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NOVASTAR FINANCIAL INC
Form 8-K
July 20, 2007

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 8-K

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

July 16, 2007
Date of Report (Date of earliest event reported)

NOVASTAR FINANCIAL, INC.
(Exact name of registrant as specified in its charter)

| | | |
|---|-----------------------------|---|
| Maryland | 001-13533 | 74-2830661 |
| ----- | ----- | ----- |
| (State or other jurisdiction of incorporation or organization) | (Commission File Number) | (I.R.S. Employer Identification No.) |

8140 Ward Parkway, Suite 300, Kansas City, MO 64114

(Address of principal executive offices)
(Zip Code)

(816) 237-7000

(Registrant's telephone number, including area code)

Not Applicable

(Former Name or Former Address, if Changed Since Last Report)

Check the appropriate box below if the Form 8-K filing is intended to simultaneously satisfy the filing obligation of the registrant under any of the following provisions (see General Instruction A.2. below):

- Written communications pursuant to Rule 425 under the Securities Act (17 CFR 230.425)
- Soliciting material pursuant to Rule 14a-12 under the Exchange Act (17 CFR 240.14a-12)
- Pre-commencement communications pursuant to Rule 14d-2(b) under the Exchange Act (17 CFR 240.14d-2(b))
- Pre-commencement communications pursuant to Rule 13e-4(c) under the Exchange Act (17 CFR 240.13e-4(c))

Section 1--Registrant's Business and Operations

Item 1.01 Entry into a Material Definitive Agreement.

Sale of Convertible Preferred Stock

On July 16, 2007, NovaStar Financial, Inc ("NFI" or the "Company") entered into a Securities Purchase Agreement (the "Securities Purchase Agreement") pursuant to which Massachusetts Mutual Life Insurance Company ("MassMutual"), Jefferies Capital Partners IV L.P., Jefferies Employee Partners IV LLC, and JCP Partners IV LLC (collectively, "Jefferies Capital Partners," and together with MassMutual, the "Investors"), purchased for \$48,825,000.00 in cash 2,100,000 shares of NFI's 9.00% Series D-1 Mandatory Convertible Preferred Stock, par value \$0.01 per share and initial liquidation preference of \$25.00 per share ("Series D-1 Preferred Stock") in a private placement not registered under the Securities Act of 1933, as amended (the "Securities Act"). NFI intends to use the proceeds from the sale of the Series D-1 Preferred Stock under the Securities Purchase Agreement for general working capital. Prior to the execution of the Securities Purchase Agreement, MassMutual, through certain of its affiliates, and certain affiliates of Jefferies Capital Partners, owned 771,800 shares and 224 shares of common stock of NFI, par value \$0.01 per share (the "Common Stock"), respectively.

In connection with the purchase of the Series D-1 Preferred Stock pursuant to the Securities Purchase Agreement, the Investors also committed to purchase up to \$101,175,000.00 of a new series of NFI's convertible preferred securities to be designated the 9.00% Series D-2 Mandatory Convertible Preferred Stock, par value \$0.01 per share and to have an initial liquidation preference of \$25.00 per share (the "Series D-2 Preferred Stock"), to the extent any such shares are not subscribed for in a planned rights offering of such shares by the Company by entering into a Standby Purchase Agreement with the Company dated July 16, 2007 (the "Standby Purchase Agreement"). Also in connection with the Securities Purchase Agreement, the Company entered into a Registration Rights and Shareholders Agreement dated July 16, 2007 (the "Registration Rights Agreement") with the Investors that provides the Investors with (i) customary registration rights with respect to certain shares owned by the Investors as described below; and (ii) certain other rights, including the right to designate Directors to the Company's Board of Directors as described below.

Securities Purchase Agreement

The Securities Purchase Agreement contains customary representations, warranties and covenants by NFI and the Investors. The Securities Purchase Agreement also obligates NFI to indemnify the Investors, and the Investors to indemnify NFI, for breaches of certain of the representations and warranties and covenants contained in the Securities Purchase Agreement, subject to certain limitations and exceptions set forth in the Securities Purchase Agreement.

As previously disclosed, NFI intends, in the third quarter of 2007, to declare a dividend (the "REIT Dividend") in order to satisfy certain requirements to distribute 2006 taxable income relating to its status as a "real estate investment trust" ("REIT") under the Internal Revenue Code of 1986, as amended (the "Code"). Timing of the declaration and distribution of the REIT Dividend will be determined by the Board of Directors, but federal tax rules for REITs require that the Company declare dividends based on 2006 taxable income by the deadline for its tax return, which is September 17, 2007, and distribute those dividends by year-end.

In the Securities Purchase Agreement, NFI has agreed (1) to declare the REIT Dividend on or before September 17, 2007, (2) that the record date for the REIT

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Dividend will not be before the earlier of (A) the date all of the shares of the Series D-2 Preferred Stock are purchased in the Rights Offering as described below or the first business day after the closing of the transactions contemplated by the Standby Purchase Agreement and (B) December 10, 2007 and (3) that the REIT Dividend will be distributed in the form of shares of 9% Series E Mandatory Convertible Preferred Stock, par value \$0.01 per share (the "Series E Preferred Stock"), ranking *pari passu* with the Series D-1 Preferred Stock and the Series D-2 Preferred Stock. The terms of the Series E Preferred Stock will be determined by NFI's Board of Directors.

