NOVATION COMPANIES, INC.
Form 10-Q
November 14, 2016

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended September 30, 2016

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the Transition Period From to

Commission File Number 001-13533

NOVATION COMPANIES, INC.
(Exact Name of Registrant as Specified in its Charter)

Maryland	74-2830661
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)

2114 Central Street, Suite 600, Kansas City, MO	64108
(Address of Principal Executive Office)	(Zip Code)

Registrant's Telephone Number, Including Area Code: (816) 237-7000

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o

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

Large accelerated filer	Accelerated filer	Non-accelerated filer	Smaller reporting company
o	o	o	x

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

The number of shares of the Registrant's Common Stock outstanding on November 9, 2016 was 92,844,907.

NOVATION COMPANIES, INC.
FORM 10-Q
For the Quarterly Period Ended September 30, 2016

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PART I. FINANCIAL INFORMATION
Item 1. Financial Statements
NOVATION COMPANIES, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands, except share and per share amounts)

	September 30, 2016 (unaudited)	December 31, 2015
Assets		
Current Assets		
Cash and cash equivalents	$ 14,917	$ 2,826
Marketable securities, current	17,388	17,500
Other current assets	809	1,119
Current assets of discontinued operations	448	1,843
Total current assets	33,562	23,288
Non-current Assets		
Marketable securities, non-current	802	1,397
Property and equipment, net of accumulated depreciation	142	358
Other assets	314	481
Non-current assets of discontinued operations	—	6,415
Total non-current assets	1,258	8,651
Total assets	$ 34,820	$ 31,939
Liabilities and Shareholders' Deficit		
Liabilities		
Current Liabilities		
Accounts payable and accrued expenses	$ 573	$ 1,453
Current liabilities of discontinued operations	—	2,470
Total current liabilities	573	3,923
Non-current liabilities		
Senior notes	—	88,385
Other liabilities	75	391
Non-current liabilities of discontinued operations	—	1,833
Total non-current liabilities	75	90,609
Total liabilities not subject to compromise	648	94,532
Liabilities subject to compromise	91,394	—
Total liabilities	92,042	94,532
Commitments and contingencies		
Shareholders' deficit:		
Capital stock, $0.01 par value per share, 120,000,000 shares authorized:		
Common stock, 92,844,907 and 92,748,753 shares issued and outstanding as of September 30, 2016 and December 31, 2015, respectively	928	928
Additional paid-in capital	744,863	744,575
Accumulated deficit	(808,657)	(809,532)
Accumulated other comprehensive income	5,644	1,436
Total shareholders' deficit	(57,222)	(62,593)
Total liabilities and shareholders' deficit	$ 34,820	$ 31,939

See notes to condensed consolidated financial statements.

NOVATION COMPANIES, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(unaudited; in thousands, except share and per share amounts)

	For the Nine Months Ended September 30,		For the Three Months Ended September 30,	
	2016	2015	2016	2015
Income and Revenues:				
Interest income – mortgage securities	$3,635	$4,585	$1,435	$ 1,379
Total	3,635	4,585	1,435	1,379
General and administrative expenses	3,563	4,627	708	1,450
Total	3,563	4,627	708	1,450
Other income (loss)	1,449	(31)	539	32
Reorganization items, net	1,326	—	1,326	—
Interest expense	(1,914)	(2,414)	(181)	(773)
Income (loss) from continuing operations before income taxes	933	(2,487)	2,411	(812)
Income tax (benefit) expense, continuing operations	(19)	2	(34)	(105)
Net income (loss) from continuing operations	952	(2,489)	2,445	(707)
Loss from discontinued operations, net of income taxes	(77)	(18,388)	—	(6,532)
Net income (loss)	$875	$(20,877)	$2,445	$ (7,239)
Earnings (Loss) Per Share attributable to Novation:				
Basic	$0.01	$(0.23)	$0.03	$ (0.08)
Diluted	$0.01	$(0.23)	$0.03	$ (0.08)
Weighted average basic shares outstanding	91,345,504	91,103,880	92,180,484	91,187,345
Weighted average diluted shares outstanding	92,185,518	91,103,880	92,465,111	91,187,345

See notes to condensed consolidated financial statements.

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NOVATION COMPANIES, INC.
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
(unaudited; in thousands)

	For the Nine Months Ended September 30, 2016	For the Nine Months Ended September 30, 2015	For the Three Months Ended September 30, 2016	For the Three Months Ended September 30, 2015
Net income (loss)	$875	$(20,877)	$2,445	$(7,239)
Other comprehensive income (loss):				
Unrealized gains realized upon the sale of securities	(100)	—	—	—
Change in unrealized gain on marketable securities – available-for-sale	4,308	(739)	1,084	(57)
Total other comprehensive income (loss)	4,208	(739)	1,084	(57)
Total comprehensive income (loss)	$5,083	$(21,616)	$3,529	$(7,296)

See notes to condensed consolidated financial statements.

NOVATION COMPANIES, INC.
CONDENSED CONSOLIDATED STATEMENTS OF SHAREHOLDERS' DEFICIT
(unaudited; in thousands)

	Common Stock	Additional Paid-in Capital	Accumulated Deficit	Accumulated Other Comprehensive Income	Total Shareholders' Deficit
Balance, December 31, 2015	$ 928	$744,575	$(809,532)	$ 1,436	$(62,593)
Compensation recognized under stock compensation plans	—	288	—	—	288
Net income	—	—	875	—	875
Other comprehensive income	—	—	—	4,208	4,208
Balance, September 30, 2016	$ 928	$744,863	$(808,657)	$ 5,644	$(57,222)
Balance, December 31, 2014	$915	$743,919	$(780,803)	$2,619	$(33,350)
Compensation recognized under stock compensation plans	—	479	—	—	479
Issuance of nonvested shares, 1,269,234 shares	13	(13)	—	—	—
Net loss	—	—	(20,877)	—	(20,877)
Other comprehensive loss	—	—	—	(739)	(739)
Balance, September 30, 2015	$928	$744,385	$(801,680)	$1,880	$(54,487)

See notes to condensed consolidated financial statements.

NOVATION COMPANIES, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited; in thousands)

	For the Nine Months Ended September 30,	
	2016	2015
Cash flows from operating activities:		
Net income (loss)	$875	$(20,877)
Net loss from discontinued operations	(77)	(18,388)
Net income (loss) from continuing operations	952	(2,489)
Adjustments to reconcile net loss to net cash (used in) operating activities:		
Amortization of marketable securities, net	25	244
Amortization of deferred debt issuance costs and senior debt premium	(2,399)	1,861
Adjustment to deferred debt issuance costs and senior debt premium	(48)	—
Deferred taxes	—	(2)
Provision for bad debt, net	—	110
Loss on disposal and impairments of fixed assets	111	—
Realized gain on sale of marketable securities	(100)	—
Compensation recognized under stock compensation plans	264	479
Depreciation and amortization expense	86	113
Changes in:		
Due from discontinued operations	(30)	(1,544)
Other current assets and liabilities, net	260	(774)
Other noncurrent assets and liabilities, net	(201)	(66)
Accounts payable and accrued expenses	2,052	(920)
Net cash from (used in) operating activities of continuing operations	972	(2,988)
Net cash used in operating activities of discontinued operations	(1,919)	(15,283)
Net cash used in operating activities	(947)	(18,271)
Cash flows from investing activities:		
Proceeds from sales and maturities of marketable securities	17,697	21,994
Proceeds from paydowns of notes receivable	21	—
Proceeds from sale of subsidiary, net	7,643	—
Purchases of marketable securities	(12,707)	—
Proceeds from restricted cash	368	—
Proceeds from sales of property and equipment	19	—
Purchases of property and equipment	—	(4)
Net cash provided by investing activities of continuing operations	13,041	21,990
Net cash used in investing activities of discontinued operations	(159)	(4,283)
Net cash provided by investing activities	12,882	17,707
Cash flows from financing activities:		
Cash payments for contributions of capital to discontinued operations	(205)	(18,080)
Net cash used in financing activities of continuing operations	(205)	(18,080)
Net cash provided by financing activities of discontinued operations	205	17,891
Net cash used in financing activities	—	(189)

Cash and cash equivalents, including discontinued operations:		
Net increase (decrease)	11,935	(753)
Beginning of period	3,178	5,654
End of period	$15,113	$4,901

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Supplemental disclosure of cash flow information:		
Cash paid for reorganization items	$426	$ —
Cash paid for interest	—	663
Cash income taxes paid (received), net	(12)	753

See notes to condensed consolidated financial statements.

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NOVATION COMPANIES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
As of and for the period ended September 30, 2016 (Unaudited)

Note 1. Financial Statement Presentation

Description of Operations – Novation Companies, Inc. (the “Company” or “Novation” or “we” or “us”) is in the process of implementing its strategy to acquire operating businesses or making other investments that generate taxable earnings. As of the date of these condensed consolidated financial statements, the Company has not yet identified any specific acquisition targets.

Prior to 2016, Novation owned 100% of Corvisa LLC ("Corvisa"). On December 21, 2015, the Company entered into a Membership Interest Purchase Agreement (the "Purchase Agreement") with Corvisa Services LLC ("Corvisa Services"), a wholly owned subsidiary of the Company, and ShoreTel, Inc. ("ShoreTel"). Subject to the terms and conditions under the Purchase Agreement, ShoreTel agreed to purchase all of the membership interests of Corvisa. This transaction closed on January 6, 2016. The operations of Corvisa have been classified as discontinued operations for all periods presented. Prior to 2015, the Company disposed of its ownership interests in StreetLinks LLC ("StreetLinks"), a national residential appraisal and mortgage real estate valuation management services company. Also prior to 2015, the Company sold a portion of the assets and conducted an orderly wind-down of Advent Financial Services LLC ("Advent"), a financial settlement services provider for professional tax preparers nationwide. See Note 4 to the condensed consolidated financial statements for additional information regarding the Company's divestiture activity.

Prior to 2008, the Company originated, purchased, securitized, sold, invested in and serviced residential nonconforming mortgage loans and mortgage securities. As a result of those activities, the Company holds mortgage securities that continue to be a source of its earnings and cash flow. See Note 5 and Note 9 to the condensed consolidated financial statements for additional information regarding these securities and the valuation thereof. Also as a result of those activities, the Company may, from time to time, receive indemnification and loan repurchase demands related to past sales of loans to securitization trusts and other third parties. See Note 8 to the condensed consolidated financial statements for additional information regarding these demands.

Liquidity and Going Concern – As of September 30, 2016, the Company had approximately $14.9 million in unrestricted cash and cash equivalents and $0.2 million of restricted cash, portions of which are included in the other current assets and other assets line items on the condensed consolidated balance sheet. In addition, the Company held approximately $18.2 million in marketable securities, which consist of $0.8 million in corporate notes and bonds with a weighted average remaining maturity of 19 months as of September 30, 2016, $15.9 million of equity securities and $1.5 million in mortgage securities. The Company's marketable securities are classified as available-for-sale as of September 30, 2016 and are included in the current and non-current marketable securities line items on the condensed consolidated balance sheet as of September 30, 2016. For additional information regarding the Company's marketable securities, see the condensed consolidated statements of cash flow and Note 5 to the condensed consolidated financial statements.

As discussed in Note 7, the Company did not make the quarterly interest payments due on March 30, June 30 and September 30, 2016, totaling $2.7 million, as required under the Company's three series of Senior Notes and three related Indentures (each as defined in Note 7). These interest payments were not made within 30 days after they became due and payable, and remain unpaid, such non-payment constituting events of default under the Indentures. The trustee under any Indenture or the holders of not less than 25% of the aggregate principal amount of the outstanding Senior Notes issued pursuant to such Indenture, by notice in writing to the Company (and to the trustee if given by the holders), may declare the principal amount of all of the Senior Notes issued under such Indenture to be due and payable immediately. On May 9, 2016, the Company received a notice of acceleration with respect to the Series 1 Senior Notes and the Series 2 Senior Notes declaring all principal and unpaid interest immediately due and payable. A similar acceleration notice was received on June 6, 2016 with respect to the Series 3 Senior Notes. Because the Senior Notes are expected to be impacted by the bankruptcy reorganization process, the Company discontinued accrued interest on the notes after the date of the Bankruptcy Petitions (as defined below). As of September 30, 2016 the aggregate outstanding principal under the Senior Notes was $85.9 million, and the recorded aggregate interest liability was $2.0 million.

