setoff nor the allowance of any Claim will constitute a waiver or release of any such claims, rights or Causes of Action.

4. Establishment of Reserves Under the Plan

Pursuant to the Plan, on or after the Effective Date the Reorganized Debtor will create one or more separate Distribution Reserve Accounts as is appropriate from the assets to be distributed to or for the benefit of the Holders of Disputed Claims pending the allowance thereof, the amount of which will be adjusted from time to time as appropriate. Each Distribution Reserve Account will be segregated by Class or, as applicable, by Administrative Claims and Priority Tax Claims. A Claimant will not be entitled to receive or recover any amount in excess of the amount provided in the Distribution Reserve Account to pay such Claim, unless permitted by Order of the Bankruptcy Court.

5. Undeliverable and Unclaimed Distributions

Pursuant to the Plan, any Distributions that become Unclaimed Property shall be retained by the Reorganized Debtor, free and clear of any claims or restrictions thereon,

and any entitlement of any Holder of any Claim to such Distribution shall be extinguished and forever barred. Unclaimed Property shall be deposited into a pool for redistribution to other Holders of Allowed Claims in the same Class as the intended recipient of Unclaimed Property.

6. Disputed Distributions

Pursuant to the Plan, no Distributions shall be made with respect to all or any portion of a Disputed Claim unless and until all objections to such Disputed Claim have been settled or withdrawn or have been determined by a Final Order, and the Disputed Claim has become an Allowed Claim. The Reorganized Debtor in its sole discretion may withhold Distributions otherwise due to the Holder of a Claim until the Objection Deadline, to enable the Reorganized Debtor to file a timely objection thereto. When a Disputed Claim becomes an Allowed Claim, the Reorganized Debtor shall make Distributions with respect to such Allowed Claim, without interest, net of any setoff and/or any required withholding of applicable taxes.

7. De Minimis Distributions

Pursuant to the Plan, notwithstanding any provision of the Plan to the contrary, no distribution of less than one hundred ($100.00) shall be made on account of an Allowed Claim. Notwithstanding any other provision of the Plan, payments of fractions of shares of New Common Stock shall not be made and any such distributions shall be deemed to be zero. Notwithstanding any other provision of the Plan, no distributions or payments of fractions of dollars shall be made. Whenever any payment of cash of a fraction of a dollar would otherwise be called for pursuant to the Plan, the actual payment may reflect a rounding of such fraction to the nearest whole dollar (up or down) with half dollar or less being rounded down.

C. Means for Resolving Disputed Claims

Pursuant to the Plan, all objections to Claims must be filed on or before the Claim Objection Deadline. "Claim Objection Deadline" is defined under the Plan as 120 days after the Effective Date of the Plan, unless extended by the Bankruptcy Court, for cause shown, upon motion filed with the Bankruptcy Court on or prior to such date. Any Disputed Claim as to which an objection is not filed on or before the Claim Objection Deadline will be deemed to constitute an Allowed Claim under the Plan following the Claim Objection Deadline.

To facilitate the timely and effective administration of Claims, the Plan further provides that, except as otherwise expressly contemplated by the Plan, following the later of the Effective Date of the Plan or the applicable Bar Date, no original or amended proof of claim may be filed in the Bankruptcy Court to assert a Claim against the Debtors without prior authorization of the Bankruptcy Court, and any such proof of claim which is filed without such authorization will be deemed null, void and of no force or effect; *provided, however*, that the holder of a Claim that has been evidenced in the Bankruptcy

Case by the filing of a proof of claim on or before the Bar Date shall be permitted to file an amended proof of claim in relation to such Claim at any time if the sole purpose of the amendment is to reduce the amount of the Claim asserted.

ARTICLE XI
CONFIRMATION OF THE PLAN, SOLICITATION OF VOTES, VOTES REQUIRED FOR CLASS ACCEPTANCE AND CRAMDOWN

A. Conditions to Confirmation and Effectiveness of the Plan

At the hearing on plan confirmation, the Bankruptcy Court must determine whether the Code's requirements for confirmation of the Plan have been satisfied, in which event the Bankruptcy Court will enter an order confirming the Plan. As set forth in section 1129 of the Code, these requirements are as follows:

(1) The plan complies with the applicable provisions of the Code;

(2) The proponent of the plan complied with the applicable provisions of the Code;

(3) The plan has been proposed in good faith and not by any means forbidden by law;

(4) Any payment made or promised by the debtors, by the plan proponents, or by a person issuing securities or acquiring property under the plan, for services or for costs and expenses in, or in connection with, the case, or in connection with the plan and incident to the case, has been approved by, or is subject to the approval of, the Bankruptcy Court as reasonable.

(5) (a)(i) The proponent of the plan has disclosed the identity and affiliations of any individual proposed to serve, after confirmation of the plan, as a director, officer, or voting trustee of the debtor, an affiliate of the debtor participating in a joint plan with the debtor, or a successor to the debtor under the plan; and

(ii) the appointment to, or continuance in, such office of such individual, is consistent with the interests of the creditors and equity security holders and with public policy; and

(b) the proponent of the plan has disclosed the identity of any insider that will be employed or retained by the Reorganized Debtor, and the nature of any compensation for such insider.

(6) Any governmental regulatory commission with jurisdiction, after confirmation of the plan, over rates of the debtor has approved any rate change provided in the plan, or such rate change is expressly conditioned on such approval.

(7) With respect to each impaired class of claims or interests:

(a) each holder of a claim or interest of such class has (i) accepted the plan or (ii) will receive or retain under the plan on account of such claim or interest property of a value, as of the effective date of the plan, that is not less than the amount that such holder would so receive or retain if the Debtor was liquidated on such date under Chapter 7 of the Bankruptcy Code on such date; or

(b) if section 1111(b)(2) of the Bankruptcy Code applies to the claims of such class, the holder of a claim of such class will receive or retain under the plan on account of such claim property of a value, as of the effective date of the plan, that is not less than the value of such holder's interest in the estate's interest in the property that secures such claims.