The Securities Purchase Agreement also requires NFI to take all action required to amend its Charter, including submitting any such amendment to a vote of its stockholders, to prohibit any issuance or transfer of NFI's stock if such issuance or transfer would cause an "ownership change" (as such term is defined in Section 382(g) of the Code). The purpose of this amendment is to attempt to preserve under certain circumstances certain net operating loss carryovers and net unrealized built-in losses of NFI under the Code. In certain instances described below under the heading "Registration Rights and Shareholders Agreement," the Investors will be exempt from these transfer restrictions. In addition, NFI is required under the Securities Purchase Agreement to seek stockholder approval of certain provisions of the Articles Supplementary for both the Series D-1 Preferred Stock and the Series D-2 Preferred Stock, which would adjust the conversion price of the Series D-1 Preferred Stock and the Series D-2 Preferred Stock to provide certain anti-dilution protection to the holders thereof upon certain issuances of capital stock by NFI.

In order to facilitate the transactions contemplated by the Securities Purchase Agreement, NFI's Board of Directors approved a 4 for 1 reverse stock split of NFI's issued and outstanding shares of Common Stock, to be effective on or about July 27, 2007. The Board of Directors also exempted the Investors from the share ownership limitations contained in NFI's Charter in connection with the purchase by the Investors of the Series D-1 Preferred Stock pursuant to the Securities Purchase Agreement and the Series D-2 Preferred Stock in connection with the Rights Offering and the Standby Purchase Agreement and took action necessary to exempt the purchase of the Series D-1 Preferred Stock and the Series D-2 Preferred Stock (and the Common Stock issuable upon the conversion thereof) by the Investors from Section 3-602 of the Maryland General

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Corporation Law (Business Combination Statute) and Section 3-702 of the Maryland General Corporation Law (Control Share Acquisition Statute).

The foregoing is a summary of the terms of the Securities Purchase Agreement. This summary is qualified in its entirety by reference to the full text of the Securities Purchase Agreement which is attached hereto as Exhibit 10.1, and is incorporated herein by reference.

Standby Purchase Agreement and Rights Offering

In connection with the Securities Purchase Agreement, NFI's Board of Directors approved a rights offering (the "Rights Offering") pursuant to which holders of NFI's Common Stock and Series D-1 Preferred Stock will receive non-transferable rights (the "Rights") to purchase shares of the Series D-2 Preferred Stock at a price of \$25.00 per share. The Series D-2 Preferred Stock will be convertible into NFI's Common Stock as contemplated in the Securities Purchase Agreement. Pursuant to the Standby Purchase Agreement, and subject to certain conditions, each of MassMutual and Jefferies Capital Partners has agreed severally to purchase 50% of the shares of Series D-2 Preferred Stock that remain unsold in the Rights Offering.

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A Form of Articles Supplementary establishing the Series D-2 Preferred Stock is filed as an Exhibit to the Securities Purchase Agreement, which is attached hereto as Exhibit 10.1. Prior to the closing of the Rights Offering, NFI will file final Articles Supplementary with the Maryland State Department of Assessments and Taxation (the "SDAT") creating the Series D-2 Preferred Stock.

As contemplated in the Securities Purchase Agreement, the Series D-2 Preferred Stock will rank *pari passu* with the shares of Series D-1 Preferred Stock, and will be convertible into the Company's Common Stock at any time, at the option of the holders, based on the initial conversion price of \$7.00 per share (\$28.00 post-split), subject to adjustment in the same manner as the Series D-1 Preferred Stock. After three years, the Series D-2 Preferred Stock also would be convertible into Common Stock at NovaStar's option, under specified circumstances. At the end of nine years, if not already converted, the Series D-2 Preferred Stock would mandatorily be converted into shares of Common Stock at the then current conversion ratio. The Series D-2 Preferred Stock will accrue cumulative dividends at the rate of 9.0% per annum (payable in kind or in certain circumstances in cash). The Series D-2 Preferred Stock would initially be non-voting, but upon receipt of certain state regulatory agency approvals relating to the acquisition by the Investors of the Series D-1 Preferred Stock and the Series D-2 Preferred Stock, would have the same voting rights, on an "as-converted" basis, as holders of NFI's Common Stock.

Pursuant to the Securities Purchase Agreement, NFI has agreed to file with the Securities and Exchange Commission (the "SEC") a registration statement under the Securities Act with respect to the Rights, the Series D-2 Preferred Stock, and the Common Stock issuable upon the conversion of the Series D-2 Preferred Stock. NFI has agreed with the

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Investors to use its reasonable best efforts to cause such registration statement to become effective under the Securities Act and to commence the Rights Offering as promptly as possible, but in no event prior to the time that NFI files with the SEC its Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2007.