The Company's available cash and other liquid assets are not sufficient to meet the demands of the holders of the Senior Notes. As discussed in Note 2 to the condensed consolidated financial statements, the Company and three of its subsidiaries filed voluntary petitions (the "Bankruptcy Petitions") for reorganization under Chapter 11 of the Bankruptcy Code in the United States Bankruptcy Court for the District of Maryland (the "Bankruptcy Court"). These factors raise substantial doubt about the Company's ability to continue as a going concern. Management intends to reorganize and exit the Chapter 11 proceedings and will actively pursue negotiation with the holders to modify or restructure the Senior Notes. However, there can be no assurance that these efforts will be successful.

The accompanying condensed consolidated financial statements have been prepared on a basis that assumes the Company will continue as a going concern and contemplates the continuity of operations, realization of assets and the satisfaction of liabilities and commitments in the normal course of business.

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Financial Statement Presentation – The Company’s condensed consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America (“GAAP”). The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of income and expense during the period. The Company uses estimates and judgments in establishing the fair value of its mortgage securities, assessing the recoverability of its long-lived assets, and accounting for income taxes, including the determination of the timing of the establishment or release of the valuation allowance related to the deferred tax asset balances and reserves for uncertain tax positions. While the condensed consolidated financial statements and footnotes reflect the best estimates and judgments of management at the time, actual results could differ significantly from those estimates.

Financial statements for the period following the Chapter 11 filing through the confirmation of a plan of reorganization distinguish transactions and events that are directly associated with the reorganization from the ongoing operations of the business. Accordingly, revenue, expenses, realized gains and losses and provision for losses directly associated with the reorganization or restructuring of the business are reported separately as Reorganization items, net, in the condensed consolidated statement of operations. The condensed consolidated balance sheet distinguishes pre-petition liabilities subject to compromise, pre-petition liabilities that are not subject to compromise and post-petition liabilities. Liabilities subject to comprise are reported at the amounts expected to be allowed, even if they may be settled for lesser amounts. In addition, cash used for reorganization items is disclosed separately in the condensed consolidated statements of cash flows.

For the nine months ended September 30, 2015, the Company's condensed consolidated statement of cash flows includes a reclassification correction of $0.4 million from accretion of marketable securities to proceeds from sales and maturities of marketable securities. The reclassification was made to correct an error in that statement as previously presented.

Cash equivalents consist of liquid investments with an original maturity of three months or less. Cash equivalents are stated at cost, which approximates fair value.

The condensed consolidated financial statements of the Company include the accounts of all wholly-owned and majority-owned subsidiaries. Intercompany accounts and transactions have been eliminated in consolidation.

The Company's condensed consolidated financial statements are unaudited. In the opinion of management, all necessary adjustments have been made, which were of a normal and recurring nature, for a fair presentation of the condensed consolidated financial statements. The Company's condensed consolidated financial statements should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations and the consolidated financial statements of the Company and the notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2015 (the "2015 Form 10-K").

Note 2. Reorganization

On July 20, 2016, Novation and three of its subsidiaries, NovaStar Mortgage LLC, NovaStar Mortgage Funding Corporation and 2114 Central LLC (collectively, the “Debtors”), filed the Bankruptcy Petitions for reorganization under Chapter 11 of the Bankruptcy Code in the Bankruptcy Court. The Debtors’ Chapter 11 cases (the “Chapter 11 Cases”) are being jointly administered under the case Novation Companies, Inc., et al, No. 16-19745-DER. The Debtors will continue to operate their businesses as “debtors-in-possession” under the jurisdiction of the Bankruptcy Court and in accordance with the applicable provisions of the Bankruptcy Code and orders of the Bankruptcy Court. Beginning with the quarterly period ended September 30, 2016, the Company accounts for the bankruptcy in accordance with Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) 852, “Reorganizations.”

Pursuant to orders granted by the Bankruptcy Court, the Company obtained approval to, among other things, pay employee wages and benefits and continue with its existing cash management practices. The Company can conduct normal business activities and pay all associated obligations for the period following its bankruptcy filing, and is also authorized to pay and has paid pre-petition employee wages and benefits. During the Chapter 11 Cases, all transactions outside the ordinary course of business require the prior approval of the Bankruptcy Court.

Generally, under the Bankruptcy Code, the filing of the Bankruptcy Petitions automatically enjoined, or stayed, the continuation of most judicial or administrative proceedings or filing of other actions against the Debtors or their property to recover, collect or secure a claim arising prior to the date of the Bankruptcy Petitions. Accordingly, creditors are generally stayed from taking any actions against the Debtors. Absent an order of the Bankruptcy Court, substantially all of the Debtors' pre-petition liabilities are subject to discharge under the Bankruptcy Code.

Under the priority requirements established by the Bankruptcy Code, unless creditors agree otherwise, pre-petition liabilities to creditors and post-petition liabilities must be satisfied in full before the holders of the Company's existing common stock are entitled to receive any distribution or retain any property under a plan of reorganization. The ultimate recovery to creditors and shareholders, if any, will not be determined until confirmation and implementation of a plan of reorganization or an alternative transaction. While the Company will seek to implement a plan of reorganization, the outcome of the Chapter 11 Cases remains

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uncertain and, as a result, the Company cannot accurately estimate the amounts or value of distributions that creditors and shareholders may receive.

For the duration of the Company's Chapter 11 proceedings, the Company's operations and ability to develop and execute its business plan are subject to the risks and uncertainties associated with the Chapter 11 process. As a result of these risks and uncertainties, the number of the Company's outstanding shares and shareholders, assets, liabilities, officers and directors could be significantly different following the outcome of the Chapter 11 Cases, and the description of the Company's operations, assets and plans included herein may not accurately reflect its operations, assets and plans following the Chapter 11 process.

Subject to certain exceptions, under the Bankruptcy Code, the Debtors may assume, assign, or reject certain executory contracts and unexpired leases subject to the approval of the Bankruptcy Court. Generally, the rejection of an executory contract or unexpired lease is treated as a pre-petition breach of such executory contract or unexpired lease and, subject to certain exceptions, relieves the Debtors of performing their future obligations under such executory contract or unexpired lease but entitles the contract counterparty or lessor to a pre-petition general unsecured claim for damages caused by such deemed breach. Counterparties to such rejected contracts or leases may assert unsecured claims in the Bankruptcy Court against the applicable Debtors' estate for such damages. Generally, the assumption of an executory contract or unexpired lease requires the Debtors to cure existing monetary defaults under the executory contract or unexpired lease and provide adequate assurance of future performance. Accordingly, any description of an executory contract or unexpired lease with the Debtors in the interim financial statements, including where applicable a quantification of the Company's obligations under any such executory contract or unexpired lease with the Debtors is qualified by any overriding rejection rights the Company has under the Bankruptcy Code. Further, nothing herein is or shall be deemed (i) an admission with respect to any claim amounts or calculations arising from the rejection of any executory contract or unexpired lease and the Debtors expressly preserve all of their rights with respect thereto, (ii) a waiver of any rights, claims, actions or defenses that the Company may have in respect of any given executory contract or unexpired leases or (iii) an affirmation by the Company to assume any given executory contract or unexpired lease.

There can be no assurances regarding the Company's ability to successfully develop, confirm and consummate a plan of reorganization or any other plans of reorganization or alternative restructuring transactions.

On August 1, 2016, the United States Trustee for the District of Maryland appointed an official committee for unsecured creditors of all of the Debtors (the "UCC").

On August 23, 2016, the Debtors filed with the Bankruptcy Court a Schedule of Assets and Liabilities and Statement of Financial Affairs (collectively, the "Schedules and Statements") setting forth, among other things, the assets and liabilities of the Debtors, subject to the assumptions filed in connection therewith. The Schedules and Statements may be subject to further amendment or modification after filing. Certain holders of pre-petition claims are required to file proofs of claim by the deadline for filing certain proofs of claims in the Debtors' Chapter 11 Cases, which deadline is November 15, 2016, for pre-petition general unsecured claims and January 17, 2017, for governmental claims. Differences between amounts scheduled by the Debtors and claims by creditors will be investigated and resolved in connection with the claims resolution process. The ultimate number and amount of allowed claims is not presently known, nor can the ultimate recovery with respect to allowed claims be presently ascertained.

Under the Bankruptcy Code, we have the exclusive right to file a plan of reorganization under Chapter 11 through and including November 17, 2016, and to solicit acceptances of such plan through January 16, 2017. On October 19, 2016, the Company filed a motion to extend their exclusive right to file a plan(s) for an additional ninety days, through and including February 15, 2017 and solicit acceptances thereof through and including April 17, 2017, subject to the right to seek further extensions. The UCC filed an objection to the motion to extend the exclusive periods. At a hearing held on November 9, 2016, the Bankruptcy Court granted the Company's motion and extended the exclusive periods for an additional ninety days.

We plan to emerge from our Chapter 11 Cases after we obtain approval from the Bankruptcy Court for a Chapter 11 plan of reorganization. Among other things, a Chapter 11 plan of reorganization will determine the rights and satisfy the claims of our creditors and security holders. The terms and conditions of a Chapter 11 plan of reorganization will be determined through negotiations with our stakeholders and, possibly, decisions by the Bankruptcy Court. Under the absolute priority scheme established by the Bankruptcy Code, unless our creditors agree otherwise, all of our pre-petition liabilities and post-petition liabilities must be satisfied in full before the holders of our existing common stock can receive any distribution or retain any property under a plan of reorganization. The ultimate recovery to creditors and/or shareholders, if any, will not be determined until confirmation and implementation of a plan or plans of reorganization. We can give no assurance that any recovery or distribution of any amount will be made to any of our creditors or shareholders. Our plan of reorganization could result in any of the holders of our liabilities and/or securities, including our common stock, receiving no distribution on account of their interests and cancellation of their holdings. Moreover, a plan of reorganization can be confirmed, under the Bankruptcy Code, even if the holders of our common stock vote against the plan and even if the plan provides that the holders of our common stock receive no distribution on account of their equity interests.

The condensed consolidated financial statements presented here include amounts classified as "liabilities subject to compromise." This amount represents estimates of known or potential pre-petition claims expected to be resolved in connection with our Chapter 11 proceedings. Additional amounts may be included in liabilities subject to compromise in future periods if we elect to reject executory contracts and unexpired leases as part of our Chapter 11 Cases. Due to the uncertain nature of many of the potential claims, the magnitude of potential claims is not reasonably estimable at this time. Potential claims not currently included with liabilities subject to compromise in our consolidated balance sheets may be material. Differences between amounts we are reporting as liabilities subject to compromise in this Quarterly Report on Form 10-Q and the amounts attributable to such matters claimed by our creditors or approved by the Bankruptcy Court may be material. We will continue to evaluate our liabilities throughout the Chapter 11 process and may make adjustments in future periods as necessary and appropriate. These adjustments may be material.

Under the Bankruptcy Code, we may assume, assign, or reject executory contracts and unexpired leases, subject to the approval of the Bankruptcy Court and other conditions. If we reject a contract or lease, such rejection generally is treated as a pre-petition breach of the contract or lease, subject to exceptions, relieves the Debtors of performing their future obligations under such contract or lease and entitles the counterparty thereto to a pre-petition general unsecured claim for damages caused by the breach. If we assume an executory contract or unexpired lease, we are generally required to cure any existing monetary defaults under the contract or lease and provide adequate assurance of future performance to the counterparty. Accordingly, any description of an executory contract or unexpired lease in this Quarterly Report on Form 10-Q, including any quantification of our obligations under any such contract or lease, is wholly qualified by the rejection rights we have under the Bankruptcy Code. Further, nothing herein is or shall be deemed an admission with respect to any claim amounts or calculations arising from the rejection of any executory contract or unexpired lease and we expressly preserve all of our rights with respect thereto. As of September 30, 2016, liabilities subject to compromise include (in thousands):

Obligations under the Senior Notes (see Note 7), including accrued interest through the petition date	$87,918
Liabilities associated with the discontinued operations of Advent	2,236
Claims and other liabilities related to operating leases	658
Income tax liabilities	300
Other	282
Liabilities subject to compromise	$91,394

To the best of our knowledge, we have notified all of our known current or potential creditors that the Debtors have filed Chapter 11 Cases. In addition, on August 23, 2016, each of the Debtors filed the Schedules and Statements with the Bankruptcy Court. These documents set forth, among other things, the assets and liabilities of each of the Debtors, including executory contracts to which each of the Debtors is a party. The Schedules and Statements are subject to the qualifications and assumptions included therein, and are subject to amendment or modification as our Chapter 11 Cases proceed. Many of the claims identified in the Schedules and Statements are listed as disputed, contingent or unliquidated. In addition, there may be differences between the amounts for certain claims listed in the Schedules and Statements and the amounts claimed by our creditors. These differences will be investigated and resolved as part of our claims resolution process in our Chapter 11 Cases. Pursuant to the Federal Rules of Bankruptcy Procedure, creditors who wish to assert pre-petition claims against us and whose claim (i) is not listed in the Schedules and Statements or (ii) is listed in the Schedules and Statements as disputed, contingent, or unliquidated, must file a proof of claim with the Bankruptcy Court prior to the bar date set by the court. The bar dates are November 15, 2016, for non-governmental creditors, and January 17, 2017, for governmental creditors.