(8) With respect to each class of claims or interests:

(a) such class has accepted the plan; or

(b) such class is not impaired under the plan.

(9) Except to the extent that the holder of a particular claim has agreed to a different treatment of such claim, the plan provides that:

(a) with respect to a claim of a kind specified in section 507(a)(2) or 507(a)(3) of the Bankruptcy Code, on the effective date of the plan, the holder of such claim will receive on account of such claim cash equal to the allowed amount of such claim;

(b) with respect to a class of claims of a kind specified in section 507(a)(1), 507(a)(4), 507(a)(5), 507(a)(6), or 507(a)(7) of the Bankruptcy Code, each holder of a claim of such class will receive:

(i) if such class has accepted the plan, deferred cash payments of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or

(ii) if such class has not accepted the plan, cash on the effective date of the plan equal to the allowed amount of such claim; and

(c) with respect to a claim of the kind specified in Section 507(a)(8) of the Bankruptcy Code, the holder of a claim will receive on account of such claim regular installment payments in cash –

(i) of a total value, as of the effective date of the plan, equal to the allowed amount of such claim;

(ii) over a period ending not later than five years after the date of the order for relief under section 301, 302, or 303; and

(iii) in a manner not less favorable than the most favored nonpriority unsecured claim provided for by the plan (other than cash payments made to a class of creditors under section 1122(b); and

(d) with respect to a secured claim which would otherwise meet the description of an unsecured claim of a governmental unit under section 507(a)(8), but for the secured status of that claim, the holder of that claim will receive on account of that claim, cash payments, in the same manner and over the same period, as described in subparagraph (c) above.

(10) If a class of claims is impaired under the plan, at least one class of claims that is impaired has accepted the plan, determined without including any acceptance of the plan by any insider holding a claim of such class.

(11) Confirmation of the plan is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor or any successor to the debtor under the plan, unless such liquidation or reorganization is proposed in the plan.

(12) All fees payable under 28 U.S.C. § 1930, as determined by the Bankruptcy Code at the hearing on confirmation of the plan, have been paid or the plan provides for the payments of all such fees on the effective date of the plan.

(13) The plan provides for the continuation after its effective date of payment of all retiree benefits, as that term is defined in section 1114 of the Bankruptcy Code, at the level established pursuant to subsection (e)(1)(B) or (g) of section 1114, at any time prior to confirmation of the plan, for the duration of the period the debtor has obligated itself to provide such benefits.

The Debtors believe that the Plan satisfied all the statutory requirements of Chapter 11 of the Bankruptcy Code, that they have complied or will have complied with all the requirements of Chapter 11, and that the Plan is proposed in good faith.

The Debtors believe that Holders of all Allowed Claims or Interests impaired under the Plan will receive payments under the Plan having a present value as of the Effective Date not less than the amounts likely to be received if the Debtors were

liquidated in a case under chapter 7 of the Bankruptcy Code. At the Confirmation Hearing, the Bankruptcy Court will determine whether Holders of Allowed Claims would receive greater distributions under the Plan than they would receive in a liquidation under chapter 7.

B. Voting Procedure

Acceptance or rejection of the Plan will be determined pursuant to the Bankruptcy Code, based upon the Ballots of the Holders of Allowed Claims or Interests in Classes 1-4 that actually vote on the Plan. Therefore, it is important that Holders of Allowed Claims or Interests in Classes 1-4 exercise their right to vote to accept or reject the Plan.

1. Classes Entitled to Vote on the Plan.

Each Impaired Class of Claims and Interests that will receive or retain property or any interest in property under the Plan shall be entitled to vote to accept or reject the Plan. By operation of law, each Unimpaired Class of Claims is conclusively presumed to have accepted the Plan and is not entitled to vote to accept or reject the Plan. Accordingly, in these Cases, any holder of Allowed Claims in Classes 1-4 of the Plan may have a voting claim and should have received a Ballot for voting since these Classes consist of Impaired Claims that are receiving property under the Plan. Holders of Classes 5 and 6 are deemed to have rejected the Plan and are not entitled to vote.

2. General Provisions

Any Claimant holding a Claim who does not vote will not be counted in the percentage or number requirements for voting. A Claim to which an objection has been filed is not an Allowed Claim unless and until the Bankruptcy Court rules on the objection. For purposes of voting on the Plan, the Bankruptcy Court may temporarily set an amount for such an objected Claim. The allowance or disallowance of any Claim for voting purposes does not necessarily mean that all or a portion of the Claim or Interest will be Allowed or Disallowed for purposes of distribution under the Plan.

3. Acceptance by Impaired Classes of Claims

An Impaired Class of Claims shall have accepted the Plan if (a) holders (other than any holder designated under Bankruptcy Code § 1126(e)) of at least two-thirds in amount of the Allowed Claims actually voting in such Class have voted to accept the Plan; and (b) the holders (other than any holder designated under Bankruptcy Code § 1126(e)) of more than one-half in number of the Allowed Claims actually voting in such Class have voted to accept the Plan.

4. Ballots.

(a) Ballots and Voting. Holders of Allowed Claims and Interests in Classes 1-4 entitled to vote on the Plan have been sent a Ballot, together with

instructions for voting, with this Disclosure Statement. Claimants should read the Ballot carefully and follow the instructions contained therein. In voting to accept or reject the Plan, you must use only the Ballot or Ballots sent to you with this Disclosure Statement. The Plan Proponent is authorized to receive and tabulate the Ballots. Claimants entitled to vote will be instructed to return their Ballots to the Debtors. The Debtors will present the results of the voting to the Bankruptcy Court at the Confirmation Hearing.