The Standby Purchase Agreement contains customary representations and covenants of NFI and the Investors. It also contains covenants requiring NFI to, among other things, make all filings with the SEC necessary to effectuate the Rights Offering, operate in the ordinary course of business until the closing of the purchase of shares by the Investors pursuant to the Standby Purchase Agreement and use its commercially reasonable efforts to obtain, with the Investor's cooperation, all necessary consents from third parties in connection with the transactions contemplated by the Standby Purchase Agreement.

The Investors' obligation to purchase the Series D-2 Preferred Stock under the Standby Purchase Agreement is subject to customary closing conditions, including, among other things, a registration statement with respect to the Rights Offering being effective; receipt of all necessary governmental approvals and third-party consents; NFI's Board of Directors having declared the REIT Dividend and having set the record date for determination of the stockholders of NFI entitled to receive payment of the REIT Dividend (which date will be on or prior to December 31, 2007 but not earlier than the first business day after the closing under the Standby Purchase Agreement); NFI having taken all actions necessary to increase the size of its Board of Directors so that the Investors are able to designate a number of directors as contemplated by the Registration Rights Agreement and having filled such vacancies with individuals designated by the Investors in accordance with the Registration Rights Agreement; since the

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date of the Standby Purchase Agreement, there not having been an "NFI Material Adverse Effect" (as defined below); and NFI having complied with the requirements of the New York Stock Exchange for purposes of reserving for listing on the exchange the shares of its Common Stock issuable upon conversion of the Series D-2 Preferred Stock, and such shares of its Common Stock having been approved for listing subject to official notice of issuance.

An "NFI Material Adverse Effect" is defined under the Standby Purchase Agreement to mean any event, change, circumstance or effect that individually or in the aggregate (with other events, changes, circumstances or effects) is or is reasonably likely to (A) be materially adverse to NFI's ability to perform its obligations under the Standby Purchase Agreement or the other transaction documents, or (B) be materially adverse on the financial condition, assets, liabilities, business or results of operations of NFI and its subsidiaries, taken as a whole (subject to certain exclusions only in the case of clause (B) for (i) events, changes, circumstances or effects relating to general economic or market conditions, so long as such conditions do not have a disproportionate effect on NFI and its subsidiaries, compared to other companies in the industries in which NFI and its subsidiaries conduct their business, (ii) certain extraordinary events such as acts of war, hostilities or natural disasters, (iii) decreases in the market value or trading volume of NFI's Common Stock on the New York Stock Exchange or failure by NFI or its subsidiaries to meet any projections, or budgets so long as, in the case of (iii), no

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underlying event or circumstance that itself constitutes such a material adverse effect has resulted in or contributed to such decrease in the market value or trading volume or such failure of any projections or budgets, and (iv) certain other exceptions).

NFI is required, subject to certain limitations, to indemnify the Investors from any claims instituted by a third party with respect to the Rights Offering, the Standby Purchase Agreement or the registration statement, prospectus or other offering documents issued in connection with the Rights Offering.

The Standby Purchase Agreement may be terminated and the transaction contemplated thereby abandoned (1) by the mutual consent of NFI and the Investors; (2) by either Investor or NFI if the other breaches any covenant, representation or warranty, which breach would cause the failure of certain conditions precedent to the closing of the transactions under the Standby Purchase Agreement, if such breach is not capable of cure on or prior to December 31, 2007; (3) by either Investor if NFI fails to satisfy any other conditions to the closing under the Standby Purchase Agreement and such failure cannot be cured on or prior to December 10, 2007; (4) by either Investor if any updates to NFI's disclosure schedules disclose any matter that has, or would be reasonably likely to have, an NFI Material Adverse Effect, (5) by either Investor if the Rights Offering has not commenced by October 25, 2007; (6) by either Investor if the record date for the REIT Dividend has occurred and/or the REIT Dividend has been paid; or (7) by NFI or either Investor after January 31, 2008 provided, that the right to terminate the Standby Purchase Agreement under clauses (3) and (7) will not be available to a party if that party has failed to fulfill any obligation under the Standby Purchase Agreement and such failure has materially contributed to the failure of any condition precedent or the closing of the standby commitment.

The foregoing is a summary of the terms of the Standby Purchase Agreement. This summary is qualified in its entirety by reference to the full text of the Standby Purchase Agreement which is attached hereto as Exhibit 10.2, and is incorporated herein by reference.

Registration Rights and Shareholders Agreement

Under the Registration Rights Agreement, the Investors have the right to request that NFI register under the Securities Act shares of Series D-1 Preferred Stock acquired under the Securities Purchase Agreement, shares of Series D-2 Preferred Stock acquired in the Rights Offering or pursuant to the Standby Purchase Agreement, if and when issued, shares of Series E Preferred Stock received in connection with the REIT Dividend, shares of Common Stock issuable upon conversion thereof, shares of Common Stock acquired by the Investors after the date of the Registration Rights Agreement, as well as other securities received by the Investors on account of such securities (collectively, the "Registrable Securities"), subject to certain limitations. This "demand" registration right can be exercised twice by each Investor. In addition, so long as NFI is eligible to register securities on a registration statement on Form S-3, NFI will be required to file a

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registration statement on Form S-3 with respect to the Registrable Securities whenever requested by the Investors subject to certain limitations.