As of November 9, 2016, approximately $228.7 million in claims have been filed with the Bankruptcy Court against the Debtors by 9 claimants. We expect additional claims to be filed prior to the bar dates. In addition, creditors who have already filed claims may amend or modify their claims in ways we cannot now predict. The amounts of additional claims may be material. Similarly, amendments or modifications to claims already filed may be material. We will investigate and evaluate all claims in connection with our plan of reorganization. As part of the process, we will work to resolve differences in amounts scheduled by the Debtors and the amounts of claims filed by creditors, including through the filing of objections with the Bankruptcy Court where appropriate.

We have substantial tax net operating loss carryforwards and other tax attributes. Under the U.S. Internal Revenue Code (the "Code"), our ability to use these net operating losses and other tax attributes may be limited if we experience a change of control, as determined under the Code. Accordingly, we obtained an order from the Bankruptcy Court that is intended to protect our ability to use our tax attributes by imposing certain notice procedures and transfer restrictions on the trading of the Company’s common stock. In general, the order applies to any person or entity that, directly or indirectly, beneficially owns (or would beneficially own as a result of a proposed transfer) at least 4.5% of the Company’s common stock. Such persons are required to notify us and the Bankruptcy Court before effecting a transaction that might result in us losing the ability to use our tax attributes, and we have the right to seek an injunction to prevent the transaction if it might adversely affect our ability to use our tax attributes. Any purchase, sale or other transfer of our equity securities in violation of the restrictions of the order is null and void ab initio as an act in violation of a Bankruptcy Court order and would therefore confer no rights on a proposed transferee.

We have incurred and will continue to incur significant costs associated with our reorganization and the Chapter 11 proceedings. We expect these costs, which are being expensed as incurred, will significantly affect our results of operations. In addition, a non-cash charge to write-off the unamortized debt issuance costs related to our Senior Notes is included in

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“Reorganization items, net” as these debt instruments are expected to be impacted by the bankruptcy reorganization process. For the three and nine months ended September 30, 2016 reorganization items include (in thousands):

Adjustments to deferred debt issuance costs and senior debt premium	$2,399
Professional fees	(763)
Adjustments to other liabilities for claims made or rejected contracts	(293)
Other	(17)
Reorganization items, net	$1,326

Note 3. New Accounting Pronouncements

On August 26, 2016, the FASB issued Accounting Standards Update ("ASU") 2016-15, which amends the guidance in ASC 230 on the classification of certain cash receipts and payments in the statement of cash flows. The primary purpose of the ASU is to reduce the diversity in practice that has resulted from the lack of consistent principles on this topic. The ASU’s amendments add or clarify guidance on eight cash flow issues:

- Debt prepayment or debt extinguishment costs.
- Settlement of zero-coupon debt instruments or other debt instruments with coupon interest rates that are insignificant in relation to the effective interest rate of the borrowing.
- Contingent consideration payments made after a business combination.
- Proceeds from the settlement of insurance claims.
- Proceeds from the settlement of corporate-owned life insurance policies, including bank-owned life insurance policies.
- Distributions received from equity method investees.
- Beneficial interests in securitization transactions.
- Separately identifiable cash flows and application of the predominance principle.

For the Company, the new standard is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017. Management has not determined if this guidance will have a significant impact on its financial statements.

In February 2016, the FASB issued ASU 2016-02 Leases, a new standard on accounting for leases. ASU 2016-02 introduces a lessee model that brings most leases on the balance sheet. The new standard also aligns many of the underlying principles of the new lessor model with those in ASC 606, the FASB’s new revenue recognition standard (e.g., those related to evaluating when profit can be recognized). Furthermore, this ASU addresses other concerns related to the current leases model. For example, this ASU eliminates the requirement in current GAAP for an entity to use bright-line tests in determining lease classification. The standard also requires lessors to increase the transparency of their exposure to changes in value of their residual assets and how they manage that exposure. The new model represents a wholesale change to lease accounting. As a result, entities will face significant implementation challenges during the transition period and beyond, such as those related to:

- Applying judgment and estimating.
- Managing the complexities of data collection, storage, and maintenance.
- Enhancing information technology systems to ensure their ability to perform the calculations necessary for compliance with reporting requirements.
- Refining internal controls and other business processes related to leases.
- Determining whether debt covenants are likely to be affected and, if so, working with lenders to avoid violations; and
- Addressing any income tax implications.

For the Company, the new standard is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. Management has not yet determined if this guidance will have a significant impact on its consolidated financial statements.

On January 5, 2016, the FASB issued ASU 2016-01 Recognition and Measurement of Financial Assets and Financial Liabilities, which amends the guidance in GAAP on the classification and measurement of financial instruments. Although the ASU retains many current requirements, it significantly revises an entity’s accounting related to (1) the classification and measurement of investments in equity securities and (2) the presentation of certain fair value changes for financial liabilities measured at fair value. This ASU also amends certain disclosure requirements associated with the fair value of financial instruments. For Novation, the new standard is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017. Management has not yet determined if this guidance will have a significant impact on its consolidated financial statements.

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Note 4. Divestitures

Corvisa LLC (Cloud SaaS Segment)

On December 21, 2015, the Company entered into the Purchase Agreement with ShoreTel. Subject to the terms and conditions under the Purchase Agreement, ShoreTel agreed to purchase 100% of the membership interests of Corvisa from Corvisa Services, a wholly-owned subsidiary of the Company. The transaction closed on January 6, 2016. The aggregate consideration for the transaction was $8.4 million in cash, subject to a potential post-closing working capital adjustment. At closing $7.0 million was paid and the following was deposited in escrow: (i) $1.0 million for a period of twelve months to secure certain indemnification obligations of the Company; and (ii) $0.35 million to secure certain obligations of the Company in connection with the post-closing working capital adjustment.

In connection with the transaction, the Company and ShoreTel also entered into a transition services agreement pursuant to which each of the Company and ShoreTel would provide the other with specified services for a transition period following the closing. Cash flows associated with these services are not significant. Other than finalizing the post-closing conditions as provided above, the Company will have no continuing involvement with Corvisa beyond the transition services.

During 2015, the Company incurred approximately $0.8 million in severance and related one-time termination benefits associated with this transaction. Approximately $0.1 million of this expense was included in current liabilities of discontinued operations at December 31, 2015. Also during 2015, the Company incurred $0.5 million of legal and audit fees related to this transaction. Due to the timing of the sale, no portion of these costs is reflected in the net loss from discontinued operations for the three and nine months ended September 30, 2015.

The Company recognized a gain on the transaction of $1.4 million during the first quarter of 2016, which is reflected in the loss from discontinued operations. The gain includes $0.7 million related to the post-closing working capital adjustment, which includes the release of the $0.35 million held in escrow and $0.3 million for the working capital adjustment, as calculated in accordance with the terms of the Purchase Agreement. Also included in discontinued operations during the first quarter of 2016 are transaction-related costs that were contingent upon the closing of the sale. These costs include approximately $0.3 million of earned bonus payments to a Corvisa executive, $1.0 million of advisory fees and $0.1 million of other transaction-related costs.

At ShoreTel’s request, the Company disposed of Corvisa’s third-party software implementation consulting business in December 2015. The Company sold the assets related exclusively to this business, including but not limited to customer contracts, computer hardware and marketing materials, to Canpango LLC (“Canpango”), which agreed to hire employees of the business, to assume Corvisa’s obligations under the customer contracts and to pay to the Company a portion of the business’s existing accounts receivable collected in the next nine months, less associated collection costs. Canpango is led by a former employee of Corvisa and certain current and former employees of Corvisa have financial interests in Canpango. The sales price, assets and operations related exclusively to this business were not material to the Company’s financial statements.

Prior to 2015, the Company disposed of its ownership interests in StreetLinks. Also prior to 2015, the Company sold a portion of the assets and conducted an orderly wind-down of Advent.

Results of Discontinued Operations

For the three and nine months ended September 30, 2015, net loss from discontinued operations consists primarily of the net operating losses of Corvisa and any necessary eliminations and income tax expense. For the three and nine months ended September 30, 2016 the net loss from discontinued operations consists of the gain on the sale of

Corvisa, offset by transaction-related costs.

The results of the Company's discontinued operations are summarized below (in thousands):

	For the Nine Months Ended September 30,		For the Three Months Ended September 30,	
	2016	2015	2016	2015
Service fee income	$—	$2,557	$—	$877
Income (loss) from discontinued operations before income taxes	$(77)	$(18,388)	$—	$(6,532)
Income tax expense (benefit)	—	—	—	—
Income (loss) from discontinued operations, net of income taxes	$(77)	$(18,388)	$—	$(6,532)

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The assets and liabilities of discontinued operations as of September 30, 2016 relate entirely to Advent. As of September 30, 2016, the current liabilities of discontinued operations were comprised of unclaimed funds and fees withheld from Advent's business partners for various violations of Advent's compliance program. Unclaimed funds will be escheated to the applicable state in accordance with unclaimed property laws. Obligations relating to fees withheld from business partners will be resolved when claims are received or when the statute of limitations for the related contractual obligation expires. Noncurrent liabilities of discontinued operations consist of fees withheld from business partners for various violations of Advent's compliance program. The classification of these fees held as current versus noncurrent is dependent on the nature of the compliance violation and the tax year during which the violation occurred. The assets and liabilities of discontinued operations as of December 31, 2015 include the assets and liabilities of Advent and Corvisa. Because the obligations of the discontinued operations arose prior to the Company's Bankruptcy Petitions, the obligations of discontinued operations are classified as liabilities subject to compromise subsequent to the petition date.

The major classes of assets and liabilities of discontinued operations as of September 30, 2016 and December 31, 2015 are detailed below (dollars in thousands).

	September 30, 2016 (unaudited)	December 31, 2015
Assets		
Current Assets		
Cash and cash equivalents	$ 196	$ 352
Service fee receivable, net	—	282
Other	252	1,209
Total current assets	448	1,843
Non-Current Assets		
Property and equipment, net of accumulated depreciation	—	5,708
Other	—	707
Total non-current assets	—	6,415
Total assets	$ 448	$ 8,258
Liabilities		
Current liabilities	$ —	$ 2,470
Non-current liabilities	—	1,833
Liabilities subject to compromise	2,236	—
Total liabilities	$ 2,236	$ 4,303

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Note 5. Marketable Securities

The following table presents certain information on the Company's portfolio of available-for-sale securities at September 30, 2016 and December 31, 2015 (in thousands):

	As of September 30, 2016 (unaudited)			
		Gross Unrealized		
Description of Securities	Amortized Cost	Gains	Losses	Estimated Fair Value
Marketable securities, current				
Equity securities	$ 11,851	$ 4,045	$ (7)	$ 15,889
Mortgage securities	441	1,058	—	1,499
Total	$ 12,292	$ 5,103	$ (7)	$ 17,388
Marketable securities, non-current				
Corporate notes and bonds	$ 254	$ 548	$ —	$ 802
Total	$ 254	$ 548	$ —	$ 802

	As of December 31, 2015			
		Gross Unrealized		
Description of Securities	Amortized Cost	Gains	Losses	Estimated Fair Value
Marketable securities, current				
Corporate notes and bonds	$ 15,517	$ —	$ (28)	$ 15,489
Mortgage securities	525	1,486	—	2,011
Total	$ 16,042	$ 1,486	$ (28)	$ 17,500
Marketable securities, non-current				
Corporate notes and bonds	$ 1,419	$ —	$ (22)	$ 1,397
Total	$ 1,419	$ —	$ (22)	$ 1,397

Prior to 2008, the Company originated, purchased, securitized, sold, invested in and serviced residential nonconforming mortgage loans and mortgage securities. As a result of those activities, the Company holds mortgage securities that continue to be a source of its earnings and cash flow. As of September 30, 2016 and December 31, 2015, these mortgage securities consisted entirely of the Company's investment in the residual securities issued by securitization trusts sponsored by the Company. Residual securities consist of interest-only, prepayment penalty and overcollateralization bonds.

There were no other-than-temporary impairments relating to available-for-sale securities for the three months ended September 30, 2016 and 2015. The weighted average remaining maturity of the Company’s short-term and long-term corporate notes and bonds at September 30, 2016 was 19 months. Maturities of mortgage securities owned by the Company depend on repayment characteristics and experience of the underlying financial instruments. See Note 9 to the condensed consolidated financial statements for details on the Company's fair value methodology.

