

**UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF MISSOURI
WESTERN DIVISION**

IN RE NOVASTAR FINANCIAL, INC.
SECURITIES LITIGATION

Case No. 04-0330-CV-W-ODS

STIPULATION AND AGREEMENT OF SETTLEMENT

This Stipulation and Agreement of Settlement (the "Stipulation") is submitted pursuant to Rule 23 of the Federal Rules of Civil Procedure. Subject to the approval of the Court, this Stipulation is entered into among Class Representatives Generic Trading of Philadelphia, LLC and Harrold Daniels on behalf of themselves and the Class (as hereinafter defined) and Defendants NovaStar Financial, Inc. ("NovaStar") and Scott F. Hartman, W. Lance Anderson, and Rodney E. Schwatken (the "Individual Defendants") (NovaStar and the Individual Defendants are collectively referred to hereinafter as the "Defendants"), by and through their respective counsel.

WHEREAS:

A. Beginning in April 2004, a number of securities fraud class actions were filed in this Court. By Order dated August 23, 2004, those actions were consolidated under the caption above and are hereinafter referred to as the "Action" and Generic Trading of Philadelphia, LLC and Harrold and Wilma Daniels were designated Lead Plaintiffs pursuant to the Private Securities Litigation Reform Act of 1995 ("PSLRA");

B. The Consolidated Class Action Complaint dated November 12, 2004 (the "Complaint") filed in the Action generally alleges, among other things, that Defendants issued materially false and misleading public statements regarding NovaStar's compliance with

applicable regulatory requirements during the Class Period — October 29, 2003 through and including April 8, 2004 — in a scheme to artificially inflate the value of NovaStar's securities;

C. The Complaint further alleges that Lead Plaintiffs and other Class Members purchased or otherwise acquired the common stock of NovaStar or sold NovaStar put options during the Class Period at prices artificially inflated as a result of the Defendants' dissemination of materially false and misleading statements regarding NovaStar in violation of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, and Rule 10b-5 promulgated thereunder;

D. On January 14, 2005, Defendants moved to dismiss the Complaint pursuant to Rules 9(b) and 12(b)(6) of the Federal Rules of Civil Procedure. Plaintiffs responded on March 4, 2005. Defendants replied on April 7, 2005. By Order and Opinion dated May 12, 2005, the Court denied the Defendants' motion to dismiss. The Court Order also lifted the PSLRA discovery stay;

E. On June 27, 2005, Defendants answered the Complaint. The Defendants denied Plaintiffs' claims and asserted several defenses. In doing so, Defendants contend that they are not liable to Plaintiffs;

F. On March 31, 2006, plaintiffs moved the Court for an order certifying the Class pursuant to Rule 23 of the Federal Rules of Civil Procedure. Defendants responded on June 30, 2006. Plaintiffs replied on September 1, 2006. Defendants responded again on September 18, 2006. Plaintiffs replied again on October 12, 2006. By Order and Opinion dated February 8, 2007, the Court granted plaintiffs' motion for class certification. The Court's Order also certified Generic Trading of Philadelphia, LLC and Harrold Daniels as Class representatives and appointed Entwistle & Cappucci LLP and Milberg Weiss Bershad & Schulman LLP (now

known as Milberg LLP) as Co-Lead Counsel for the Class and Walters Bender Strohhahn & Vaughan, P.C. as Liaison Counsel for the Class;

G. On February 20, 2007, Defendants moved for reconsideration and clarification of the Court's February 8, 2007 Order and Opinion certifying the Class. Plaintiffs responded on March 8, 2007. Defendants replied on March 23, 2007. By Order dated May 17, 2007, the Court denied Defendants' motion for reconsideration of the February 8, 2007 Order and Opinion;

H. On February 22, 2007, Plaintiffs moved for reconsideration and clarification of the Court's February 8, 2007 Order and Opinion certifying the Class. Defendants responded on March 2, 2007. Plaintiffs replied on March 19, 2007. By Order dated May 17, 2007, the Court granted Plaintiffs' motion for clarification of the February 8, 2007 Order and Opinion;

I. On June 3, 2007, Defendants petitioned the U.S. Court of Appeals for the Eighth Circuit to permit an appeal from the District Court's order certifying the Class. On June 29, 2007, Plaintiffs filed a brief in opposition. On July 19, 2007, the Eighth Circuit denied Defendants' petition. Thereafter, Defendants sought rehearing or rehearing en banc, which was also denied;