Whenever NFI proposes to register any of its securities and the registration form it intends to use may be used for the resale of any of the Registrable Securities, the Investors have the right to include the Registrable Securities they own in such registration statement subject to certain limitations.

Generally, subject to certain limitations, NFI will pay all registration expenses in connection with registration statements to register the Registrable Securities. The Registration Rights Agreement also contains customary indemnities.

The Registration Rights Agreement also grants the Investors certain rights to designate up to four individuals for election to NFI's Board of Directors depending on the percentage of shares owned by the Investors. For so long as the Investors have the right to designate one or more individuals for election to NFI's Board of Directors, the Registration Rights Agreement provides that the total authorized number of members of the Board shall be fixed at eight, subject to adjustment as is necessary to ensure that the Investors can designate the number of directors that they are entitled to designate under the Registration Rights Agreement. Subject to applicable law and exchange regulations, each Investor is also entitled to designate the number of members of each committee of the Board that is proportionate to such Investor's representation on the Board. In lieu of designating members of the Board, the Investors have the right to designate "board observers" who will receive, subject to certain exceptions, all materials that are provided to Board members and will be entitled to attend, but not vote at, all Board meetings. In addition, each Investor shall be entitled to appoint up to two board observers who will be entitled to attend board meetings of NFI's subsidiaries.

The Registration Rights Agreement further provides that so long as any Investor owns at least 25% of the shares of Series D-1 Preferred Stock purchased pursuant to the Securities Purchase Agreement, the Investors have the right, in addition to any other voting rights granted under applicable law or the Charter or Bylaws of NFI, to approve (1) any Change of Control (as defined in the Registration Rights Agreement), any Liquidation Event (as defined in the Registration Rights Agreement) or any voluntary bankruptcy of NFI or its subsidiaries unless, in each case, the Investors receive certain amounts of proceeds in connection with such transactions as set forth in the Registration Rights Agreement; (2) subject to certain exceptions, including the consummation of the stock issuances

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contemplated under the transaction documents, the creation, authorization, or issuance of, or the increase in, the authorized amount of, any Series D-1 Preferred Stock, any Series D-2 Preferred Stock, or any series of capital stock that ranks *pari passu* with the Series D-1 Preferred Stock or Series D-2 Preferred Stock, or any capital stock of any subsidiary of NFI, or any obligation or security convertible into, or exercisable or exchangeable for, such stock; (3) any amendment of any terms of the Series D-1 Preferred Stock or the Series D-2 Preferred Stock; (4) any reclassification of any authorized shares of NFI into Series D-1 Preferred Stock, Series D-2 Preferred Stock, any securities that rank *pari passu* with the Series D-1 Preferred Stock or Series D-2 Preferred Stock or any obligation

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or security convertible into, or excisable for, such stock; (5) except as provided in the Registration Rights Agreement, any change in the number of, or method of electing, any directors or any members of any committee of the Board; (6) NFI's entering into or amending any transactions with any affiliates of NFI other than wholly owned subsidiaries that are not on an arms-length basis; and (7) the consummation of any transaction that could or could reasonably be expected to, individually or in the aggregate, adversely affect the rights, privileges or preferences of the Investors, as holders of NFI's shares of capital stock.

The Registration Rights Agreement provides that if there is a recapitalization of NFI's Common Stock (other than a subdivision, combination or merger or sale of assets transaction provided for elsewhere in the Registration Rights Agreement) a provision will be made so that the Investors will be entitled to receive upon conversion of any Convertible Shares (as defined below) the number of securities or property of NFI to which a holder of Common Stock deliverable upon conversion would have been entitled on such recapitalization. In any such case, appropriate adjustments are required to be made to the Convertible Shares and NFI's organizational documents relating to such Convertible Shares (including adjustments to the conversion price and the number of shares issuable upon the conversion of the Convertible Shares) so that after the recapitalization, the securities outstanding shall be as nearly equivalent as practical to the Convertible Shares immediately prior to such recapitalization. Further, the Registration Rights Agreement prohibits NFI from avoiding or seeking to avoid the observance or performance of any terms of the Registration Rights Agreement, the Articles Supplementary for the Series D-1 Preferred Stock or Articles Supplementary for the Series D-2 Preferred Stock and requires NFI at all times in good faith to assist in carrying out the provisions of the Registration Rights Agreement, the Articles Supplementary for the Series D-1 Preferred Stock and the Articles Supplementary for the Series D-2 Preferred Stock, and to take all action necessary to protect the Investors against dilution or other impairment.

In addition, for so long as each Investor owns 25% or more of the shares of Series D-1 Preferred Stock it purchased pursuant to the Securities Purchase Agreement, if NFI issues or sells any shares of Common Stock, Common Share Equivalents (as defined in the Registration Rights Agreement) or Debt Securities (as defined in the Registration Rights Agreement), the Investors shall have the preemptive right, subject to certain limitations, to purchase a number of such securities equal to the percentage of shares of Common Stock on a fully diluted basis owned by the Investors immediately prior to such sale.