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The following table relates to the securitizations where the Company retained an interest in the assets issued by the securitization trust (in thousands):

	Size/Principal Outstanding (A)	Assets on Balance Sheet (B)	Liabilities on Balance Sheet	Maximum Exposure to Loss(C)	Year to Date Loss on Sale	Year to Date Cash Flows (D)
September 30, 2016	$ 3,287,616	$ 1,499	$ —	$ 1,499	$ —	$ 3,719
December 31, 2015	3,601,468	2,011	—	2,011	—	6,287

(A) Size/Principal Outstanding reflects the estimated principal of the underlying assets held by the securitization trust.
(B) Assets on balance sheet are securities issued by the entity and are recorded in the current marketable securities line item on the condensed consolidated balance sheets.
(C) The maximum exposure to loss includes the assets held by the Company. The maximum exposure to loss assumes a total loss on the referenced assets held by the securitization trust.
(D) Year to date cash flows are for the nine months ended September 30, 2016 and 2015, respectively.

Note 6. Property and Equipment, Net

All of the Company's property and equipment are stated at cost less accumulated depreciation. Depreciation is computed using the straight-line method over the estimated useful lives of the related assets. The estimated useful lives of the Company's property and equipment are the lesser of 5 years or remaining lease term for leasehold improvements, 5 years for furniture and fixtures, 3 to 5 years for office and computer equipment, and 1 to 3 years for software.

Maintenance and repairs are charged to expense. Major renewals and improvements are capitalized. Gains and losses on dispositions are credited or charged to earnings as incurred. Depreciation expense for property and equipment is not material. Office furniture with a carrying value of $94,000 was written down to its fair value of $20,000 on June 30, 2016, resulting in an impairment charge of $74,000.

The following table shows the Company's property and equipment (in thousands):

	September 30, 2016 (unaudited)	December 31, 2015
Furniture, fixtures and office equipment	$ 73	$ 314
Leasehold improvement	317	402
Hardware and computer equipment	71	157
Software	—	547
Total Cost	461	1,420
Less: Accumulated depreciation and amortization	(319)	(1,062)
Property and equipment, net	$ 142	$ 358

Note 7. Borrowings

Senior Notes. The Company has outstanding three series of unsecured senior notes (collectively, the "Senior Notes") pursuant to three separate indentures (collectively, the “Indentures”) with an aggregate principal balance of $85.9 million. The Senior Notes were created through an exchange of the Company's previously outstanding junior subordinated notes that occurred prior to 2015. This exchange was considered a modification of a debt instrument for accounting purposes. Through the Bankruptcy Petition date, the Company used the effective interest method to accrete from the principal balance as of the modification date to the carrying balance as of any reporting date. Under the effective interest method, significant changes in the rate at which a debt instrument accrues interest over its term can result in a recorded balance in excess of the aggregate principal balance of the debt instrument. As of the Bankruptcy Petition date, the Company charged off the entire difference between the contractual principal amount of the Senior Notes and their carrying value as these notes are expected to be impacted by the bankruptcy reorganization process.

The Senior Notes accrued interest at a rate of 1.0% per annum until January 1, 2016 and since then have accrued interest at a rate of three-month LIBOR plus 3.5% per annum (the “Full Rate”). Interest on the Senior Notes was payable on a quarterly basis and no principal payments were due until maturity on March 30, 2033. However, the Company did not make the quarterly interest payments due on March 30, June 30 and September 30, 2016 totaling $2.7 million. These interest payments were not made within 30 days after they became due and payable, and remain unpaid, such non-payments constituting events of default under the Indentures. As a result, the Senior Notes have been classified as current liabilities in the September 30, 2016 balance sheet. The trustee under any Indenture or the holders of not less than 25% of the aggregate principal amount of the outstanding Senior Notes issued pursuant to such Indenture, by notice in writing to the Company (and to the trustee if given by the holders), may declare the principal amount of all the Senior Notes issued under such Indenture to be due and payable immediately. On May 9, 2016, the Company received a notice of acceleration with respect to the Series 1 Senior Notes and the Series 2 Senior Notes, declaring all principal and unpaid interest immediately due and payable. A similar acceleration notice was received on June 6, 2016 with respect to the Series 3 Senior Notes.

Because the Senior Notes are expected to be impacted by the bankruptcy reorganization process, the Company discontinued accrued interest on the notes after the Bankruptcy Petition date. The aggregate outstanding principal under the Senior Notes is $85.9 million and the aggregate recorded interest liability is $2.0 million. The principal and recorded unpaid interest are classified as liabilities subject to compromise in the Company's condensed consolidated balance sheet. Had the Company continued the accrual of interest on the Senior Notes, interest expense and accounts payable and accrued expenses would have been higher and net income lower by $0.7 million during the three and nine months periods ended September 30, 2016.

The Indentures contain certain restrictive covenants (the “Negative Covenants”) subject to certain exceptions in the Indentures, including written consent of the holders of the Senior Notes. The Negative Covenants prohibit the Company and its subsidiaries, from among other things, incurring debt, permitting any lien upon any of its property or assets, making any cash dividend or distribution or liquidation payment, acquiring shares of the Company or its subsidiaries, making payment on debt securities of the Company that rank pari passu or junior to the Senior Notes, or disposing of any equity interest in certain subsidiaries or all or substantially all of the assets of certain subsidiaries unless certain conditions are met. The Negative Covenants remain in effect until the Company satisfies certain financial covenants (the “Financial Covenants”). Satisfaction of the Financial Covenants requires the Company to demonstrate on a consolidated basis that (1) its Tangible Net Worth is equal to or greater than $40 million, and (2) either (a) the Interest Coverage Ratio is equal to or greater than 1.35x, or (b) the Leverage Ratio is not greater than 95% (each such term as defined in the Indentures). The Negative Covenants, as defined above, were in effect as of September 30, 2016 and December 31, 2015. Compliance with the Financial Covenants is required only when the Company seeks to take action prohibited by the Negative Covenants that has not been approved by the holders of the Senior Notes.

With respect to the Company's recent divestiture activity, which is discussed further in Note 4 to the condensed consolidated financial statements, the sale of a subsidiary is not prohibited by the Negative Covenants provided that the sale is at fair market value and the proceeds are reinvested in the Company. The Company was in compliance with the Negative Covenants as of September 30, 2016 and December 31, 2015, and therefore the Company was under no obligation to comply with the Financial Covenants during these periods.

Note 8. Commitments and Contingencies

Contingencies – Prior to 2008, the Company originated, purchased, securitized, sold, invested in and serviced residential nonconforming mortgage loans and mortgage securities. The Company has received indemnification and loan repurchase demands with respect to alleged violations of representations and warranties (“defects”) and with respect to other alleged misrepresentations and contractual commitments made in loan sale and securitization agreements. These demands have been received substantially beginning in 2006 and have continued into 2016. Prior to the Company ceasing the origination of loans in its mortgage lending business, it sold loans to securitization trusts and other third parties and agreed to repurchase loans with material defects and to otherwise indemnify parties to these transactions. Beginning in 1997 and ending in 2007, affiliates of the Company sold loans to securitization trusts and third parties with the potential of such obligations. The aggregate original principal balance of these loans was $43.1 billion at the time of sale or securitization. The remaining principal balance of these loans is not available as these loans are serviced by third parties and may have been refinanced, sold or liquidated. Claims to repurchase loans or to indemnify under securitization documents have not been acknowledged as valid by the Company. In some cases, claims were made against affiliates of the Company that have ceased operations and have no or limited assets. The Company has not repurchased any loans or made any such indemnification payments since 2010.

Historically, repurchases of loans or indemnification of losses where a loan defect has been alleged have been insignificant and any future losses for alleged loan defects have not been deemed to be probable or reasonably estimable; therefore, the Company has recorded no reserves related to these claims. The Company does not use internal groupings for purposes of determining the status of these loans. The Company is unable to develop an estimate of the maximum potential amount of future payments related to repurchase demands because the Company does not have access to information relating to loans sold and securitized and the number or amount of claims deemed probable of assertion is not known nor is it reasonably estimable. Further, the validity of claims received remains questionable. Also, considering that the Company completed its last sale or securitization of loans during 2007, the Company believes that it will be difficult for a claimant to successfully validate any additional repurchase demands. Management does not expect that the potential impact of claims will be material to the Company's financial statements.

Legal Proceedings – The Company is a party to various legal proceedings. Except as set forth below, these proceedings are of an ordinary and routine nature. Any legal fees associated with these proceedings are expensed as incurred.

Although it is not possible to predict the outcome of any legal proceeding, in the opinion of management, other than the active

proceedings described in detail below, proceedings and actions against the Company should not, individually, or in the aggregate, have a material effect on the Company's financial condition, operations or liquidity. Furthermore, due to the uncertainty of any potential loss as a result of pending litigation and due to the Company's belief that an adverse ruling is not probable, the Company has not accrued a loss contingency related to the following matters in its consolidated financial statements. However, a material outcome in one or more of the active proceedings described below could have a material impact on the results of operations in a particular quarter or fiscal year. See Note 2 to condensed consolidated financial
statements for a description of the impact of the Company's Chapter 11 Cases on these proceedings. The automatic stay provided by the Bankruptcy Code is currently in effect as to the defendants in these proceedings that are Debtors in the Chapter 11 Cases.

On May 21, 2008, a purported class action case was filed in the Supreme Court of the State of New York, New York County, by the New Jersey Carpenters' Health Fund, on behalf of itself and all others similarly situated. Defendants in the case included NovaStar Mortgage Funding Corporation (NMFC) and NovaStar Mortgage, Inc. (NMI), wholly-owned subsidiaries of the Company, and NMFC's directors, several securitization trusts sponsored by the Company ("affiliated defendants") and several unaffiliated investment banks and credit rating agencies. The case was removed to the United States District Court for the Southern District of New York. On June 16, 2009, the plaintiff filed an amended complaint. The plaintiff seeks monetary damages, alleging that the defendants violated sections 11, 12 and 15 of the Securities Act of 1933, as amended, by making allegedly false statements regarding mortgage loans that served as collateral for securities purchased by the plaintiff and the purported class members. On August 31, 2009, the Company filed a motion to dismiss the plaintiff's claims, which the court granted on March 31, 2011, with leave to amend. The plaintiff filed a second amended complaint on May 16, 2011, and the Company again filed a motion to dismiss. On March 29, 2012, the court dismissed the plaintiff's second amended complaint with prejudice and without leave to replead. The plaintiff filed an appeal. On March 1, 2013, the appellate court reversed the judgment of the lower court, which had dismissed the case. Also, the appellate court vacated the judgment of the lower court which had held that the plaintiff lacked standing, even as a class representative, to sue on behalf of investors in securities in which plaintiff had not invested, and the appellate court remanded the case back to the lower court for further proceedings. On April 23, 2013 the plaintiff filed its memorandum with the lower court seeking a reconsideration of the earlier dismissal of plaintiff's claims as to five offerings in which plaintiff was not invested, and on February 5, 2015 the lower court granted plaintiff's motion for reconsideration and vacated its earlier dismissal. Given the stage of the litigation, the Company cannot provide an estimate of the range of any loss. The Company believes that the affiliated defendants have meritorious defenses to the case and expects them to defend the case vigorously.

On June 20, 2011, the National Credit Union Administration Board, as liquidating agent of U.S. Central Federal Credit Union, filed an action against NMFC and numerous other defendants in the United States District Court for the District of Kansas, claiming that the defendants issued or underwrote residential mortgage-backed securities pursuant to allegedly false or misleading registration statements, prospectuses, and/or prospectus supplements. On August 24, 2012, the plaintiff filed an amended complaint making essentially the same claims against NMFC. NMFC filed a motion to dismiss the amended complaint which was denied on September 12, 2013. The defendants had claimed that the case should be dismissed based upon a statute of limitations and sought an appeal of the court's denial of this defense. An interlocutory appeal of this issue was allowed, and on August 27, 2013, the Tenth Circuit affirmed the lower court's denial of defendants' motion to dismiss the plaintiff's claims as being time barred; the appellate court held that the Extender Statute, 12 U.S.C. §1787(b)(14) applied to plaintiff's claims. On June 16, 2014, the United States Supreme Court granted a petition of NMFC and its co-defendants for certiorari, vacated the ruling of the Tenth Circuit, and remanded the case back to that court for further consideration in light of the Supreme Court's decision in CTS Corp. v. Waldburger, 134 S. Ct. 2175 (2014). On August 19, 2014, the Tenth Circuit reaffirmed its prior decision, and on October 2, 2014 the defendants filed a petition for writ of certiorari with the Supreme Court, which was denied. On March 22, 2016, NMFC filed motions for summary judgment and plaintiff filed a motion for partial summary judgment. Those motions remain pending. Given the stage of the litigation, the Company cannot provide an estimate of the range of any loss. The Company believes that NMFC has meritorious defenses to the case and expects it to defend the case vigorously.