J. Pursuant to formal pretrial discovery, Plaintiffs obtained from Defendants and various third parties approximately 135,000 pages of documents relating to matters at issue in the case, which Plaintiffs' Co-Lead Counsel carefully reviewed and analyzed;

K. The Defendants deny any wrongdoing whatsoever and this Stipulation shall in no event be construed or deemed to be evidence of or an admission or concession on the part of any Defendant with respect to any claim or of any fault or liability or wrongdoing or damage whatsoever, or any infirmity in the defenses that the Defendants have asserted. The parties to this Stipulation recognize, however, that the litigation has been filed by Plaintiffs and defended

by Defendants in good faith and with adequate basis in fact under Federal Rule of Civil Procedure 11, that the litigation is being voluntarily settled after advice of counsel, and that the terms of the settlement are fair, adequate and reasonable. This Stipulation shall not be construed or deemed to be a concession by any Plaintiff of any infirmity in the claims asserted in the Action;

L. Plaintiffs' Co-Lead Counsel have conducted an investigation relating to the claims and the underlying events and transactions alleged in the Complaint. Plaintiffs' Co-Lead Counsel have analyzed the evidence adduced during pretrial discovery and have researched the applicable law with respect to the claims of the Class Representatives and the Class against the Defendants and the potential defenses thereto;

M. With the assistance of former Chief Magistrate Judge of the U.S. District Court, Northern District of California, Edward A. Infante, of JAMS, acting as a mediator, the Class Representatives, by their counsel, have conducted lengthy discussions and arm's length negotiations with counsel for Defendants with respect to a compromise and settlement of the Action with a view to settling the issues in dispute and achieving the best relief possible consistent with the interests of the Class; and

N. Based upon their investigation and pretrial discovery as set forth above, Plaintiffs' Co-Lead Counsel have concluded that the terms and conditions of this Stipulation are fair, reasonable and adequate to the Class Representatives and the Class, and in their best interests, and have agreed to settle the claims raised in the Action pursuant to the terms and provisions of this Stipulation, after considering, among other things, (a) the substantial benefits that the Class Representatives and the members of the Class will receive from settlement of the Action, (b) the attendant risks of continued litigation, (c) the ability of Defendants to satisfy a judgment greater

than the settlement amount, particularly in light of NovaStar's difficult financial condition, and (d) the desirability of permitting the Settlement to be consummated as provided by the terms of this Stipulation.

NOW THEREFORE, without any admission or concession on the part of the Class Representatives of any lack of merit of the Action whatsoever, and without any admission or concession of any liability or wrongdoing or lack of merit in the defenses whatsoever by Defendants, it is hereby STIPULATED AND AGREED, by and among the parties to this Stipulation, through their respective attorneys, subject to approval of the Court pursuant to Rule 23(e) of the Federal Rules of Civil Procedure, in consideration of the benefits flowing to the parties hereto from the Settlement, that all Settled Claims (as defined below) as against the Released Parties (as defined below) and all Settled Defendants' Claims (as defined below) shall be compromised, settled, released and dismissed with prejudice, upon and subject to the following terms and conditions:

CERTAIN DEFINITIONS

1. As used in this Stipulation, the following terms shall have the following meanings:
 - (a) "Authorized Claimant" means a Class Member who submits a timely and valid Proof of Claim form to the Claims Administrator.
 - (b) "Cash Settlement Amount" means the amount specified in ¶ 4 hereof.
 - (c) "Claims Administrator" means the firm of Analytics Incorporated which shall administer the Settlement.
 - (d) "Class" means all persons who EITHER (1) purchased or otherwise acquired common stock of NovaStar Financial, Inc. ("NovaStar") during the period from

October 29, 2003 through April 8, 2004, inclusive (the “Class Period”) and still held shares of stock as of April 8, 2004, OR (2) sold NovaStar put options during the Class Period whose option extended beyond, and was exercised after, April 8, 2004, AND (3) as a result of NovaStar’s actions, suffered damages. Excluded from the Class are the Defendants; the subsidiaries and affiliates of NovaStar; the officers and directors of NovaStar or its subsidiaries and affiliates, at all relevant times; members of the immediate family of any excluded person; the legal representatives, heirs, successors, and assigns of any excluded person; and any entity in which any excluded person has or had a controlling interest. Also excluded from the Class are any putative Class Members who exclude themselves by filing a request for exclusion in accordance with the requirements set forth in the Notice. “Class Member” means a member of the Class.