In addition, upon a Change of Control (as defined in the Registration Rights Agreement), the Investors have the right to require NFI to redeem all or a portion of their Series D-1 Preferred Stock purchased pursuant to the Securities Purchase Agreement, the Series D-2 Preferred Stock purchased by the Investors in

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connection with the Rights Offering or the Standby Purchase Agreement or, if and when issued, any Series E Preferred Stock (collectively, the "Convertible Shares"), at a price equal to the greater of (1) the aggregate liquidation preference of the shares or (2) an amount equal to \$37.50, less all cash dividends paid on such shares, subject to adjustment in the event of a stock split or

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combination. In the event there shall occur a sale of all or substantially all of NFI's assets or any other Change of Control in which NFI is not the surviving entity, each Investor is entitled to receive securities of the acquiring entity in form and substance substantially similar to the Convertible Shares, to the extent it did not elect to have its Convertible Shares redeemed. In addition, prior to any Change of Control, NFI is required to ensure that after the Change of Control each Investor will have the right to acquire and receive such shares of stock, securities or assets that would have been issued or payable in such Change of Control with respect to the Common Stock issuable upon conversion of the Investor's Convertible Shares as of the date of the Change of Control.

The Articles Supplementary for the Series D-1 Preferred Stock and the Series D-2 Preferred Stock contain certain transfer restrictions intended to preserve NFI's status as a REIT and under certain circumstances certain net operating loss carryovers and net unrealized built-in losses for NFI under the Code. Under the Registration Rights Agreement, NFI's Board irrevocably waived certain of such transfer restrictions imposed (or to be imposed) on the Series D-1 Preferred Stock and the Series D-2 Preferred Stock by the Articles Supplementary for such series owned by the Investors or any of their respective affiliates so long as the Investors or any such affiliate did not know that a particular transfer would result in a substantial limitation on NFI's use of net operating loss carryovers and net unrealized built-in losses under the Code. The Board did not waive the transfer restrictions intended to preserve NFI's status as a REIT. In addition, the Board irrevocably waived certain of these transfer restrictions imposed (or to be imposed) by the Articles Supplementary for the Series D-1 Preferred Stock and the Series D-2 Preferred Stock with respect to Shares of Series D-1 Preferred Stock and Series D-2 Preferred Stock owned by the Investors or any of their respective affiliates in connection with transfers by the Investors or any of their respective affiliates (1) pursuant to a registered public offering or a sale through a broker, dealer or market-maker pursuant to Rule 144 promulgated under the Securities Act; (2) to affiliates of the Investors or any of their respective affiliates; (3) pursuant to transactions approved by NFI's Board, and (4) pursuant to the Rights Offering or under the Standby Purchase Agreement. The Board also waived, with respect to the Investors and their respective affiliates, the application of any other restrictions (except as may be required by law) that may be in effect from time to time on the transfer, sale or other disposition of shares of capital stock of NFI that are similar in nature to the transfer restrictions imposed on the Series D-1 Preferred Stock or the Series D-2 Preferred Stock by the Articles Supplementary of such series whether such restrictions are set forth in NFI's Charter or any other agreement.

The foregoing is a summary of the terms of the Registration Rights Agreement. This summary is qualified in its entirety by reference to the full text of the Registration Rights Agreement which is attached hereto as Exhibit 10.3, and is incorporated herein by reference.

The disclosure under the heading "5.02 Departures of Directors or Certain Officers; Election of Directors; Appointment of Certain Officers; Compensatory Arrangements of Certain Officers" is incorporated herein by reference.

Section 3 - Securities and Trading Markets

Item 3.02 Unregistered Sales of Equity Securities.

As discussed in "Item 1.01 Entry into a Material Definitive Agreement", on July 16, 2007, NFI sold 2,100,000 shares of Series D-1 Preferred Stock for \$48,825,000.00 in cash to the Investors. The Series D-1 Preferred Stock was issued by NFI in a private placement pursuant to an exemption from the registration requirements of the Securities Act provided by Section 4(2) of the Securities Act and Rule 506 of Regulation D promulgated under the Securities Act ("Regulation D") as the offer and sale of the Series D-1 Preferred Stock were made to four "accredited investors" as defined by Regulation D. Appropriate restrictive legends were affixed to the certificates representing the Series D-1 Preferred Stock.

In addition, shares to be sold to the Investors pursuant to their exercise of a subscription in the Rights Offering or pursuant to the Standby Purchase Agreement will be similarly sold on the basis of the exemption provided by Section 4(2) of the Securities Act and Rule 506 of Resolution D. The shares of Series D-2 Preferred Stock to be acquired by the Investors will contain a similar restrictive legend.

The Series D-1 Preferred Stock is convertible into Series D-2 Preferred Stock or Common Stock as described under "Item 5.03 Amendments to Articles of Incorporation or Bylaws; Change in Fiscal Year," which description is incorporated herein by reference. The Series D-2 Preferred Stock is to be convertible into Common Stock as described in "Item 1.01 Entry into a Material Definitive Agreement," which description is incorporated herein by reference.