On February 28, 2013, the Federal Housing Finance Agency, as conservator for the Federal Home Loan Mortgage Corporation (Freddie Mac) and on behalf of the Trustee of the NovaStar Mortgage Funding Trust, Series 2007-1 (the "Trust"), a securitization trust in which the Company retains a residual interest, filed a summons with notice in the Supreme Court of the State of New York, County of New York against the Company and NMI, a wholly-owned subsidiary of the Company. The notice provides that this is a breach of contract action with respect to certain, unspecified mortgage loans and defendant's failure to repurchase such loans under the applicable agreements. Plaintiff alleges that defendants, from the closing date of the transaction that created the Trust, were aware of the breach of the representations and warranties made and failed to notice and cure such breaches, and due to the failure of defendants to cure any breach, notice to defendants would have been futile. The summons with notice was not served until June 28, 2013. By letter dated June 24, 2013, the Trustee of the Trust forwarded a notice from Freddie Mac alleging breaches of representations and warranties with respect to 43 loans, as more fully set forth in included documentation. The 43 loans had an aggregate, original principal balance of about $6.5 million. On August 19, 2013, Deutsche Bank National Trust Company, as Trustee, filed a complaint identifying alleged breaches of representations and warranties with respect to seven loans that were included in the earlier list of 43 loans. Plaintiff also generally alleged a trust-wide breach of representations and warranties by defendants with respect to loans sold and transferred to the trust. Plaintiff seeks specific performance of repurchase obligations; compensatory, consequential, recessionary and equitable damages for breach of contract; specific performance and damages for anticipatory breach of contract; and indemnification (indemnification against NMI only). On October 9, 2013, the Company and NMI filed a motion to dismiss plaintiff's complaint. This motion to dismiss was

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withdrawn after plaintiff filed an amended complaint on January 28, 2014, and on March 4, 2014 the Company and NMI filed a motion to dismiss the amended complaint. That motion remains pending. Given the stage of the litigation, the Company cannot provide an estimate of the range of any loss. The Company believes that it has meritorious defenses to the case and expects to defend the case vigorously.

Note 9. Fair Value Accounting

Fair Value Measurements

The Company's valuation techniques are based upon observable and unobservable inputs. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect the Company's market assumptions. These two types of inputs create the following fair value hierarchy:

- Level 1 – Valuations based on quoted prices in active markets for identical assets and liabilities.
- Level 2 – Valuations based on observable inputs in active markets for similar assets and liabilities, other than Level 1 prices, such as quoted interest or currency exchange rates.
- Level 3 – Valuations based on significant unobservable inputs that are supported by little or no market activity, such as discounted cash flow methodologies based on internal cash flow forecasts.

The following tables present for each of the fair value hierarchy levels, the Company's assets which are measured at fair value on a recurring basis as of September 30, 2016 and December 31, 2015 (dollars in thousands):

		Fair Value Measurements at Reporting Date Using		
Description	Fair Value as of September 30, 2016 (unaudited)	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Cash and cash equivalents:				
Cash	$ 1,832	$1,832	$ —	$ —
Money market funds	13,085	13,085	—	—
Marketable securities, current:				
Equity securities	15,889	15,889	—	—
Mortgage securities	1,499	—	—	1,499
Marketable securities, non-current:				
Corporate notes and bonds	802	802	—	—
Total	$ 33,107	$31,608	$ —	$ 1,499

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Description	Fair Value as of December 31, 2015	Fair Value Measurements at Reporting Date Using Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Cash and cash equivalents:				
Cash	$ 1,674	$1,674	$ —	$ —
Money market funds	1,152	1,152	—	—
Marketable securities, current:				
Corporate notes and bonds	15,489	—	15,489	—
Mortgage securities	2,011	—	—	2,011
Marketable securities, non-current:				
Corporate notes and bonds	1,397	—	1,397	—
Total	$ 21,723	$2,826	$ 16,886	$ 2,011

Valuation Methods and Processes

The Company determines the fair value of its cash equivalents and marketable securities based on pricing from our service provider and market prices from industry-standard independent data providers. Such market prices may be quoted prices in active markets for identical assets (Level 1 inputs) or pricing determined using inputs other than quoted prices that are observable either directly or indirectly (Level 2 inputs), such as yield curve, volatility factors, credit spreads, default rates, loss severity, current market and contractual prices for the underlying instruments or debt, broker and dealer quotes, as well as other relevant economic measures.

To the extent observable inputs are not available, as is the case with the Company's mortgage securities, the Company estimates fair value using present value techniques and generally does not have the option to choose other valuation methods for these securities. The methods and processes used to estimate the fair value of the Company's mortgage securities are discussed further below. There have been no significant changes to the Company's valuation techniques during the nine months ended September 30, 2016. Accordingly, there have been no material changes to the condensed consolidated financial statements resulting from changes to our valuation techniques during the nine months ended September 30, 2016.

The Company's marketable securities are classified as available-for-sale and are reported at their estimated fair value with unrealized gains and losses reported in accumulated other comprehensive income. To the extent that the cost basis of the Company's marketable securities exceeds the fair value and the unrealized loss is considered to be other than temporary, an impairment charge is recognized and the amount recorded in accumulated other comprehensive income or loss is reclassified to earnings as a realized loss. The specific identification method is used in computing realized gains or losses.

Mortgage securities - available-for-sale. As discussed above and in Note 5 to the condensed consolidated financial statements, the Company's mortgage securities – available-for-sale, are measured at fair value. These securities are valued at each reporting date using significant unobservable inputs (Level 3) by discounting the expected cash flows.

An independent entity has been engaged to prepare projected cash flows and values of the Company's mortgage securities for each quarterly reporting period. Estimates, made by the Company's provider, for key assumptions, most notably the expected life of the security, are used in estimating future cash flows.

The most critical assumption used in estimating the value of the mortgage securities is the length of time the security will continue to provide cash flow. The loan servicer for the underlying mortgage loans, an independent party, retains the right to call our mortgage securities and therefore the decision to call the securitization is beyond the Company's control. In the event that were to occur, the mortgage securities would discontinue generating cash flows. For purposes of valuing the mortgage securities, the independent entity we have engaged to prepare the mortgage security valuations uses a 2-year time frame, after which it is assumed that the securities have been called. Given the long-term nature of the underlying mortgages, if the mortgage security is not called by the servicer, the cash flows could extend for many years, which would indicate a significantly higher value than the Company has recorded.

In addition to owning mortgage securities that represent excess interest, the Company also owns overcollateralization (OC) classes of various securities. These OC bonds represent the difference in the principal of the underlying mortgage loans compared to the bonds sold to third parties. This extra collateral serves as a cushion for losses that has and may occur in the

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underlying mortgage pool. The OC bonds may receive cash if and when it is determined that actual losses are less than expectations. As of September 30, 2016, the aggregate overcollateralization was $27.0 million. The timing and amount of cash to be generated by the OC bonds is contingent upon the performance of the underlying mortgage loan collateral. The independent loan servicer controls and manages the individual mortgage loans and therefore the Company has no control over the loan performance. Because of these uncertainties, the Company maintains no value for the OC bonds. The Company may in the future place a value on the OC securities.

The following table provides a reconciliation of the beginning and ending balances for the Company's mortgage securities – available-for-sale, which are measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the nine months ended September 30, 2016 and 2015 (dollars in thousands):

	For the Nine Months Ended September 30,	
	2016	2015
Balance, beginning of period	$2,011	$3,381
Increases (decreases) to mortgage securities – available-for-sale:		
Total proceeds from paydowns of securities (A)	(84)	(84)
Market value adjustment	(428)	(802)
Net decrease to mortgage securities – available-for-sale	(512)	(886)
Balance, end of period	$1,499	$2,495

(A) Cash received on mortgage securities with no cost basis was $3.3 million and $4.2 million for the nine months ended September 30, 2016 and 2015, respectively.

Adjustments to assets and liabilities measured at fair value on a recurring and nonrecurring basis did not have a material impact on the earnings of continuing operations for any period presented.

The following disclosure of the estimated fair value of financial instruments presents amounts that have been determined using available market information and appropriate valuation methodologies. However, considerable judgment is required to interpret market data to develop the estimates of fair value. Accordingly, the estimates presented herein are not necessarily indicative of the amounts that could be realized in a current market exchange. The use of different market assumptions or estimation methodologies could have a material impact on the estimated fair value amounts. The fair value of short-term financial assets and liabilities, such as service fees receivable, notes receivable, and accounts payable and accrued expenses are not included in the following table as their carrying value approximates their fair value.

The estimated fair values of the Company's financial instruments are as follows as of September 30, 2016 and December 31, 2015 (in thousands):

	As of September 30, 2016 (unaudited)		As of December 31, 2015	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Financial assets:				
Restricted cash	$112	$112	$598	$435
Marketable securities	18,190	18,190	18,897	18,897
Financial liabilities:				
Senior notes	$85,900	$18,629	$88,385	$18,331

For the items in the table above not measured at fair value in the statement of financial position but for which the fair value is disclosed, the fair value has been estimated using Level 3 methodologies, based on significant unobservable inputs that are supported by little or no market activity, such as discounted cash flow calculations based on internal cash flow forecasts. No assets or liabilities have been transferred between levels during any period presented.

Restricted cash. As of September 30, 2016, the fair value of restricted cash is not material to the financial statements taken as a whole and the fair value is assumed to be equal to carrying value. As of December 31, 2015, the fair value of restricted cash was estimated by discounting estimated future releases of the cash from restriction. Restricted cash is included in the other current assets and other assets line items in the Company's condensed consolidated balance sheets.

Senior notes. The fair value is estimated by discounting future projected cash flows using a discount rate commensurate with the risks involved. The value of the Senior Notes was calculated assuming that the Company would be required to pay interest at

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a rate of 1.0% per annum until January 2016, at which time the Company would be required to start paying the Full Rate of three-month LIBOR plus 3.5% per annum until maturity in March 2033. The three-month LIBOR used in the analysis was projected using a forward interest rate curve.

Note 10. Income Taxes

Prior to 2015, the Company determined that it was no longer more likely than not that it will recognize a portion of its deferred tax assets. Therefore, as of September 30, 2016 and December 31, 2015, the Company maintained a full valuation allowance against its deferred tax assets of $279.9 million and $281.5 million, respectively. The Company's determination of the extent to which its deferred tax assets will be realized requires the exercise of significant judgment, based in part on business plans and expectations about future outcomes. In the event the actual results differ from these estimates in future periods, the Company may need to adjust the valuation allowance, which could materially impact our financial position and results of operations. The Company will continue to assess the need for a valuation allowance in future periods. Because of the full valuation allowance, the Company's effective tax rate is expected to be near 0% and therefore the consolidated income tax expense is not material for any period presented.

As of September 30, 2016 and December 31, 2015, the total gross amount of unrecognized tax benefits was $0.3 million and $0.4 million, respectively. This amount also represents the total amount of unrecognized tax benefits that would impact the effective tax rate in the respective periods. The Company does not anticipate a material reduction of the unrecognized tax benefits due to the lapse of the related statute of limitations in the next twelve months.

Note 11. Earnings Per Share

Basic earnings per share is computed by dividing net earnings available to common shareholders by the weighted average number of shares of common stock outstanding during the period. Diluted earnings per share include the effect of conversions of stock options and nonvested shares. The computations of basic and diluted earnings per share for the three and nine months ended September 30, 2016 and 2015 (in thousands, except share and per share amounts) are as follows:

	For the Nine Months Ended September 30,		For the Three Months Ended September 30,	
	2016	2015	2016	2015
Numerator:				
Net income (loss) from continuing operations	$952	$(2,489)	$2,445	$(707)
Net loss from discontinued operations	(77)	(18,388)	—	(6,532)
Net income (loss) available to common shareholders	$875	$(20,877)	$2,445	$(7,239)
Denominator:				
Weighted average common shares outstanding – basic	91,345,501	91,103,880	92,180,484	91,187,345
Weighted average common shares outstanding – dilutive:				
Weighted average common shares outstanding – basic	91,345,501	91,103,880	92,180,484	91,187,345
Stock options	—	—	—	—
Nonvested shares	840,014	—	284,627	—
Weighted average common shares outstanding – dilutive	92,185,515	91,103,880	92,465,111	91,187,345

Basic earnings (loss) per share:

Net income (loss) from continuing operations	$0.01	$(0.03)	$0.03	$(0.01)
Net loss from discontinued operations	—	(0.20)	—	(0.07)
Net income (loss) available to common shareholders	$0.01	$(0.23)	$0.03	$(0.08)
Diluted earnings (loss) per share:				
Net income (loss) from continuing operations	$0.01	$(0.03)	$0.03	$(0.01)
Net loss from discontinued operations	—	(0.20)	—	(0.07)
Net income (loss) available to common shareholders	$0.01	$(0.23)	$0.03	$(0.08)

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The following weighted-average options to purchase shares of common stock were outstanding during each period presented, but were not included in the computation of diluted earnings per share because the calculated number of shares assumed to be repurchased was greater than the number of shares to be obtained upon exercise, therefore, the effect would be anti-dilutive (in thousands, except exercise prices):

	For the Nine Months Ended September 30,		For the Three Months Ended September 30,	
	2016	2015	2016	2015
Number of stock options	4,613	10,379	4,443	10,832
Weighted average exercise price of stock options	$0.71	$ 0.62	$0.70	$ 0.62

There were no options granted during the nine months ended September 30, 2016. Option grants for the nine months ended September 30, 2015 were not significant.