(e) “Class Period” means the period from October 29, 2003 through April 8, 2004, inclusive.

(f) “Defendants” means NovaStar and the Individual Defendants.

(g) “Defendants’ Counsel” means the law firms of Husch Blackwell Sanders LLP and Orrick, Herrington & Sutcliffe LLP.

(h) “Effective Date” means the date upon which the Settlement contemplated by this Stipulation shall become effective, as set forth in ¶ 23 below.

(i) “Final,” with respect to the Order and Final Judgment, means: (a) if no appeal is filed, the expiration date of the time for filing or noticing of any appeal from the Court’s Judgment approving the Settlement substantially in the form of Exhibit B hereto, i.e. thirty (30) days after entry of the Judgment; or (b) if there is an appeal, the date of final dismissal of any appeal from the Judgment, or the final dismissal of any proceeding on certiorari to review

the Judgment; or (c) the date of final affirmance on an appeal of the Judgment, the expiration of the time to file a petition for a writ of certiorari, or the denial of a writ of certiorari to review the Judgment, and, if certiorari is granted, the date of final affirmance of the Judgment following review pursuant to that grant. Any proceeding or order, or any appeal or petition for a writ of certiorari pertaining solely to any plan of allocation and/or application for attorneys' fees, costs or expenses, shall not in any way delay or preclude the Judgment from becoming Final.

(j) "Gross Settlement Fund" means the Cash Settlement Amount plus any income or interest earned thereon.

(k) "Individual Defendants" means Scott F. Hartman, W. Lance Anderson, and Rodney E. Schwatken.

(l) "Net Settlement Fund" has the meaning defined in ¶ 5 hereof.

(m) "Notice" means the Notice of Pendency of Class Action and Proposed Settlement, Motion for Attorneys' Fees and Settlement Fairness Hearing, which is to be sent to members of the Class substantially in the form attached hereto as Exhibit 1 to Exhibit A.

(n) "Order and Final Judgment" means the proposed order to be entered approving the Settlement substantially in the form attached hereto as Exhibit B.

(o) "Order for Notice and Hearing" means the proposed order preliminarily approving the Settlement and directing notice thereof to the Class substantially in the form attached hereto as Exhibit A.

(p) "Plaintiffs' Counsel" means Plaintiffs' Co-Lead Counsel and all other counsel representing Class Member Plaintiffs in the Action.

(q) "Plaintiffs' Co-Lead Counsel" means the law firms of Entwistle & Cappucci LLP and Milberg LLP.

(r) “Publication Notice” means the summary notice of proposed Settlement and hearing for publication substantially in the form attached as Exhibit 3 to Exhibit A.

(s) “Released Parties” means any and all of the Defendants, their past or present subsidiaries, parents, successors and predecessors, officers, directors, agents, employees, attorneys, advisors, investment advisors, auditors, insurers, accountants, and any person, firm, trust, corporation, officer, director or other individual or entity in which any Defendant has a controlling interest or which is related to or affiliated with any of the Defendants, and the legal representatives, heirs, successors in interest or assigns of the Defendants.

(t) “Settled Claims” means any and all claims, debts, demands, rights or causes of action or liabilities whatsoever (including, but not limited to, any claims for damages, interest, attorneys’ fees, expert or consulting fees, and any other costs, expenses or liability whatsoever), whether based on federal, state, local, statutory or common law or any other law, rule or regulation, whether fixed or contingent, accrued or un-accrued, liquidated or un-liquidated, at law or in equity, matured or un-matured, whether class or individual in nature, including both known claims and Unknown Claims, (i) that have been asserted in this Action by the Class Members or any of them against any of the Released Parties, or (ii) that could have been asserted in any forum by the Class Members or any of them against any of the Released Parties which arise out of or are based upon the allegations, transactions, facts, matters or occurrences, representations or omissions involved, set forth, or referred to in the Complaint and which relate to the purchase or acquisition of NovaStar common stock or to the sale of NovaStar put options during the Class Period. “Settled Claims” does not mean or include claims, if any, against the Released Parties arising under the Employee Retirement Income Security Act of 1974, 29 U.S.C. § 1001, *et seq.* (“ERISA”) that could be asserted by an individual Class Member

or an ERISA Fiduciary in a capacity other than as a purchaser of NovaStar common stock (or seller of NovaStar put options) during the Class Period at prices allegedly artificially inflated (or deflated) by the misrepresentations or omissions alleged in the Action.