Item 3.03 Material Modification to Rights of Security Holders

On July 16, 2007, NFI filed the Articles Supplementary for the Series D-1 Preferred Stock with the Maryland SDAT, which became effective upon filing. The Articles Supplementary define the rights of the Series D-1 Preferred Stock. Pursuant to the Articles Supplementary, the shares of Series D-1 Preferred Stock issued pursuant to the Securities Purchase Agreement have certain rights as to conversion, liquidation and adjustment to conversion price. In addition, the Registration Rights Agreement establishes certain additional rights of the Investors. The disclosures under the headings "Item 1.01 Entry into a Material Definitive Agreement" and "Item 5.03 Amendments to Articles of Incorporation or Bylaws; Change in Fiscal Year" are incorporated herein by reference.

Section 5--Corporate Governance and Management

Item 5.02. Departures of Directors or Certain Officers; Election of Directors; Appointment of Certain Officers; Compensatory Arrangements of Certain Officers

On July 16, 2007, NFI, the Investors and each of Scott Hartman, Lance Anderson and Mike Bamberg (collectively, the "Executives," and each an "Executive") entered into an agreement in principle with respect to certain incentive compensation to be paid to the Executives (each a "Letter Agreement"). Pursuant to the Letter Agreements, the parties agreed that (1) awards to the Executives under the NovaStar Financial, Inc. Executive Bonus Plan will be paid in

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restricted stock in a manner consistent with the Executive's existing compensation arrangements with NFI; (2) each Executive would receive options to purchase 1,000,000 shares of NFI's Common Stock with an exercise price equal to the weighted average conversion price of the Series D-1 Preferred Stock and the Series D-2 Preferred Stock owned by the Investors (following the issuance of the REIT Dividend), which options will vest on the third anniversary of the Letter Agreement and be forfeited if the Executive is not continuously employed with NFI through the third anniversary of the date of the Letter Agreement; and (3) the Executives will not be entitled to any long-term incentive awards under NFI's employee benefit plans for three years from the date of the Letter Agreement (collectively, the "Compensation Arrangements"). The Compensation Arrangements remain subject to approval by NFI's Board of Directors and shareholders, as applicable, and completion of definitive documentation. In the event it is not possible to effectuate the Compensation Arrangements as contemplated by the Letter Agreements, the Executives and the Investors agreed to negotiate in good faith compensation awards that are equivalent in terms of the economic value, risk and reward retention characteristics and commitment to the long-term growth in equity value to the Compensation Arrangements. In addition, in the Letter Agreement, the Executives agreed, subject to certain exceptions, not to sell or enter into any contract or arrangement with the effect of selling any shares of Common Stock or securities convertible into or exchangeable or exercisable for Common Stock for three years from the date of the Letter Agreement without the prior consent of the Investors.

The foregoing is a summary of the terms of the Letter Agreements. This summary is qualified in its entirety by reference to the full text of the Letter Agreements which are attached hereto as Exhibits 10.4, 10.5, and 10.6 and are incorporated herein by reference.

Item 5.03 Amendments to Articles of Incorporation or Bylaws; Change in Fiscal Year.

Series D-1 Preferred Stock

On July 16, 2007, NFI filed Articles Supplementary with the Maryland SDAT, which became effective upon filing, creating the Series D-1 Preferred Stock.

The Articles Supplementary for the Series D-1 Preferred Stock provide for the following:

Designation and number. The number of shares of Series D-1 Preferred Stock is 2,100,000 and the par value per share is \$0.01.

Ranking. The Series D-1 Preferred Stock will rank, with respect to payment of dividends and distribution of assets upon liquidation, (1) senior to the Common Stock and each

other class or series of capital stock of NFI the terms of which do not expressly provide that such class or series ranks senior to or *pari passu* with the Series D-1 Preferred Stock as to the payment of dividends and distribution of assets upon a liquidation; (2) *pari passu* with NFI's shares of 8.90% Series C Cumulative Redeemable Preferred Stock ("Series C Preferred Stock"), the Series D-2 Preferred Stock, the Series E Preferred Stock, if and when issued, and each other class or series of shares of NFI, the terms of which expressly provide that such class or series ranks *pari passu* with the Series D-1 Preferred Stock as to payment of dividends and distribution of assets upon a liquidation; and (3) junior to each other class or series of shares of NFI the terms of which expressly provide that such class or series ranks senior to the Series D-1

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Preferred Stock as to payment of dividends and distributions of assets upon a liquidation.

Dividends. The Series D-1 Preferred Stock will accrue cumulative dividends which shall accumulate daily, whether or not such dividends have been declared and whether or not there are profits, surplus or other funds of NFI legally available for the payment of cash dividends, at the rate of 9.00% per annum payable semi-annually in cash. No dividends or distributions (other than stock dividends or distributions) can be made with respect to any capital stock which ranks junior to or ranks *pari passu* with the Series D-1 Preferred Stock and no redemptions or repurchases of any such capital stock can be made unless all dividends on the Series D-1 Preferred Stock and all stock ranking *pari passu* with the Series D-1 Preferred Stock have been declared and paid or set aside for payment. The Series D-1 Preferred Stock is also entitled to participate in any dividends paid on the Common Stock on an as-converted basis.