If you are a member of a Class entitled to vote on the Plan and did not receive a Ballot for such Class, or if your Ballot is damaged or lost, or if you have any questions concerning voting procedures, you should contact:

Scott M. DeWolf
Rochelle McCullough LLP
325 N. St. Paul, Suite 4500
Dallas, Texas 75201
Tel: (214) 953-0182
Fax: (214) 953-0185

(b) Returning Ballots by Voting Deadline. You should complete and sign the Ballot that your receive and return it to counsel for the Debtors on or before the Voting Deadline in the enclosed, pre-addressed envelope. Ballots will not be accepted by telecopy. Creditors' must vote all of their Claims either for acceptance or rejection of the Plan.

(c) Objections. All objections to Confirmation of the Plan must be made in writing, filed with the Clerk of the Bankruptcy Court and served upon the Persons designated in Article I of this Disclosure Statement by the Objection Deadline. It is important to note that whether a holder of a Claim or Interest votes on the Plan, such Person will be bound by the terms and treatment set forth in the Plan if it is accepted by the various Classes and number of holders of Claims in the required majorities and/or it is confirmed by the Bankruptcy Court.

BALLOTS OF HOLDERS OF CLAIMS THAT ARE SIGNED AND RETURNED BUT DO NOT INDICATE A VOTE EITHER FOR ACCEPTANCE OR REJECTION OF THE PLAN WILL BE COUNTED AS BALLOTS TO ACCEPT THE PLAN.

(d) Changing Votes. Federal Rule of Bankruptcy Procedure 3018(a) permits a claimant, for cause, to move the Bankruptcy Court to permit such claimant to change or withdraw its acceptance or rejection of a plan of reorganization. Any request to change or withdraw a vote must occur at least fourteen days before the Confirmation Hearing, unless otherwise allowed by the Bankruptcy Court.

(e) Reservation of Rights. By enclosing a Ballot, the Plan Proponent is not representing that you are entitled to vote on the Plan. By including a Claim Amount on the Ballot, the Plan Proponent is not acknowledging that you

have an Allowed Claim in that amount or waiving any rights they may have to object to your vote or claim.

5. Disputed and Undisputed Claims.

Disputed Claims are not entitled to vote to accept or reject the Plan. If you are a Claimant holding a Disputed Claim, you may ask the Bankruptcy Court to have your Claim temporarily Allowed for the purpose of voting pursuant to Federal Rule of Bankruptcy Procedure 3018.

6. Possible Reclassification of Claimants.

The Debtors are required pursuant to Bankruptcy Code § 1122 to place Claims into Classes that contain substantially similar Claims. Although the Debtors believes they have classified all Claims in compliance with Bankruptcy Code § 1122, it is possible that a Claimant may challenge the classification of its Claim. If the Debtors are required to reclassify the Claim of any Claimants under the Plan, the Debtors, to the extent permitted by the Bankruptcy Court, intends to continue to use the acceptances received from such Claimants pursuant to the solicitation of acceptances using this Disclosure Statement for the purposes of obtaining the approval of the Class or Classes of which such Claimants are ultimately deemed to be a member. Any reclassification of Claimants should affect the Class in which such Claimants were initially a member, or any other Class under the Plan, by changing the composition of the Class and the required vote thereof for approval of the Plan.

ARTICLE XII
EFFECTS OF CONFIRMATION OF THE PLAN; INJUNCTION AND EXCULPATION

A. Binding Effect of the Plan

Upon the Effective Date of the Plan, the Plan and each of its provisions will be binding on the Plan Proponent, the Reorganized Debtor, all Equity Interest Holders and all Persons acquiring property under the Plan, whether or not they voted to accept the Plan, whether or not they had a right to vote on the Plan, whether or not any Claim or Equity Interest held by any of them is impaired under the Plan, whether or not any Claim or Equity Interest held by any of them is Allowed in full, only in part, or Disallowed in full, and whether or not a distribution is made to any of them under the Plan.

B. Vesting of Assets

Except as expressly otherwise provided in the Plan, from and after the Effective Date the Reorganized Debtor shall exist and manage the Debtors' Assets to consummate the Plan. All professionals of the Debtors and the Creditors Committee shall be discharged upon the Effective Date except to the extent necessary to file and prosecute

their final fee applications. The Bankruptcy Case shall be closed as soon as practicable after the Effective Date upon a motion filed by the Reorganized Debtor.

C. Injunction Against Interference with Plan

Upon the Effective Date of the Plan, all holders of Claims, all holders of Equity Interests, and all other parties in interest in the Bankruptcy Case, along with their respective current and former officers, directors, principals, employees and agents, will be enjoined from taking any action to interfere with the implementation or consummation of the Plan.

D. Exculpation

Pursuant to the Plan, the Exculpated Parties will neither have nor incur any liability to any Person for any action taken or omitted in soliciting acceptances of the Plan, except to the extent expressly provided otherwise by Section 1125(e) of the Code. "Exculpated Parties" is defined under the Plan as "[c]ollectively, the Plan Proponents and their respective officers, directors, employees, attorneys, accountants, financial advisors and other agents, professionals and representatives."

E. Modification of the Plan

Subject to the provisions of Section 1127 of the Code, the Plan Proponents reserve the right to amend or modify the Plan (a) at any time prior to the Confirmation Date without Bankruptcy Court approval, or (b) at any time after the Confirmation Date, but prior to the Effective Date of the Plan, with Bankruptcy Court approval. In the event that the Plan Proponents are required to provide the holders of Claims (or certain of them) the opportunity to re-vote on the Plan, as amended or modified, then each such holder that previously voted to accept or reject the Plan will be deemed to have cast the same vote for acceptance or rejection, as the case may be, of the Plan, as amended or modified, unless, within the time fixed by the Bankruptcy Court, such holder changes its previously cast vote for acceptance or rejection of the Plan.

F. Retention of Jurisdiction

Pursuant to the Plan, from and after the Effective Date of the Plan, the Bankruptcy Court will retain jurisdiction, to the fullest extent legally permitted, over the Bankruptcy Case, all proceedings arising under, arising in or related to the Bankruptcy Case, the Confirmation Order, and the Plan. The specific types of disputes and proceedings that the Bankruptcy Court will retain jurisdiction over are identified in Article XI of the Plan.