(u) “Settled Defendants’ Claims” means any and all claims, rights or causes of action or liabilities whatsoever, whether based on federal, state, local, statutory or common law or any other law, rule or regulation, including both known claims and Unknown Claims, that have been or could have been asserted in the Action or any forum by the Defendants or any of them or the successors and assigns of any of them against any of the Class Representatives, other Class Members or their attorneys, which arise out of or relate in any way to the institution, prosecution, or settlement of the Action (except for claims to enforce the Settlement).

(v) “Settlement” means the settlement contemplated by this Stipulation.

(w) “Unknown Claims” means any and all Settled Claims which any of the Class Representatives or Class Members does not know or suspect to exist in his, her or its favor at the time of the release of the Released Parties, and any Settled Defendants’ Claims which any Defendant does not know or suspect to exist in his or its favor, which if known by him, her or it might have affected his, her or its decision(s) with respect to the Settlement. With respect to any and all Settled Claims and Settled Defendants’ Claims, the parties stipulate and agree that upon the Effective Date, the Class Representatives and the Defendants shall expressly waive, and each Class Member shall be deemed to have waived, and by operation of the Judgment shall have expressly waived, any and all provisions, rights and benefits conferred by any law of any state or territory of the United States, or principle of common law, which is similar, comparable, or equivalent to Cal. Civ. Code § 1542, which provides:

A general release does not extend to claims which the creditor does not know or suspect to exist in his or her favor at the

time of executing the release, which if known by him or her must have materially affected his or her settlement with the debtor.

The Class Representatives and Defendants acknowledge, and all other Class Members by operation of law shall be deemed to have acknowledged, that the inclusion of “Unknown Claims” in the definition of Settled Claims and Settled Defendants’ Claims was separately bargained for and was a key element of the Settlement.

SCOPE AND EFFECT OF SETTLEMENT

2. The obligations incurred pursuant to this Stipulation shall be in full and final disposition of the Action and any and all Settled Claims as against all Released Parties and any and all Settled Defendants’ Claims.

3. (a) Upon the Effective Date of this Settlement, the Class Representatives and all the other members of the Class on behalf of themselves, their heirs, executors, administrators, predecessors, successors and assigns, shall, with respect to each and every Settled Claim, release and forever discharge, and shall forever be enjoined from prosecuting, any Settled Claims against any of the Released Parties.

(b) Upon the Effective Date of this Settlement, each of the Defendants, on behalf of themselves, their heirs, executors, administrators, predecessors, successors and assigns, and the other Released Parties, shall release and forever discharge each and every of the Settled Defendants’ Claims, and shall forever be enjoined from prosecuting the Settled Defendants’ Claims against the Class Representatives, all other Class Members and their counsel.

(c) Notwithstanding the provisions of ¶¶ 3(a) and (b) hereof, in the event that any of the Released Parties asserts against the Class Representatives, any Class Member or their respective counsel, any claim that is a Settled Defendants’ Claim, then the Class Representatives, such Class Member or counsel shall be entitled to use and assert such factual matters included

within the Settled Claims only against such Released Party in defense of such claim but not for the purposes of affirmatively asserting any claim against any Released Party.

THE SETTLEMENT CONSIDERATION

4. (a) Unless excused by operation of paragraph 4 (b) below, within fifteen (15) business days from the entry of an Order for Notice and Hearing, substantially in the form annexed hereto as Exhibit A (the “Normal Due Date”), Defendants shall pay or cause to be paid an amount equal to \$7,250,000 (the “Cash Settlement Amount”) into escrow for the benefit of Plaintiffs and the Class. Upon deposit of the Cash Settlement Amount into escrow, the Cash Settlement Amount and any income or interest earned thereon shall be the “Gross Settlement Fund.”