Liquidation Preference. In the event of a liquidation of NFI, a holder of the Series D-1 Preferred Stock will be entitled to receive, prior and in preference to any payment or distribution of assets to holders of Common Stock or shares ranking junior to the Series D-1 Preferred Stock, but after any distribution on any shares ranking senior to the Series D-1 Preferred Stock, an amount equal to the greater of the liquidation preference attributable to the Series D-1 Preferred Stock or an amount that the holder would have been entitled to receive if it had exercised its rights to convert its Series D-1 Preferred Stock into Common Stock immediately prior to liquidation. The liquidation preference attributable to the Series D-1 Preferred Stock corresponds to an amount equal to \$25.00, subject to adjustment in the event of a stock split or combination, plus all accumulated but unpaid dividends on the Series D-1 Preferred Stock.

Voting Rights. The Series D-1 Preferred Stock is entitled to vote on an as-converted basis with the Common Stock. The prior consent of holders of 2/3 of the outstanding shares of Series D-1 Preferred Stock is required for NFI to: (1) subject to certain exceptions, create, authorize or issue, or increase the authorized amount of, any Series D-1 Preferred Stock, any stock ranking *pari passu* with the Series D-1 Preferred Stock or any stock ranking senior to the Series D-1 Preferred Stock or any obligation or security convertible into, or exercisable or exchangeable for, such stock; (2) approve or make any amendment to the terms of the Series D-1 Preferred Stock; (3) amend, alter change, repeal or waive any provision of NFI's Charter or Bylaws that would adversely affect the rights of the Series D-1 Preferred Stock; (4) reclassify any authorized shares of NFI into any

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Series D-1 Preferred Stock, any stock ranking *pari passu* with or senior to the Series D-1 Preferred Stock or any obligation or security convertible into such stock; or (5) consummate any transaction that could, or could reasonably be expected to, individually or in the aggregate, adversely affect or impair the rights and preferences of the Series D-1 Preferred Stock.

Conversion. The Series D-1 Preferred Stock is convertible into Common Stock at any time at the option of the holders. The Series D-1 Preferred Stock sold to the Investors under the Securities Purchase Agreement is initially convertible into 7,500,000 shares of Common Stock based upon the initial conversion price of \$7.00 per share, which conversion price is subject to adjustment as provided in the Articles Supplementary for the Series D-1 Preferred Stock. If NFI has not obtained stockholder approval for certain adjustments to the conversion price of the Series D-1 Preferred Stock and Series D-2 Preferred Stock designed to provide certain anti-dilution protection to the holders of such stock upon certain issuances of capital stock by NFI (the "Shareholder Approval") on or

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prior to the third anniversary of the issuance of the Series D-1 Preferred Stock, NFI can convert all of the D-1 Preferred Stock into Common Stock, if at such time NFI's common stock is publicly traded and the Common Stock price is greater than 200% of the then existing conversion price for 40 of 50 consecutive trading days preceding delivery of the forced conversion notice. If NFI has not obtained Shareholder Approval on or prior to the ninth anniversary of the issuance of the Series D-1 Preferred Stock, the Series D-1 Preferred Stock will automatically convert into shares of Common Stock. In addition, if NFI has obtained Shareholder Approval, the shares of Series D-1 Preferred Stock will automatically convert into shares of Series D-2 Preferred Stock on the second anniversary of issuance or such later date when NFI obtains the Shareholder Approval.

Transfer Restrictions. The Series D-1 Preferred Stock is subject to certain transfer restrictions intended to attempt to preserve NFI's status as a REIT and under certain circumstances certain net operating loss carryovers and net unrealized built-in losses for NFI under the Code. In certain instances described above under the heading "Item 1.01 Entry into a Material Definitive Agreement-Registration and Rights Shareholders Agreement," the Investors will be exempt from these transfer restrictions.

Appraisal Rights. Holders of Series D-1 Preferred Stock will not have appraisal rights.

The foregoing is a summary of the terms of the Series D-1 Preferred Stock. This summary is qualified in its entirety by reference to the Articles Supplementary for the Series D-1 Preferred Stock which are attached hereto as Exhibit 4.1, and are incorporated herein by reference.

Series D-2 Preferred Stock

Prior to the closing of the Rights Offering and Standby Purchase Agreement, NFI will file Articles Supplementary with the Maryland SDAT creating the Series D-2 Preferred Stock. A form of the Articles Supplementary for the Series D-2 Preferred Stock is

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included herein as an Exhibit to the Securities Purchase Agreement, which is attached hereto as Exhibit 10.1.

Important Information

The commencement of the Rights Offering described herein is subject to certain conditions, principally the effectiveness of a registration statement filed with the SEC. This report does not constitute an offer to sell or the solicitation of any offer to buy any securities in the Rights Offering, nor shall there be any sale of securities in any state in which such offer, solicitation or sale would be unlawful prior to the registration or qualification under the securities of any such states. The Rights Offering will only be made by means of a prospectus pursuant to an effective registration statement.

An overview of the process regarding the distribution and exercise of the Rights will be the subject of a separate report when the Company proceeds with the Rights Offering, and the details will be the subject of a registration statement and prospectus.

The sale of the Series D-1 Preferred Stock has not been registered, and the sale of the Series D-2 Preferred Stock to be sold to MassMutual and Jefferies Capital Partners will not be registered, under the Securities Act of 1933, as amended,

and such securities may not be offered or sold in the United States absent registration or an applicable exemption. The Company has entered into a Registration Rights Agreement with the Investors with respect to these securities.