ARTICLE XIII
COMPARISION OF PLAN TO ALTERNATIVES

A. Alternatives to the Plan

Any discussions referring to alternatives are limited by both practical consideration of space and the opinion of the Plan Proponent regarding same. In addition, applicable law does not require that information regarding alternatives be included in a disclosure statement, so any information is provided at the discretion of the Plan Proponent.

The Debtors believe that the Plan affords Holders of Claims or Interests the greatest realization from the Debtors' assets, and is in the best interest of all Holders of Allowed Claims or Interests. The Plan Proponent has considered alternatives to the Plan, such as dismissal of the Debtors' Case, a liquidation in the context of Chapter 7 and the formulation of other possible Chapter 11 plans. In the opinion of the Plan Proponent, such alternatives would not afford the Holders of Claims or Interests a return as great as may be achieved under the Plan.

If the Debtors' Cases were dismissed, the Debtors would no longer have the protection of the Bankruptcy Code. In the event of a dismissal of the Cases, even the most diligent of Creditors likely would experience difficulty realizing a significant recovery on their Claims.

If the automatic stay is lifted, as requested by Hall Phoenix, the Debtors' Cases would likely be converted to Chapter 7. In such circumstance, a trustee would be elected or appointed to liquidate the remaining assets of the Debtors for distribution to Creditors in accordance with the priorities established under the Bankruptcy Code. If the Debtors' Cases were converted to Chapter 7, the present Administrative and Priority Claims would have a lower priority than claims generated in the Chapter 7 case.

If an alternative plan were pursued by another party in interest, it would only result in the incurrence of a substantial amount of Professional Fees, which would cause the reduction of funds available to distribute to holders of Allowed Claims.

B. Liquidation Analysis

1. The Plan Meets the "Best Interest of Creditors" Test. The "best interest of creditors" test set out in Bankruptcy Code § 1129(a)(7) requires that the Bankruptcy Court find that the Plan provides to each non-accepting holder of a Claim or Interest treated under the Plan a recovery that has a present value at least equal to the present value of the distribution that such Person would receive from the debtor if the debtor were liquidated under Chapter 7 of the Bankruptcy Code. The Plan Proponent has considered the impact of a conversion to Chapter 7 and compared the amounts Claimants with Allowed Claims would receive upon liquidation to the amounts they will receive under the Plan. The Plan Proponent's analysis leads them to conclude that each Creditor,

and the Creditors as a whole, would receive substantially less under Chapter 7 than each will receive pursuant to the Plan.

2. Costs of Chapter 7 Liquidation. Conversion to Chapter 7 would impose significant additional monetary and time costs on the Debtors' Estates. Under Chapter 7, one or more trustees would be elected or appointed to administer the Estates, to resolve pending controversies, including Disputed Claims against the Debtors and Claims of the various Estates against other parties, and to make distributions to Claimants. A Chapter 7 trustee would be entitled to compensation in accordance with the scale set forth in Bankruptcy Code § 326 and the trustee would also incur significant administrative expenses.

Additionally, the Chapter 7 trustee will be entitled to retain his or her own professionals to assist in the liquidation and administration of the estate. The fees and expenses of such professionals, to the extent allowed, are also entitled to priority in payment as administrative claims. Chapter 7 administrative costs are entitled to priority in payment over Chapter 11 administrative costs. Nevertheless, Chapter 11 administrative costs continue to have priority over all other non-administrative priority claims and non-priority unsecured claims in the bankruptcy case.

Conversion to Chapter 7 could result in the appointment of a trustee having no experience or knowledge of the prior proceedings in the bankruptcy case or of the debtor's business, its books and records and its assets. In the Debtors' cases, a substantial amount of time would most definitely be required in order for the new Chapter 7 trustee to become familiar with the Debtors, their prior business operations, their assets, and pending litigation in order to wind the case up effectively.

Further, distributions under the Plan probably would be made earlier than would distributions in a Chapter 7 case. In contrast to the Plan, which contemplates distributions to holders of Allowed Claims as soon as practicable after the Effective Date, distributions of the proceeds of a Chapter 7 liquidation might not occur until one or years after the completion of the liquidation in order to afford the trustee the opportunity to resolve claims and prepare for distributions.

C. Conclusion

THE DEBTORS BELIEVE THAT CONFIRMATION AND IMPLEMENTATION OF THE PLAN IS PREFERABLE TO ANY OF THE ALTERNATIVES DESCRIBED HEREIN BECAUSE THE PLAN SHOULD PROVIDE GREATER CERTAINTY AND RECOVERIES THAN THOSE THAT WOULD BE AVAILABLE UNDER CHAPTER 7. IN ADDITION, OTHER ALTERNATIVES WOULD INVOLVE DELAY, UNCERTAINTY AND SUBSTANTIAL ADMINISTRATIVE COSTS.

ARTICLE XIV
MATERIAL UNCERTAINTIES AND RISKS

In considering whether to vote to accept or reject the Plan, Holders of Claims or Interests should consider certain material uncertainties and risks inherent in any plan of reorganization.

THE DEBTORS' PROJECTED FINANCIAL INFORMATION AND OTHER FORWARD LOOKING STATEMENTS CONTAINED IN THIS DISCLOSURE STATEMENT ARE BASED ON VARIOUS ASSUMPTIONS AND ESTIMATES THAT WILL NOT BE UPDATED TO REFLECT EVENTS OCCURING AFTER THE DATE HEREOF. SUCH INFORMATION AND STATEMENTS ARE SUBJECT TO INHERENT UNCERTAINTIES AND TO A WIDE VARIETY OF SIGNIFICANT RISKS, INCLUDING, AMONG OTHER THINGS, THOSE DESCRIBED HEREIN, CONSEQUENTLY, ACTUAL EVENTS, CIRCUMSTANCES, EFFECTS AND RESULTS MAY VARY SIGNIFICANTLY FROM THOSE INCLUDED IN OR CONTEMPLATED BY SUCH PROJECTED FINANCIAL INFORMATION AND SUCH OTHER FORWARD LOOKING STATEMENTS.