As of September 30, 2016, the Company had no nonvested shares outstanding. As of September 30, 2015 there were 1.5 million nonvested shares outstanding. While the nonvested shares granted during 2016 and 2015 vest one year from the date of grant, the nonvested shares granted in prior years vest ratably over their original term of six years.

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

Forward-Looking Statements

Statements in this report regarding Novation Companies, Inc. and its business, that are not historical facts are “forward-looking statements” within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Forward-looking statements are those that predict or describe future events, do not relate solely to historical matters and include statements regarding management's beliefs, estimates, projections, and assumptions with respect to, among other things, our future operations, business plans and strategies, as well as industry and market conditions, all of which are subject to change at any time without notice. Words such as “believe,” “expect,” “anticipate,” “promise,” “plan,” and other expressions or words of similar meanings, as well as future or conditional auxiliary verbs such as “would,” “should,” “could,” or “may” are generally intended to identify forward-looking statements. Actual results and operations for any future period may vary materially from those discussed herein. Some important factors that could cause actual results to differ materially from those anticipated include: the disposition and results of our Chapter 11 Cases (as defined below), our ability to identify and acquire operating business or make other investments that generate taxable earnings; decreases in cash flows from our mortgage securities; our ability to remain in compliance with the agreements governing our indebtedness; the outcome of litigation actions pending against us or other legal contingencies; our compliance with applicable local, state and federal laws and regulations; compliance with new accounting pronouncements; the impact of general economic conditions; and the risks that are from time to time included in our filings with the Securities and Exchange Commission, including the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2015, as amended (the "2015 Form 10-K"), and this Quarterly Report on Form 10-Q. Other factors not presently identified may also cause actual results to differ. This report speaks only as of its date and we expressly disclaim any duty to update the information herein except as required by federal securities laws.

Executive Overview

The following Management's Discussion and Analysis of Financial Condition and Operating Results (“MD&A”) should be read in conjunction with the preceding unaudited condensed consolidated financial statements of Novation Companies, Inc. and its subsidiaries (the “Company,” ”Novation," “we,” “us,” or "our") and the notes thereto as well as the 2015 Form 10-K. The MD&A includes the following sections:

- Corporate Overview, Background and Strategy – a brief overview of our business, current strategy, and significant recent events.
- Critical Accounting Policies – an update, since December 31, 2015, of our discussion of accounting policies that impact our financial statements and involve a high degree of judgment or complexity and a discuss of the impact of new accounting standards.
- Results of Operations – an analysis of our results of operations for the nine months ended September 30, 2016 and 2015 as presented in our unaudited condensed consolidated financial statements.
- Liquidity and Capital Resources – an analysis of our cash flows and financial commitments.

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Reorganization

On July 20, 2016, Novation and three of our subsidiaries, NovaStar Mortgage LLC, NovaStar Mortgage Funding Corporation and 2114 Central, LLC (collectively, the "Debtors"), filed voluntary petitions (the "Bankruptcy Petitions") for reorganization under the Bankruptcy Code in the United States Bankruptcy Court for the District of Maryland (the "Bankruptcy Court"). Our Chapter 11 cases (the "Chapter 11 Cases") are being jointly administered under the case Novation Companies, Inc., et al, No. 16-19745-DER. We will continue to operate our businesses as “debtors-in-possession” under the jurisdiction of the Bankruptcy Court and in accordance with the applicable provisions of the Bankruptcy Code and orders of the Bankruptcy Court. Beginning with the quarterly period ended September 30, 2016, the Company accounts for the bankruptcy in accordance with the FASB ASC 852, “Reorganizations”. Under the Bankruptcy Code, we have the exclusive right to file a plan of reorganization under Chapter 11 through and including November 17, 2016, and to solicit acceptances of such plan through January 16, 2016. On October 19, 2016, the Company filed a motion to extend their exclusive right to file a plan(s) for an additional 90 days, through and including February 15, 2017 and solicit acceptances thereof through and including April 17, 2017, subject to the right to seek further extensions. The UCC filed an objection to the motion to extend the exclusive periods. At a hearing held on November 9, 2016, the Bankruptcy Court granted the Company’s motion and extended the exclusive periods for an additional ninety days.

Pursuant to orders granted by the Bankruptcy Court, we obtained approval to, among other things, pay employee wages and benefits and continue with its existing cash management practices. The Company is able to conduct normal business activities and pay all associated obligations for the period following its bankruptcy filing, and is also authorized to pay and has paid pre-petition employee wages and benefits. During the Chapter 11 Cases, all transactions outside the ordinary course of business require the prior approval of the Bankruptcy Court.

For the duration of our Chapter 11 Cases, our operations and ability to develop and execute our business plan are subject to the risks and uncertainties associated with the Chapter 11 process. For example, negative events associated with
our Chapter 11 Cases could adversely affect our relationships with our service providers and other third parties and our ability to retain employees, which in turn could adversely affect our operations and financial condition. For a description of these and other risks, please see Part II, Item 1A. “Risk Factors.” As a result of these risks and uncertainties, the number of our outstanding shares and shareholders, assets, liabilities, officers and directors could be significantly different following the outcome of the Chapter 11 Cases, and the description of our operations, assets and plans included in this quarterly report may not accurately reflect our operations, assets and plans following the Chapter 11 process. The significant recent events surrounding the Bankruptcy Petitions raise significant doubts about our ability to continue as a going concern. If we cannot continue as a going concern, adjustments to the carrying values and classification of our assets and liabilities and our reported income and expenses could be required and could be material.

As discussed in Notes 1 and 7 to the condensed consolidated financial statements and in the Liquidity and Capital Resources section of this MD&A, the Company did not make the quarterly Senior Notes interest payments due on March 30, June 30 and September 30, 2016, totaling $2.7 million. These interest payments were not made within 30 days after they became due and payable, and remain unpaid, such non-payment constituting events of default under the Indentures. As a result, the Senior Notes have been classified as current liabilities in the September 30, 2016 balance sheet. On May 9, 2016, the Company received a notice of acceleration with respect to the Series 1 Senior Notes and the Series 2 Senior Notes, declaring all principal and unpaid interest immediately due and payable. A similar acceleration notice was received on June 6, 2016 with respect to the Series 3 Senior Notes. See “Liquidity and Capital Resources” below for additional discussion regarding the implications of default and acceleration under the Senior Notes.

Corvisa Sale

On December 21, 2015, the Company entered into a Membership Interest Purchase Agreement (the "Purchase Agreement") with ShoreTel, Inc. ("ShoreTel"), pursuant to which ShoreTel agreed to purchase all of the membership interests of Corvisa LLC ("Corvisa") from Corvisa Services LLC, a wholly-owned subsidiary of the Company, subject to the terms and conditions of the Purchase Agreement. This transaction closed on January 6, 2016. Additional details of this and related transactions are discussed in Note 4 to the condensed consolidated financial statements.

Corporate Overview
Our Business
The Company is continuing its strategy of seeking to acquire operating businesses or making other investments that generate taxable earnings. As part of its efforts to identify acquisition or investment targets, the Company may nominate individuals to public company board of directors as a way to fully evaluate these potential targets. As of the date the financial statements included in this report the Company has not yet identified any specific acquisition targets.

The key performance measures for executive management are:

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- maintaining and/or generating adequate liquidity to sustain us and allow us to take advantage of acquisition opportunities, and
- generating taxable income and long-term value for our shareholders.

The following key performance metrics are derived from our consolidated financial statements for the periods presented and should be read in conjunction with the more detailed information therein and with the disclosure included in this report under the heading "Management's Discussion and Analysis of Financial Condition and Results of Operations."

Table 1 – Summary of Financial Highlights and Key Performance Metrics (dollars in thousands; except per share amounts)

	September 30, 2016	December 31, 2015
Cash and cash equivalents	$ 14,917	$ 2,826
Marketable securities	18,190	18,897

	For the Nine Months Ended September 30, 2016	2015
Net income (loss) available to common shareholders, per diluted share	$ 0.01	$ (0.23)

Critical Accounting Policies

In our 2015 Form 10-K, we disclose critical accounting policies that require management to use significant judgment or that require significant estimates. Management regularly reviews the selection and application of our critical accounting policies. Other than as discussed below and in Note 3 to the condensed consolidated financial statements, there have been no updates to the critical accounting policies contained in the 2015 Form 10-K.

Recently Issued Accounting Pronouncements that May Impact Our Financial Statements

On August 26, 2016, the FASB issued ASU 2016-15, which amends the guidance in ASC 230 on the classification of certain cash receipts and payments in the statement of cash flows. The primary purpose of the ASU is to reduce the diversity in practice that has resulted from the lack of consistent principles on this topic. The ASU's amendments add or clarify guidance on eight cash flow issues:

- Debt prepayment or debt extinguishment costs.
- Settlement of zero-coupon debt instruments or other debt instruments with coupon interest rates that are insignificant in relation to the effective interest rate of the borrowing.
- Contingent consideration payments made after a business combination.
- Proceeds from the settlement of insurance claims.
- Proceeds from the settlement of corporate-owned life insurance policies, including bank-owned life insurance policies.
- Distributions received from equity method investees.
- Beneficial interests in securitization transactions.
- Separately identifiable cash flows and application of the predominance principle.

For the Company, the new standard is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017. Management has not determined if this guidance will have a significant impact on its financial statements.

In February 2016, the FASB issued ASU 2016-02 Leases, a new standard on accounting for leases. ASU 2016-02 introduces a lessee model that brings most leases on the balance sheet. The new standard also aligns many of the underlying principles of the new lessor model with those in ASC 606, the FASB's new revenue recognition standard (e.g., those related to evaluating when profit can be recognized). Furthermore, this ASU addresses other concerns related to the current leases model. For example, this ASU eliminates the requirement in current GAAP for an entity to use bright-line tests in determining lease classification. The standard also requires lessors to increase the transparency of their exposure to changes in value of their residual assets and how they manage that exposure. The new model represents a wholesale change to lease accounting. As a result, entities will face significant implementation challenges during the transition period and beyond, such as those related to:

- Applying judgment and estimating.
- Managing the complexities of data collection, storage, and maintenance.
- Enhancing information technology systems to ensure their ability to perform the calculations necessary for compliance with reporting requirements.
- Refining internal controls and other business processes related to leases.

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- Determining whether debt covenants are likely to be affected and, if so, working with lenders to avoid violations; and
- Addressing any income tax implications.

For the Company, the new standard is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. Management has not determined if this guidance will have a significant impact on its financial statements.

On January 5, 2016, the FASB issued ASU 2016-01 Recognition and Measurement of Financial Assets and Financial Liabilities, which amends the guidance in U.S. GAAP on the classification and measurement of financial instruments. Although this ASU retains many current requirements, it significantly revises an entity’s accounting related to (1) the classification and measurement of investments in equity securities and (2) the presentation of certain fair value changes for financial liabilities measured at fair value. This ASU also amends certain disclosure requirements associated with the fair value of financial instruments. For Novation, the new standard is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017. Management has not determined if this guidance will have a significant impact on its financial statements.

Results of Operations

Interest Income – Mortgage Securities

Interest income on the mortgage securities decreased to approximately $3.6 million during the nine months ended September 30, 2016 compared to $4.6 million during the nine months ended September 30, 2015. Interest income on the mortgage securities was unchanged at $1.4 million during the three months ended September 30, 2016 and 2015. Fluctuations in the interest income received from our mortgage portfolio are typically due to factors beyond the Company's control, such as the performance of the underlying loan collateral, prepayment speeds, interest rates, etc. The Company expects interest income and cash flow from its mortgage securities to decline as the principal on the underlying loan collateral is paid, written down, or written off.