Forward Looking Statements

This Current Report and the Exhibits attached hereto contain forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, regarding management's beliefs, estimates, projections, and assumptions with respect to, among other things, NFI's ability to consummate the transactions contemplated by this Current Report and the Exhibits attached hereto, future income, dividends, operations, business plans and strategies, as well as industry and market conditions, all of which are subject to change at any time without notice. Actual results and operations for any future period may vary materially from those projected herein and from past results. Some important factors that could cause actual results to differ materially from those anticipated include: NFI's ability to consummate the transactions as described in this Current Report and the Exhibits attached hereto; NFI's ability to generate sufficient liquidity on favorable terms; NFI's ability to sell loans it originates in the market place; the size, frequency and structure of NFI's securitizations; impairments on NFI's mortgage assets; increases in prepayment or default rates on NFI's mortgage assets; increases in loan repurchase requests; inability of potential borrowers to meet NFI's underwriting guidelines; changes in assumptions regarding estimated loan losses and fair value amounts; finalization of the amount and terms of any severance provided to terminated employees; finalization of the accounting impact of previously announced reduction in workforce; events impacting the subprime mortgage industry in general,

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including events impacting NFI's competitors and liquidity available to the industry; the initiation of margin calls under NFI's credit facilities; the ability of NFI's servicing operations to maintain high performance standards and maintain appropriate ratings from rating agencies; NFI's ability to generate acceptable origination volume while maintaining an acceptable level of overhead; the stability of residual property values; NFI's continued status as a REIT; interest rate fluctuations on NFI's assets that differ from its liabilities; the outcome of litigation or regulatory actions pending against NFI or other legal contingencies; NFI's compliance with applicable local, state and federal laws and regulations or opinions of counsel relating thereto and the impact of new local, state or federal legislation or regulations or opinions of counsel relating thereto or court decisions on NFI's operations; compliance with new accounting pronouncements; the impact of general economic conditions; NFI's ability to adapt to and implement technological changes; NFI's ability to successfully integrate acquired business or assets with its existing business; and the risks that are from time to time included in NFI's filings with the SEC, including its Annual Report on Form 10-K, for the year ended December 31, 2006, and its quarterly report on Form 10-Q, for the period ending March 31, 2007. Other factors not presently identified may also cause actual results to differ. Words such as "believe," "expect," "anticipate," "promise," "plan," and other expressions or words of similar meanings, as well as future or conditional verbs such as "will," "would," "should," "could," or "may" are generally intended to identify forward-looking statements. This Current Report speaks only as of its date and NFI expressly disclaims any duty to update the information herein.

Section 9-Financial Statements and Exhibits

Item 9.01 Financial Statement and Exhibits

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(d) Exhibits. The following are filed as Exhibits to this Report:

| <u>Exhibit No.</u> | <u>Document</u> |
|--------------------|---|
| 4.1 | Articles Supplementary 9.00% Series D-1 Mandatory Convertible Preferred Stock (Par Value \$0.01 Per Share). |
| 10.1 | Securities Purchase Agreement, dated July 16, 2007, by and among NovaStar Financial, Inc., Massachusetts Mutual Life Insurance Company, Jefferies Capital Partners IV L.P., Jefferies Employee Partners IV LLC and JCP Partners IV LLC. |
| 10.2 | Standby Purchase Agreement, dated July 16, 2007, by and among NovaStar Financial, Inc., Massachusetts Mutual Life Insurance Company, Jefferies Capital Partners IV L.P., Jefferies Employee Partners IV LLC and JCP Partners IV LLC. |

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| <u>Exhibit No.</u> | <u>Document</u> |
|--------------------|--|
| 10.3 | Registration Rights and Shareholders Agreement, dated July 16, 2007, by and among NovaStar Financial, Inc., Massachusetts Mutual Life Insurance Company, Jefferies Capital Partners IV L.P., Jefferies Employee Partners IV LLC and JCP Partners IV LLC. |
| 10.4 | Letter Agreement, dated July 16, 2007, by and among NovaStar Financial, Inc., Massachusetts Mutual Life Insurance Company, Jefferies Capital Partners IV L.P., Jefferies Employee Partners IV LLC and JCP Partners IV LLC, and Scott Hartman. |
| 10.5 | Letter Agreement, dated July 16, 2007, by and among NovaStar Financial, Inc., Massachusetts Mutual Life Insurance Company, Jefferies Capital Partners IV L.P., Jefferies Employee Partners IV LLC and JCP Partners IV LLC, and Lance Anderson. |
| 10.6 | Letter Agreement, dated July 16, 2007, by and among NovaStar Financial, Inc., Massachusetts Mutual Life Insurance Company, Jefferies Capital Partners IV L.P., Jefferies Employee Partners IV LLC and JCP Partners IV LLC, and Mike Bamberg. |

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SIGNATURE

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.

NOVASTAR FINANCIAL, INC.

DATE: July 20, 2007

/s/ Gregory S. Metz

Gregory S. Metz
Chief Financial Officer

Index To Exhibits

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