The Debtors caution all parties not to place undue reliance on the forward-looking statements, which speak only as of the date of this Disclosure Statement, and the Debtors undertake no obligation to update this information. The Debtors urge Holders of Claims or Interests to carefully review and consider the disclosures made herein and consider them in voting on the Plan.

A. Risk Factors

There are certain risks involved in the carrying out of any plan of reorganization. This Plan is no exception. There is risk inherent in the starting, or re-starting, of any business. Because a substantial portion of the payments under the plan are to be derived from funds generated in future by the Debtors' operations, certain of those risk factors bear directly on the Debtors' performance under the plan.

The following is intended as a summary of certain risks associated with the Plan, but it is not exhaustive and must be supplemented by the analysis and evaluation made by each holder of a Claim or interest of the Plan and this Disclosure Statement as a whole with such holder's own advisors.

1. Insufficient Acceptances.

For the Plan to be confirmed, each impaired Class of Claims is given the opportunity to vote to accept or reject the Plan. With regard to such impaired voting Classes, the Plan will be deemed accepted by a Class of impaired Claims if the Plan is accepted by claimants of such Class actually voting on the Plan who hold at least two-thirds (2/3) in amount and more than one-half (1/2) in number of the total Allowed

Claims of the Class voted. Only those members of a Class who vote to accept or reject the Plan will be counted for voting purposes. The Debtors reserve the right to request confirmation pursuant to the cramdown provisions in section 1129(b) of the Bankruptcy Code, which will allow confirmation of the Plan regardless of the fact that a particular Class of Claims or Interests has not accepted the Plan. However, there can be no assurance that any impaired Class of Claims or Interests under the Plan will accept the Plan or that the Debtors would be able to use the cramdown provisions of the Bankruptcy Code for confirmation of the Plan.

2. Confirmation Risks

The following specific risks exist with respect to confirmation of the Plan:

a. Any objection to confirmation of the Plan filed by a member of a Class of Claims or Interests can either prevent confirmation of the Plan or delay confirmation for a significant period of time.

b. Since the Debtors may be seeking to obtain approval of the Plan over the rejection of one or more impaired Classes of Claims or Interests, the cramdown process could delay confirmation.

3. Conditions Precedent

Confirmation of the Plan and occurrence of the Effective Date are subject to certain conditions precedent that may never occur. The Debtors, however, are working diligently with all parties in interest to ensure that all conditions precedent are satisfied.

4. The Debtors Have No Duty to Update

The statements contained in this Disclosure Statement are made by the Debtors as of the date hereof, unless otherwise specified herein, and the delivery of this Disclosure Statement after that date does not imply that there has been no change in the information set forth herein since that date. The Debtors have no duty to update this Disclosure Statement unless otherwise ordered to do so by the Court.

5. No Representations Outside The Disclosure Statement Are Authorized

No representations concerning or related to the Debtors, the Chapter 11 Cases or the Plan are authorized by the Bankruptcy Court or the Bankruptcy Code, other than as set forth in this Disclosure Statement. Any representations or inducements made to secure your acceptance, or rejection, of the Plan that are other than as contained in, or included with, this Disclosure Statement should not be relied upon by you in arriving at your decision. You should promptly report unauthorized representations or inducements to Debtors' counsel and the Office of the United States Trustee.

6. Information Presented is Based on the Debtors' Books and Records

While the Debtors have endeavored to present information fairly in this Disclosure Statement, because of Debtors' financial difficulties, as well as the complexity of Debtors' financial matters, the Debtors' books and records upon which this Disclosure Statement is based might be incomplete or inaccurate. The financial information contained herein, unless otherwise expressly indicated, is unaudited.

7. All Information Was Provided by Debtors and Was Relied Upon by Professionals

Rochelle McCullough LLP has been approved by the Court as counsel for the Debtors. All counsel and other professionals for the Debtors have relied upon information provided by the Debtors in connection with preparation of this Disclosure Statement. Although counsel for the Debtors has performed certain limited due diligence in connection with the preparation of this Disclosure Statement, counsel has not verified independently the information contained herein.

8. Projections and Other Forward Looking Statements Are not Assured, and Actual Results Will Vary

Certain of the information contained in this Disclosure Statement is, by nature, forward looking, and contains estimates and assumptions which might ultimately prove to be incorrect, and contains projections which may be materially different from actual future experiences. There are uncertainties associated with any projections and estimates, and they should not be considered assurances or guarantees of the amount of funds or the amount of Claims in the various classes that might be allowed.

a. Claims Could be More Than Projected

The allowed amount of Claims in each Class could be significantly more than projected, which in turn, could cause the value of distributions to be reduced substantially. If Administrative Claims and/or Other Priority Tax Claims exceed projections, it may impair the value of distributions to Holders of Classes 1-4.

b. Projections

While the Debtors believe that their projections are reasonable, there can be no assurance that they will be realized, resulting in recoveries that could be significantly less than projected.

9. This Disclosure Statement Was Not Approved by the Securities and Exchange Commission

Neither this Disclosure Statement, nor the issuance of the New Common Stock,

was registered under the Securities Act or applicable state securities laws. Neither the SEC nor any state regulatory authority has passed upon the accuracy or adequacy of this Disclosure Statement or the exhibits or the statements contained herein, and any representation to the contrary is unlawful.

10. No Legal or Tax Advice is Provided to You by This Disclosure Statement

The contents of this Disclosure Statement should not be construed as legal, business or tax advice. Each creditor or Holder of Interest should consult his, her or its own legal counsel and accountant as to legal, tax and other matters concerning his, her or its Claim or equity interest. This Disclosure Statement is not legal advice to you. This Disclosure Statement may not be relied upon for any purpose other than to determine how to vote on the Plan or object to confirmation of the Plan.