General and Administrative

General and administrative expenses consist of salaries, office costs, legal and professional expenses and other customary costs of corporate administration. Because of the recent divestitures (see Note 4 to the condensed consolidated financial statements) and given that our operations have been significantly reduced, management has been able to significantly reduce the amount of general and administrative expenses. The future amount of general and administrative expenses will depend largely on corporate activities, professional fees associated with those activities and staffing needs based on the evolving business strategy. However, management expects these expenses to generally remain low and to decrease for the foreseeable future.

Other Income

During the first quarter of 2016, the Company used available cash to acquire various equity and fixed income securities as part of its strategy to generate taxable earnings. Other income for the three and nine months ended September 30, 2016 consists primarily of the interest, dividend, and other income received from these securities. Fluctuations in the income received from these securities are generally beyond the Company's control. Other income was not material for the three and nine months ended September 30, 2015.

Interest Expense

As discussed in Note 7 to the condensed consolidated financial statements, the Company discontinued accruing interest on the Senior Notes as the notes are subject to the reorganization process. As a result, interest expense was $1.9 million during the nine months ended September 30, 2016 and $2.4 million for the same period in 2015. Similarly, interest expense was significantly lower when comparing the three month periods ended September 30, 2016 and 2015 at $0.2 million and $0.8 million, respectively.

Income Tax Expense

The income tax expense was not material for any period presented.

Liquidity and Capital Resources

As of September 30, 2016, the Company had approximately $14.9 million in unrestricted cash and cash equivalents and $0.2 million of restricted cash, portions of which are included in the other current assets and other assets line items on the condensed consolidated balance sheet. In addition, the Company held approximately $18.2 million in marketable securities, which consist of $0.8 million in corporate notes and bonds with a weighted average remaining maturity of 19 months as of September 30, 2016, $15.9 million of equity securities and $1.5 million in mortgage securities, which contributed approximately $3.7 million in cash flows during the nine months ended September 30, 2016. The Company's marketable securities are classified as available-for-sale as of September 30, 2016 and are included in the current and non-current marketable securities line items on the condensed consolidated balance sheet as of September 30, 2016. For additional information regarding the Company's marketable securities, see the condensed consolidated statements of cash flow and Note 5 to the condensed consolidated financial statements. The Company's ongoing contractual obligations consist primarily of the Senior Notes (as defined below) and obligations under its operating lease agreements.

The Company has outstanding three series of unsecured senior notes (collectively, the "Senior Notes") pursuant to three separate indentures (collectively, the "Indentures") with an aggregate principal balance of $85.9 million. The Senior Notes accrued interest at a rate of 1.0% per annum until January 1, 2016 and since then have accrued interest at a rate of three-month LIBOR plus 3.5% per annum (the “Full Rate”). Interest on the Senior Notes was payable on a quarterly basis and no principal payments were due until maturity on March 30, 2033.

The Company's available cash and other liquid assets are not sufficient to meet the demands of the holders of the Senior Notes. These factors raise substantial doubt about the Company’s ability to continue as a going concern. As discussed
in “Reorganization” above and in Note 2 to the condensed consolidated financial statements, the Company filed for reorganization under the Bankruptcy Code in the Bankruptcy Court. As discussed in Notes 1 and 7 to the condensed consolidated financial statements, the Company did not make the quarterly interest payments due on March 30, June 30, 2016, and September 30, 2016 totaling $2.7 million, as required under the Senior Notes and related Indentures. These interest payments were not made within 30 days after they became due and payable, and remain unpaid, such non-payments constituting events of default under the Indentures. The trustee under any Indenture or the holders of not less than 25% of the aggregate principal amount of the outstanding Senior Notes issued pursuant to such Indenture, by notice in writing to the Company (and to the trustee if given by the holders), may declare the principal amount of all the Senior Notes issued under such Indenture to be due and payable immediately. On May 9, 2016, the Company received a notice of acceleration with respect to the Series 1 Senior Notes and the Series 2 Senior Notes, declaring all principal and unpaid interest immediately due and payable. A similar acceleration notice was received on June 6, 2016 with respect to the Series 3 Senior Notes. The aggregate outstanding principal under the Senior Notes is $85.9 million and the aggregate recorded unpaid interest is $2.0 million. The principal and recorded unpaid interest are classified as liabilities subject to compromise in the Company's condensed consolidated balance sheet.

The Indentures contain certain restrictive covenants (the “Negative Covenants”) subject to certain exceptions in the Indentures, including written consent of the holders of the Senior Notes. The Negative Covenants prohibit the Company and its subsidiaries, from among other things, incurring debt, permitting any lien upon any of its property or assets, making any cash dividend or distribution or liquidation payment, acquiring shares of the Company or its subsidiaries, making payment on debt securities of the Company that rank pari passu or junior to the Senior Notes, or disposing of any equity interest in certain subsidiaries or all or substantially all of the assets of certain subsidiaries unless certain conditions are met. The Negative Covenants remain in effect until the Company satisfies certain financial covenants (the “Financial Covenants”). Satisfaction of the Financial Covenants requires the Company to demonstrate on a consolidated basis that (1) its Tangible Net Worth is equal to or greater than $40 million, and (2) either (a) the Interest Coverage Ratio is equal to or greater than 1.35x, or (b) the Leverage Ratio is not greater than 95% (each such term as defined in the Indentures). The Negative Covenants, as defined above, were in effect as of September 30, 2016 and December 31, 2015. Compliance with the Financial Covenants is required only when the Company seeks to take action prohibited by the Negative Covenants that has not been approved by the holders of the Senior Notes.

With respect to the Company's recent divestiture activity, which is discussed further in Note 4 to the condensed consolidated financial statements, the sale of a subsidiary is not prohibited by the Negative Covenants provided that the sale is at fair market value and the proceeds are reinvested in the Company. The Company was in compliance with all Negative Covenants as of September 30, 2016.

As discussed in Note 8 to the condensed consolidated financial statements, the Company is also the subject of various legal proceedings, the outcomes of which are uncertain. We may also face demands in the future that are unknown to us today related to our legacy lending and servicing operations.

Based on current projections, the Company believes its existing liquid assets, as described above, and the ongoing cash flows from its mortgage securities portfolio will be sufficient to meet normal operating cash needs, which exclude the demands of the holders of the Senior Notes discussed above.

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Overview of Cash Flow for the Nine Months Ended September 30, 2016
The following table provides a summary of our operating, investing and financing cash flows as taken from our condensed consolidated statements of cash flows for the nine months ended September 30, 2016 and 2015.

Table 3 – Summary of Operating, Investing and Financing Cash Flows (dollars in thousands)

	For the Nine Months Ended September 30,	
	2016	2015
Consolidated Statements of Cash Flows:		
Cash used in operating activities	$(947)	$(18,680)
Cash flows provided by investing activities	12,882	17,707
Cash flows used in financing activities of continuing operations	—	(189)

Operating Activities
The decrease in net cash flows used in operating activities to $0.9 million during the nine months ended September 30, 2016 from 18.3 million during the nine months ended September 30, 2016 was driven by the sale of Corvisa, which dramatically decreased the Company's net loss and operating cash requirements.

Investing Activities
The decrease in the net cash flows provided by investing activities is due primarily to proceeds from the sale of Corvisa and an increase in proceeds from the sale or maturity of marketable securities, which was offset by an increase in purchases of marketable securities.

Financing Activities
Cash flows used in financing activities were not significant for any period presented.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Not applicable.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures
The Company maintains a system of disclosure controls and procedures that are designed to ensure that information required to be disclosed by the Company in reports that it files or submits under the federal securities laws, including this report, is recorded, processed, summarized and reported, within the time periods specified in the applicable rules and forms, and that it is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

The Company's principal executive officer and principal financial officer evaluated the effectiveness of the Company's disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(d)) as of the end of the period covered by this report and, based on such evaluation, concluded that the Company's disclosure controls and procedures were effective as of such date.

Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting during the quarter ended September 30, 2016 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings

On May 21, 2008, a purported class action case was filed in the Supreme Court of the State of New York, New York County, by the New Jersey Carpenters' Health Fund, on behalf of itself and all others similarly situated. Defendants in the case included NovaStar Mortgage Funding Corporation (“NMFC”), a wholly-owned subsidiary of the Company, and its individual directors, several securitization trusts sponsored by the Company (“affiliated defendants”) and several unaffiliated investment banks and credit rating agencies. The case was removed to the United States District Court for the Southern District of New York. On June 16, 2009, the plaintiff filed an amended complaint. The plaintiff seeks monetary damages, alleging that the defendants violated sections 11, 12 and 15 of the Securities Act of 1933, as amended, by making allegedly false statements regarding mortgage loans that served as collateral for securities purchased by the plaintiff and the purported class members. On August 31, 2009, the Company filed a motion to dismiss the plaintiff's claims, which the court granted on March 31, 2011, with leave to amend. The plaintiff filed a second amended complaint on May 16, 2011, and the Company again filed a motion to dismiss. On March 29, 2012, the court dismissed the plaintiff's second amended complaint with prejudice and without leave to replead. The plaintiff filed an appeal. On March 1, 2013, the appellate court reversed the judgment of the lower court, which had dismissed the case. Also, the appellate court vacated the judgment of the lower court which had held that the plaintiff lacked standing, even as a class representative, to sue on behalf of investors in securities in which plaintiff had not invested, and the appellate court remanded the case back to the lower court for further proceedings. On April 23, 2013 the plaintiff filed its memorandum with the lower court seeking a reconsideration of the earlier dismissal of plaintiff's claims as to five offerings in which plaintiff was not invested, and on February 5, 2015 the lower court granted plaintiff's motion for reconsideration and vacated its earlier dismissal. Given the stage of the litigation, the Company cannot provide an estimate of the range of any loss. The Company believes that the affiliated defendants have meritorious defenses to the case and expects them to defend the case vigorously.

On June 20, 2011, the National Credit Union Administration Board, as liquidating agent of U.S. Central Federal Credit Union, filed an action against NMFC and numerous other defendants in the United States District Court for the District of Kansas, claiming that the defendants issued or underwrote residential mortgage-backed securities pursuant to allegedly false or misleading registration statements, prospectuses, and/or prospectus supplements. On August 24, 2012, the plaintiff filed an amended complaint making essentially the same claims against NMFC. NMFC filed a motion to dismiss the amended complaint which was denied on September 12, 2013. The defendants had claimed that the case should be dismissed based upon a statute of limitations and sought an appeal of the court's denial of this defense. An interlocutory appeal of this issue was allowed, and on August 27, 2013, the Tenth Circuit affirmed the lower court’s denial of defendants’ motion to dismiss the plaintiff’s claims as being time barred; the appellate court held that the Extender Statute, 12 U.S.C. §1787(b)(14) applied to plaintiff’s claims. On June 16, 2014, the United States Supreme Court granted a petition of NMFC and its co-defendants for certiorari, vacated the ruling of the Tenth Circuit, and remanded the case back to that court for further consideration in light of the Supreme Court’s decision in CTS Corp. v. Waldburger, 134 S. Ct. 2175 (2014). On August 19, 2014, the Tenth Circuit reaffirmed its prior decision, and on October 2, 2014 the defendants filed a petition for writ of certiorari with the Supreme Court, which was denied. On March 22, 2016, NMFC filed motions for summary judgment and plaintiff filed a motion for partial summary judgment. Those motions remain pending. Given the stage of the litigation, the Company cannot provide an estimate of the range of any loss. The Company believes that NMFC has meritorious defenses to the case and expects it to defend the case vigorously.

On February 28, 2013, the Federal Housing Finance Agency, as conservator for the Federal Home Loan Mortgage Corporation (Freddie Mac) and on behalf of the Trustee of the NovaStar Mortgage Funding Trust, Series 2007-1 (the “Trust”), a securitization trust in which the Company retains a residual interest, filed a summons with notice in the

Supreme Court of the State of New York, County of New York against the Company and NovaStar Mortgage, Inc. ("NMI"), a wholly-owned subsidiary of the Company. The notice provides that this is a breach of contract action with respect to certain, unspecified mortgage loans and defendant's failure to repurchase such loans under the applicable agreements. Plaintiff alleges that defendants, from the closing date of the transaction that created the Trust, were aware of the breach of the representations and warranties made and failed to notice and cure such breaches, and due to the failure of defendants to cure any breach, notice to defendants would have been futile. The summons with notice was not served until June 28, 2013. By letter dated June 24, 2013, the Trustee of the Trust forwarded a notice from Freddie Mac alleging breaches of representations and warranties with respect to 43 loans, as more fully set forth in included documentation. The 43 loans had an aggregate, original principal balance of about $6.5 million. On August 19, 2013, Deutsche Bank National Trust Company, as Trustee, filed a complaint identifying alleged breaches of representations and warranties with respect to seven loans that were included in the earlier list of 43 loans. Plaintiff also generally alleged a trust-wide breach of representations and warranties by defendants with respect to loans sold and transferred to the trust. Plaintiff seeks specific performance of repurchase obligations; compensatory, consequential, recessionary and equitable damages for breach of contract; specific performance and damages for anticipatory breach of contract; and indemnification (indemnification against NMI only). On October 9, 2013, the Company and NMI filed a motion to dismiss plaintiff's complaint. This motion to dismiss was withdrawn after plaintiff filed an amended complaint on January 28, 2014, and on March 4, 2014 the Company and NMI filed a motion to dismiss the amended complaint. That motion remains pending. Given the stage of the litigation, the Company cannot provide an estimate of the range of any loss. The Company believes that it has meritorious defenses to the case and expects to defend the case vigorously.