(b) In the event of proceedings by or on behalf of NovaStar, whether voluntary or involuntary, under any chapter of the United States Bankruptcy Code, including any act of receivership, asset seizure, or similar federal or state law action (“Bankruptcy Proceedings”), no payment need be made or caused to be made by the Defendants prior to the entry of an order by the Bankruptcy Court presiding over such Bankruptcy Proceedings providing either that the payment of the Cash Settlement Amount on behalf of the Defendants by their insurers under their respective policies or related compromise of coverage (1) does not violate the automatic stay or that the automatic stay is lifted for purposes of authorizing such payment; and (2) does not constitute a preference, voidable transfer, fraudulent transfer or similar transaction. Upon entry of such an order, the Defendants shall pay or cause to be paid the Cash Settlement Amount into escrow for the benefit of Plaintiffs and the Class within fifteen (15) business days. A motion seeking the aforementioned Order shall be promptly brought by Defendants, and shall be supported and assented to by the Class Representatives. The Class

Representatives have the right to terminate the Settlement in the event that no such order is obtained within 90 days after the bankruptcy filing.

5. (a) Except in the event of Bankruptcy Proceedings by or on behalf of NovaStar after payment of the Cash Settlement Amount into escrow and before entry of the Order and Final Judgment substantially in the form attached hereto as Exhibit B, the Gross Settlement Fund, net of any Taxes (as defined below) on the income thereof, shall be used to pay (i) the notice and administration costs referred to in ¶ 7 hereof, (ii) the attorneys' fee and expense award referred to in ¶ 8 hereof, and (iii) the remaining administration expenses referred to in ¶ 9 hereof. The balance of the Gross Settlement Fund after the above payments shall be the "Net Settlement Fund." The Net Settlement Fund shall be distributed to the Authorized Claimants as provided in ¶¶ 10-12 hereof.

(b) In the event of Bankruptcy Proceedings by or on behalf of NovaStar after payment of the Cash Settlement Amount into escrow and before entry of the Order and Final Judgment substantially in the form attached hereto as Exhibit B, then the Gross Settlement Fund, net of any Taxes (as defined below) on the income thereof, and net of any Notice and Administration Costs incurred prior to such Bankruptcy Proceedings, shall be held in escrow and subject to the Jurisdiction of the Court herein, without making any further distributions, except for Taxes, pending: (1) discharge and/or dismissal of the Bankruptcy Proceedings; or (2) entry of an Order by the Bankruptcy Court presiding over such Bankruptcy Proceedings providing that distribution of the Gross Settlement Fund (a) does not violate the automatic stay or that the automatic stay is lifted to permit distribution of the Gross Settlement Fund and (b) does not constitute a preference, voidable transfer, fraudulent transfer or similar transaction. A motion seeking the aforementioned Order, if brought, shall be brought by the Class Representatives, and

shall be supported and assented to by Defendants. The Class Representatives have the right to terminate the Settlement in the event that no such order is obtained within 90 days after the bankruptcy filing.

(c) Any sums required to be held in escrow hereunder prior to the Effective Date shall be held by a bank or banks selected by Plaintiffs' Co-Lead Counsel as Escrow Agents for the Settlement Fund. All funds held by the Escrow Agents shall be deemed to be in the custody of the Court and shall remain subject to the jurisdiction of the Court until such time as the funds shall be distributed or returned to the persons or entities paying the same pursuant to this Stipulation and/or further order of the Court. The Escrow Agents shall invest any funds held in escrow in short-term United States Agency or Treasury Securities (or a mutual fund invested solely in such instruments), and shall collect and reinvest all interest accrued thereon. The parties hereto agree that the Settlement Fund is intended to be a Qualified Settlement Fund within the meaning of Treasury Regulation § 1.468B-1 and that Plaintiffs' Co-Lead Counsel, as administrator of the Settlement Fund within the meaning of Treasury Regulation § 1.468B-2(k)(3), shall be responsible for filing tax returns for the Settlement Fund and paying from the Settlement Fund any Taxes owed with respect to the Settlement Fund. The parties hereto agree that the Settlement fund shall be treated as a Qualified Settlement Fund from the earliest date possible, and agree to any relation-back election required to treat the Settlement Fund as a Qualified Settlement Fund from the earliest date possible. Defendants' Counsel agree to provide promptly to the Escrow Agents the statement described in Treasury Regulation § 1.468B-3(e).

(d) All (i) taxes on the income of the Gross Settlement Fund and (ii) expenses and costs incurred in connection with the taxation of the Gross Settlement Fund (including, without limitation, expenses of tax attorneys and accountants) (collectively "Taxes") shall be