11. No Admission Made

Nothing contained herein shall constitute an admission of fact or liability by any party (including, without limitation, the Debtors) or to be deemed evidence of the tax or other legal effects of the Plan on the Debtors or on Holders of Claims or Equity Interests.

12. No Waiver of Right to Object Or Right to Recover Transfers And Estate Assets

A creditor's vote for or against the Plan does not constitute a waiver or release of any Claims or rights of the Debtors (or any party in interest, as the case may be) to object to that creditor's Claim, or recover any preferential, fraudulent or other voidable transfer or estate assets, regardless of whether any Claims of the Debtors or their respective estates are specifically or generally identified herein.

B. Business Risk Factors and Competitive Conditions

1. Risks Inherent in the Oil and Gas Exploration Business

Following Plan Confirmation, the Debtors will be subject to all of the risks associated with the oil and gas production and development business, including the unavailability of necessary equipment, challenges to title of properties, risks of drilling dry holes, blowouts resulting in the loss of property and/or injury to personnel, access to pipelines, costs of maintenance and workovers, inability to attract and retain management, unavailability of financing at acceptable interest rates, and numerous other factors which contribute to the failure of oil and gas exploration and production companies.

2. Competition

The oil and gas industry is highly competitive; many companies and individuals engage in the drilling for and production of oil and gas, and the market for natural gas seems to be shifting (as oil did many decades ago) from a regional and national market to an international one. Further, as is the case historically, the current market for oil and natural gas is highly unstable. Prices for oil and natural gas products have declined over the past year, and gas prices may be further impacted if the current market oversupply continues.

3. Pricing

The current range of gas prices have been for some months at their lowest point in the past six years. Such conditions may continue in the future; if they do, they could result in a negative impact on the Reorganized Debtor's revenues, equity value, ability to generate investment capital, and payments made under the Plan.

Oil and gas prices are determined by market and government forces on a national and international scale. The Debtors have no real influence on the market and can give no assurance that prices will rise, or even remain stable.

Debtors' business plan reflects an expected general upward direction of the major determinants of profitability. The outlook for gas prices is the most critical assumption underlying Debtors' forecasts, and while the general direction is likely to be up, periodic fluctuations are more probable than a steady increase. The U.S. gas market currently suffers from substantial oversupply, and most market analysts believe that this overcapacity and overproduction, which drive down prices, is not likely to abate until at least the end of 2009.

4. Operating Hazards and Uninsured Risks

The Debtors maintain and the Reorganized Debtor will maintain, such insurance coverage as is customary for concerns of a similar size engaged in similar operations, but losses can occur from uninsured risks or in amounts that exceed existing insurance coverage.

5. Exploration Success

Although it has in the past developed significant reserves through exploration and thinks highly of some of its present prospects, parts of which already have established and profitable production, the Debtors can give no assurance that subsequent exploration will substantially add to reserves and cash flow.

6. Reserves

Production from the Debtors' present wells is forecast to continue for a number of

years to come. Fluctuations of price mentioned above, however, can influence total recoverable reserves by making them either more or less economic to extract. Present projections as to the size of reserves will therefore vary with change in market price.

7. Regulation

All states in which the Debtors conduct activities have statutory provisions regulating the production and sale of oil and gas. Such statutes and the regulations promulgated thereunder are generally intended to prevent waste of oil and gas, and to protect correlative rights and opportunities to produce oil and gas as between owners of interests in a common reservoir. Certain state regulatory authorities also regulate the amount of oil and gas produced by assigning allowable rates of production to each well or proration unit. The Reorganized Debtor's operations will also be to local, state and federal environmental laws and regulations. While not predictable at this date, future compliance with these regulations could require significant expenditures or otherwise affect operations.

8. Variances from Projections

The fundamental premises of the Plan are the implementation of the Debtors' business plan, as reflected in the projections, and the reasonableness of the assumptions underlying them. These projections reflect numerous assumptions concerning the anticipated future performance of the Reorganized Debtor, many of which are beyond their control and some of which may not materialize. The Projections include, among other items, assumptions concerning general economic conditions; the ability to make necessary capital expenditures and control future expenses. The Debtors believe that the assumptions underlying the projected financial statements are reasonable. However, unanticipated events and circumstances occurring subsequent to the preparation of the projections may affect the actual financial results of Reorganized Debtor. Therefore, the actual results achieved throughout the periods covered by the projections will vary from the projected results, which variations may be material and adverse.

9. Projections Based on Alternative Assumptions

Debtors' business plan is based on the above assumptions relating to oil and gas prices. Debtors consider these assumptions to be those with the highest probability of occurring. Other assumptions, also within the range of possible occurrences, could be formulated. Specifically, Debtors' assumptions could prove to be either too optimistic or too pessimistic. Accordingly, Debtors have formulated two additional sets of assumptions, one less favorable and one more favorable than Debtors' base case assumptions, and have prepared projected financial statements under each set.

Debtors' assessment of the most likely probabilities and the ones on which they base their projected business plan ("Base Case") assumes a gradual increase in oil and gas prices beginning in 2010. Debtors believe that an assumption of gradual increases is the only reasonable one on which to predicate a plan of reorganization. While Debtors

believe that their assumption of when the gradual increase will begin is the most probable, it is also within the range of possibilities for such increases to be delayed or accelerated. Accordingly, additional sets of assumptions and projected financial statements based on the Low Case and on the High Case are presented below.

10. Funding

Debtors anticipate that they will be largely dependent on outside sources of capital to finance their exploration activities for the foreseeable future. Accordingly, global economic trends, federal tax issues, and the general state of the financial markets are likely to have a significant impact on the Reorganized Debtors' activities.

11. Market for Equity in the Reorganized Debtor

The Interests in the Reorganized Debtor will be held by a relatively small number of individuals. No plans exist to create a public market for the stock of the Reorganized Debtor; consequently, any realization of value in these Interests will have to come either through private sales or through such exit strategies as the Reorganized Debtor may in future devise.