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Item 1A. Risk Factors

The following risk factors supplement those included in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2015, as filed with the SEC on February 16, 2016.

Non-payment of interest on outstanding unsecured senior notes has resulted in events of default under their governing indentures and our obligations under certain of these senior notes have been accelerated.

As of September 30, 2016, the Company had outstanding $85.9 million aggregate principal balance of its Senior Notes. The Company did not make the quarterly interest payments on the Senior Notes due on March 30, June 30 and September 30, 2016, totaling approximately $2.7 million. These interest payments were not made within 30 days after they became due and payable, and remain unpaid, such non-payment constituting events of default under the Indentures. The trustee under any Indenture or the holders of not less than 25% of the aggregate principal amount of the outstanding Senior Notes issued pursuant to such Indenture, by notice in writing to the Company (and to the trustee if given by the holders), may declare the principal amount of all the Senior Notes issued under such Indentures to be due and payable immediately. On May 9, 2016, the Company received a notice of acceleration with respect to the Accelerated Notes, declaring all principal and unpaid interest immediately due and payable. A similar acceleration notice was received on June 6, 2016 with respect to the Series 3 Senior Notes. Management will actively pursue negotiation with the holders to modify or restructure the Senior Notes. However, there can be no assurance that negotiations will be successful and if the Company is not successful in such negotiations it will result in a material adverse effect on our financial condition.

We are subject to risks and uncertainties associated with our Chapter 11 proceedings.

For the duration of our Chapter 11 proceedings, our operations and our ability to develop and execute our business strategy, and our continuation as a going concern are subject to the risks and uncertainties associated with bankruptcy. These risks include the following:

- Our ability to develop, confirm and consummate a Chapter 11 plan or other restructuring transaction;

- Our ability to obtain court approval with respect to Chapter 11 proceedings from time to time;

- Our ability to maintain our relationships with our suppliers, service providers, employees, and other third parties;

- Our ability to execute on our strategy of acquiring operating businesses or make other investments that generate taxable earnings;

- The ability of third parties to seek and obtain court approval to terminate contracts and other agreements with us;

- The ability of third parties to seek and obtain court approval to terminate or shorten the exclusivity period for us to propose and confirm a Chapter 11 plan, to appoint a Chapter 11 trustee, or to convert the Chapter 11 proceedings to a Chapter 7 proceeding; and

- The actions and decisions of our creditors or other third parties who have interests in our Chapter 11 proceedings that may be inconsistent with our plans.

These risks and uncertainties could affect our business and operations in various ways. For example, negative events associated with our Chapter 11 proceedings could adversely affect our relationships with our employees and other third parties, which in turn could adversely affect our operations and financial condition. Also, we need the prior approval of the Bankruptcy Court for transactions outside the ordinary course of business, which may limit our ability to respond timely to certain events or take advantage of certain opportunities, including to execute on our strategy of acquiring operating businesses or make other investments that generate taxable earnings. Because of the risks and uncertainties associated with our Chapter 11 proceedings, we cannot accurately predict or quantify the ultimate impact of events which could occur during our Chapter 11 proceedings that may be inconsistent with our plans.

Operating under Bankruptcy Court protection for a long period of time may harm our business.

Our future results are dependent upon the successful confirmation and implementation of a plan of reorganization. A long period of operations under Bankruptcy Court protection could have a material adverse effect on our business, results of operations and liquidity. So long as the proceedings related to the Chapter 11 proceedings continue, our Board and management will be required to spend a significant amount of time and effort dealing with the reorganization instead of focusing exclusively on our business operations. A prolonged period of operating under Bankruptcy Court protection also may make it more difficult to retain management and other personnel necessary to the success our business.

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So long as the proceedings related to the Chapter 11 proceedings continue, we will be required to incur substantial costs for professional fees and other expenses associated with the administration of the Chapter 11 proceeding. If we are unable to fund these expenses, our chances of successfully reorganizing our business may be seriously jeopardized, the likelihood that we instead will be required to liquidate our assets may be enhanced, and, as a result, any securities in the Debtor could become further devalued or become worthless.

We cannot predict the ultimate amount of all settlement terms for the liabilities that will be subject to a plan of reorganization. Even once a plan of reorganization is approved and implemented, our operating results may be adversely affected by the possible reluctance of prospective lenders and other counterparties to do business with a company that recently emerged from Chapter 11 proceedings.

Due to our Chapter 11 proceedings, our outstanding shares of common stock may be canceled and holders of our common stock may not be entitled to any payment in respect of their shares.

As a result of our Chapter 11 Cases, all of our outstanding shares of common stock may be canceled and holders of our common stock may not be entitled to any payment in respect of their shares. In addition, certain of our obligations to certain of our creditors may be satisfied by the issuance of shares of common stock in satisfaction of their claims. The value of any common stock so issued may be less than the face value of our obligations to those creditors and, if our common stock remains traded on an over-the-counter market, its price may be volatile. We would expect trading in our common stock to be limited, and our shareholders may not be able to resell our common stock for their purchase price or at all. Furthermore, our current shareholders may receive no continuing interest in us once we emerge from Chapter 11.

We may not be able to obtain confirmation of a Chapter 11 plan of reorganization.

To emerge successfully from Bankruptcy Court protection as a viable entity, we must meet certain statutory requirements with respect to adequacy of disclosure with respect to a Chapter 11 plan of reorganization (the “Plan”), solicit and obtain the requisite acceptances of such a Plan and fulfill other statutory conditions for confirmation of such a Plan, which have not occurred to date. The confirmation process is subject to numerous unanticipated potential delays, including a delay in the Bankruptcy Court’s commencement of the confirmation hearing regarding our Plan. If a Plan is not confirmed by the Bankruptcy Court, it is unclear whether we would be able to reorganize our business and what, if anything, holders of claims against us would ultimately receive with respect to their claims.

We face uncertainty regarding the adequacy of our liquidity and capital resources.

In addition to the cash requirements necessary to fund ongoing operations, we have incurred, and will continue to incur, significant professional fees and costs throughout our Chapter 11 proceedings. We cannot assure you that cash on hand and cash flow from operations will be sufficient to continue to fund our operations and allow us to satisfy our obligations related to Chapter 11 cases until we are able to emerge from our Chapter 11 proceedings.

Our liquidity, including our ability to meet our ongoing operation obligations, is dependent upon, among other things; (i) our ability to comply with the terms and conclusion of any cash collateral order entered by the Bankruptcy Court in connection with the Chapter 11 proceedings, (ii) our ability to maintain adequate cash on hand, (iii) our ability to generate cash flow from operations, (iv) our ability to develop, confirm and consummate a Chapter 11 plan or other alternative restructuring transaction, and (v) the cost, duration and outcome of the Chapter 11 proceedings. Our ability to maintain adequate liquidity depends in part upon industry conditions and general economic, financial, competitive, regulatory and other factors beyond our control. Our liquidity requirements and the adequacy of our capital resources are difficult to predict at this time.

In certain instances, a Chapter 11 case may be converted to a case under Chapter 7 of the Bankruptcy Code.

If the Bankruptcy Court finds that it would be in the best interest of creditors and/or the Debtors, the Bankruptcy Court may convert our Chapter 11 bankruptcy case to a case under Chapter 7 of the Bankruptcy Code. In such event, a Chapter 7 trustee would be appointed or elected to liquidate our assets for distribution in accordance with the priorities established by the Bankruptcy Code. We believe that liquidation under Chapter 7 would result in a significantly smaller distributions being made to our creditors than those provided for in a Chapter 11 plan because of (i) the likelihood that the assets would have to be sold or otherwise disposed of in a disorderly fashion over a short period of time rather than reorganizing or selling in a controlled manner our businesses as a going concern, (ii) additional administrative expenses involved in the appointment of a Chapter 7 trustee, and (iii) additional expenses and claims, some of which would be entitled to priority, that would be generated during the liquidation and from the rejection of leases and other executory contracts in connection with cessation of operations.

We may be subject to claims that will not be discharged in the Chapter 11 proceedings, which could have a material adverse effect on our financial condition and results or operations.

The Bankruptcy Code provides that the confirmation of a plan of reorganization discharges a debtor from substantially all debts arising prior to confirmation. With few exceptions, all claims that arose prior to July 20, 2016 or before confirmation of

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the plan of reorganization (i) would be subject to compromise and/or treatment under the plan of reorganization and/or (ii) would be discharged in accordance with the terms of the plan of reorganization. Any claims not ultimately discharged through a plan of reorganization could be asserted against the reorganized entities and may have an adverse effect on our financial condition and results of operations on a post-reorganization basis.

Our financial results may be volatile and may not reflect historical trends.

During the Chapter 11 proceedings, we expect our financial results to continue to be volatile as asset impairments, asset dispositions, restructuring activities and expenses, contract terminations and rejections, and claims assessments significantly impact our consolidated financial statements. As a result, our historical financial performance is likely not indicative of our financial performance after the date of the bankruptcy filing.

Transfers of our equity, or issuances of equity in connection with our Chapter 11 proceedings, may impair our ability to utilize our federal income tax net operating loss carryforwards in future years.

Under federal income tax law, a corporation is generally permitted to deduct from taxable income net operating losses carried forward from prior years. Our ability to utilize our net operating loss carryforwards to offset future taxable income and to reduce federal income tax liability is subject to certain requirements and restrictions. If we experience an “ownership change,” as defined in section 382 of the Internal Revenue Code (the "Code"), then our ability to use our net operating loss carryforwards may be substantially limited, which could have a negative impact on our financial position and results of operations. Generally, there is an “ownership change” if one or more shareholders owning 5% or more of a corporation’s common stock have aggregate increases in their ownership of such stock of more than 50 percentage points over the prior three-year period. Following the implementation of a plan of reorganization, it is possible that an “ownership change” may be deemed to occur. Under section 382 of the Code, absent an applicable exception, if a corporation undergoes an “ownership change,” the amount of its net operating losses that may be utilized to offset future taxable income generally is subject to an annual limitation. Even if the net operating loss carryforwards is subject to limitation under Section 382, the net operating losses can be reduced from the amount of discharge of indebtedness arising in a Chapter 11 case under Section 108 of the Code.

Loss of additional personnel could adversely affect our operations.

Execution of our strategy and maintenance of our existing business is dependent on a small group of employees. Our recent liquidity issues and our Chapter 11 proceedings have created distractions and uncertainty for our employees. As a result, we may experience increased levels of employee attrition. Loss of personnel could have a material adverse effect on our ability to meet regulatory and other administrative requirements, thereby adversely affecting our business and results of operations.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds
None.

Item 3. Defaults Upon Senior Securities
See the "Liquidity and Capital Resources" section of the MD&A above for a detailed discussion of events of default under the Senior Notes and related Indentures.

Item 4. Mine Safety Disclosures

None.

Item 5. Other Information

None.

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Item 6. Exhibits

Exhibit No.	Description of Document
31.1	Chief Executive Officer and Chief Financial Officer Certification filed pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Chief Executive Officer and Chief Financial Officer Certification furnished pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101	The following financial information from Novation Companies, Inc.'s Quarterly Report on Form 10-Q for the quarter ended September 30, 2016, formatted in XBRL (Extensible Business Reporting Language) includes: (i) Condensed Consolidated Balance Sheets as of September 30, 2016 and December 31, 2015, (ii) Condensed Consolidated Statements of Operations for the three and nine months ended September 30, 2016 and 2015, (iii) Condensed Consolidated Statements of Comprehensive Income for the three and nine months ended September 30, 2016 and 2015, (iv) Condensed Consolidated Statements of Shareholders' Deficit for the three and nine months ended September 30, 2016 and 2015, (v) Condensed Consolidated Statements of Cash Flows for the nine months ended September 30, 2016 and 2015, and (vi) the Notes to Condensed Consolidated Financial Statements.

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SIGNATURES

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

		NOVATION COMPANIES, INC.
DATE:	November 14, 2016	/s/ Rodney E. Schwatken Rodney E. Schwatken, Chief Executive Officer and Chief Financial Officer (Principal Executive and Financial Officer)

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