12. Value of the Debtors' Causes of Action

Although the Debtors believe that the causes of action retained under the Plan have significant value, their ultimate value and collectibility is not determinable at this date.

Additionally, there can be no assurance that the Plan will not be modified up to an through the Confirmation Date, and the Plan Proponents reserve the right to modify the Plan, subject to compliance with the Code, in the event the modification becomes warranted or necessary in furtherance of confirmation.

ARTICLE XV
CERTAIN FEDERAL INCOME TAX CONSEQUENCES OF THE PLAN

A. Introduction

Implementation of the Plan may have federal, state and local tax consequences to the Debtors and their Estates, as well as to Creditors and Equity Interest holders of the Debtors. No tax opinion has been sought or will be obtained with respect to any tax consequences of the Plan, and the following disclosure does not constitute and is not intended to constitute either a tax opinion or tax advice to any Person. This disclosure is provided for informational purposes only. This disclosure does not address state, local or foreign tax consequences or the consequences of any federal tax other than the federal income tax. Finally, the tax consequences of certain aspects of the Plan are uncertain due to a lack of applicable legal authority and may be subject to judicial or administrative interpretations that differ from the discussion below.

B. Creditors and Interest Holders Should Seek Independent Advice

CREDITORS AND EQUITY INTEREST HOLDERS, THEREFORE, ARE ADVISED TO CONSULT WITH THEIR OWN TAX ADVISORS REGARDING THE TAX CONSEQUENCES TO THEM AND TO THE DEBTORS OF THE TRANSACTIONS CONTEMPLATED BY THE PLAN, INCLUDING FEDERAL, STATE, LOCAL AND FOREIGN TAX CONSEQUENCES.

ARTICLE XVI
CERTAIN SECURITIES LAWS CONSIDERATIONS UNDER THE PLAN

Currently, the Debtors do not anticipate the Reorganized Debtor registering under the Exchange Act or having the New Common Stock listed for trading on any exchange or over-the-counter market. If the Debtors or the Reorganized Debtor subsequently determine that registration under the Exchange Act or the listing of the New Common Stock on an exchange or over-the-counter market is desirable, the Debtors or the Reorganized Debtor will take steps to comply with these requirements. If the Reorganized Debtor is required to register under the Exchange Act, the Reorganized Debtor would be required to file certain reports with the Securities and Exchange Commission, including quarterly and annual financial reports.

The Reorganized Debtor's amended and restated governing documents will restrict the transfer of the New Common Stock in certain circumstances. As such, the level of liquidity, the ability of creditors to sell the shares of New Common Stock, or the price at which the shares of New Common Stock may be sold in a trading market may be negatively impacted.

A. Applicability of Certain Federal and State Securities Laws

No registration statement will be filed under the Securities Act or any state securities laws with respect to the offer and distribution under the Plan of the New Common Stock. The Debtors believe that the provisions of section 1145(a)(1) of the Code exempt the offer and distribution of such securities under the Plan from federal and state securities registration requirements.

B. Code Exemption from Registration Requirements

1. Initial Offer and Sale of Securities

Section 1145(a)(1) of the Code exempts the offer and sale of securities under a plan of reorganization from registration under the Securities Act and state laws if the following three principal requirements are satisfied: (a) the securities must be offered and sold under a plan of reorganization and must be securities of the debtor, an affiliate participating in a joint plan with the debtor, or a successor to the debtor under the plan; (b) the recipients of the securities must hold a prepetition or administrative expense claim

against the debtor or an interest in the debtor; and (c) the securities must be issued in exchange for the recipient's claim against or interest in the debtor or principally in such exchange and partly for cash or property. The Debtors believe that the offer and sale of the New Common Stock under the Plan satisfies the requirements of section 1145(a)(1) of the Code and, therefore, are exempt from registration under the Securities Act and state securities laws.

2. Subsequent Transfers of Securities

The Reorganized Debtor's amended and restated corporate documents will restrict the transfer of the New Common Stock. In particular, the amended and restated corporate documents of the Reorganized Debtor will not permit any transfer of New Common Stock, and will treat any purported transfer of New Common Stock as *void ab initio* and the purported transferee will acquire no rights in such shares of New Common Stock, if such transfer would cause the Reorganized Debtor to have a class of equity securities to be held of record by 500 or more persons. These restrictions shall be conspicuously noted on the certificates evidencing the shares of New Common Stock issued pursuant to the Plan.

To the extent that the shares of New Common Stock are transferable, in general, all resales and subsequent transactions in the New Common Stock distributed under the Plan will be exempt from registration under the Securities Act pursuant to section 4(1) of the Securities Act, unless the holder thereof is deemed to be an "underwriter" with respect to such securities, an "affiliate" of the issuer of such securities or a "dealer." Section 1145(b) of the Code defines four types of "underwriters":

(a) persons who purchase a claim against, an interest in, or a claim for administrative expense against the debtor with a view to distributing any security involved in exchange for such a claim or interest ("accumulators");

(b) persons who offer to sell securities offered under a plan for the holders of such securities ("distributors");

(c) persons who offer to buy securities from holders of such securities, if the offer to buy is (i) with a view to distributing such securities and (ii) made under a distribution agreement; and

(d) a person who is an "issuer" with respect to the Securities, as the term "issuer" is defined in section 2(11) of the Securities Act.

Under section 2(11) of the Securities Act, an "issuer" includes any "affiliate" of the issuer, which means any person directly or indirectly through one or more intermediaries controlling, controlled by, or under common control with the issuer. Under section 2(12) of the Securities Act, a "dealer" is any person who engages in part or in whole, directly or indirectly, as agent, broker, or principal in the business of offering, buying, selling or otherwise dealing or trading in securities issued by another person.

Whether or not any particular person would be deemed to be an "underwriter" or an "affiliate" with respect to any security to be issued pursuant to the Plan or to be a "dealer" would depend upon the various facts and circumstances applicable to that person. Accordingly, the Debtors express no view as to whether any person would be deemed to be an "underwriter" or an "affiliate" with respect to any security to be issued pursuant to the Plan or to be a "dealer."

In connection with prior bankruptcy cases, the staff of the SEC has taken the position that resales by accumulators and distributors of securities distributed under a plan of reorganization are exempt from registration under the Securities Act if effected in "ordinary trading transactions." The staff of the SEC has indicated in this context that a transaction may be considered an "ordinary trading transaction" if it is made on an exchange or in the over-the-counter market and does not involve the following factors:

(a) either (i) concerted action by the recipients of securities issued under a plan in connection with the sale of such securities or (ii) concerted action by distributors on behalf of one or more such recipients in connection with such sales;

(b) the use of informational documents concerning the offering of the securities prepared or used to assist in the resale of such securities, other than a Bankruptcy Court-approved disclosure statement and supplements thereto and documents filed with the SEC pursuant to the Exchange Act; or

(c) the payment of special compensation to brokers and dealers in connection with the sale of such securities designed as a special incentive to the resale of such securities (other than the compensation that would be paid pursuant to arms' length negotiations between a seller and a broker or dealer, each acting unilaterally, not greater than the compensation that would be paid for a routine similar-sized sale or similar securities of a similar issuer).

The Debtors have not sought the views of the SEC on this matter, and, therefore, no assurance can be given regarding the proper application of the "ordinary trading transaction" exemption described above. Any persons intending to rely on such exemptions are urged to consult their own counsel as to the applicability thereof to any particular circumstances.

In addition, Rule 144 provides an exemption from registrations under the Securities Act for certain limited public resales of unrestricted securities by "affiliates" of the issuer of such securities. Rule 144 allows a holder of unrestricted securities that is an affiliate of the issuer of such securities to sell, without registration, within any three-month period a number of shares of such unrestricted securities that does not exceed the greater of 1% of the number of outstanding securities in question or the average weekly trading volume in the securities in question during the four calendar weeks preceding the date on which notice of such sale was filed pursuant to Rule 144, subject to the satisfaction of certain other requirements of Rule 144 regarding the manner of sale, notice requirements, and the availability of current public information regarding the issuer. The

Debtors believe that, pursuant to section 1145(c) of the Code, the New Common Stock to be issued pursuant to the Plan will be unrestricted securities for the purposes of Rule 144.

GIVEN THE COMPLEX NATURE OF THE QUESTION OF WHETHER A PARTICULAR PERSON MAY BE AN UNDERWRITER, THE DEBTORS MAKE NO REPRESENTATIONS CONCERNING THE RIGHT OF ANY PERSON TO TRADE IN THE NEW COMMON STOCK TO BE DISTRIBUTED PURSUANT TO THE PLAN. THE DEBTORS RECOMMEND THAT HOLDERS OF CLAIMS CONSULT THEIR OWN COUNSEL CONCERNING WHETHER THEY MAY FREELY TRADE SUCH SECURITIES.

C. Subsequent Transfers Under State Law

State securities laws generally provide registration exemptions for subsequent transfers by a bona fide owner of the owner's own account and subsequent transfers to institutional or accredited investors. If the prohibition on the transfer of the New Common Stock is subsequently terminated and the shares of New Common Stock may then be transferred such exemptions generally are expected to be available for such subsequent transfers of New Common Stock.

ARTICLE XVII
DISCLAIMERS

PERSONS CONCERNED WITH THE TAX CONSEQUENCES OF THE PLAN SHOULD CONSULT THEIR OWN ACCOUNTANTS, ATTORNEYS AND/OR ADVISORS. THE PLAN PROPONENTS MAKE THE ABOVE-NOTICED DISCLOSURE OF POSSIBLE TAX CONSEQUENCES FOR THE SOLE PURPOSE OF ALERTING READERS TO TAX ISSUES THEY MAY WISH TO CONSIDER. THE PLAN PROPONENTS CANNOT, AND DO NOT, REPRESENT THAT THE TAX CONSEQUENCES MENTIONED ABOVE ARE COMPLETELY ACCURATE BECAUSE, AMONG OTHER THINGS, THE TAX LAW EMBODIES MANY COMPLICATED RULES THAT MAKE IT DIFFICUALT TO STATE ACCURATELY WHAT THE TAX IMPLICATIONS OF ANY ACTION MIGHT BE.

IRS CIRCULAR 230 NOTICE: TO ENSURE COMPLIANCE WITH REQUIREMENTS IMPOSED BY THE INTERNAL REVENUE SERVICE, THE PLAN PROPONENTS INFORM ALL RECIPIENTS OF THIS DISCLOSURE STATEMENT THAT ANY U.S. TAX INFORMATION CONTAINED IN THIS DISCLOSURE STATEMENT (INCLUDING THE EXHIBITS HERE) IS NOT INTENDED OR WRITTEN TO BE USED, AND CANNOT BE USED, FOR THE PURPOSE OF (A) AVOIDING PENALTIES UNDER THE INTERNAL REVENUE CODE, OR (B) PROMOTING, MARKETING OR RECOMMENDING TO ANOTHER PARTY ANY TRANSACTION OR MATTER ADDRESSED IN THIS DISCLOSURE STATEMENT.

ARTICLE XVIII
CONCLUSION

The Plan Proponents believe that the Plan complies with Section 1129 of the Code and is fair and equitable and in the best interests of the Debtors, the Estates and the Creditors. Accordingly, the Plan Proponents urge Creditors receiving Ballots to vote to accept the Plan.

Respectfully submitted,

By: _____
James R. Latimer, III
Title: Chief Restructuring Officer of the Debtors

-AND-

Rochelle McCullough LLP

By: _____
Michael R. Rochelle
State Bar No. 17126700
Scott M. DeWolf
State Bar No. 24009990
325 N. St. Paul, Suite 4500
Dallas, Texas 75201
P: (214) 953-0182
F: (214) 953-0185

COUNSEL FOR THE DEBTORS