UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

Form 10-K

☑	**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934** **For the fiscal year ended December 31, 2006**

or

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: 001-13417

Hanover Capital Mortgage Holdings, Inc.
(Exact name of registrant as specified in its charter)

Maryland *(State or other Jurisdiction of Incorporation or Organization)*	**13-3950486** *(I.R.S. Employer Identification No.)*
200 Metroplex Drive, Suite 100, Edison, NJ *(Address of principal executive offices)*	**08817** *(Zip Code)*

(732) 548-0101
(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

Title of Class	Name of Exchange on Which Registered
Common Stock, $0.01 Par Value per Share	American Stock Exchange

Securities registered pursuant to Section 12(g) of the Act:
None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No ☑

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934. Yes o No ☑

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 ☑ No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K ☑

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o Accelerated filer o Non-accelerated filer ☑

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

The aggregate market value of the voting and non-voting common equity held by non-affiliates, based on the price at which the common equity was last sold as of June 30, 2006, was $36,808,000.

The registrant had 8,063,962 shares of common stock outstanding as of March 13, 2007.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's Proxy Statement for the 2007 Annual Meeting of Stockholders, to be filed with the Securities and Exchange Commission within 120 days after the end of registrant's fiscal year, are incorporated by reference into Part III.

HANOVER CAPITAL MORTGAGE HOLDINGS, INC.

FORM 10-K ANNUAL REPORT

FOR THE FISCAL YEAR ENDED DECEMBER 31, 2006

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Safe Harbor Statement Under the Private Securities Litigation Reform Act of 1995

Certain statements in this report, including, without limitation, matters discussed under Item 7, “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” should be read in conjunction with the financial statements, related notes, and other detailed information included elsewhere in this Annual Report on Form 10-K. We are including this cautionary statement to make applicable and take advantage of the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Statements that are not historical fact are forward-looking statements. Certain of these forward- looking statements can be identified by the use of words such as “believes,” “anticipates,” “expects,” “intends,” “plans,” “projects,” “estimates,” “assumes,” “may,” “should,” “will,” or other similar expressions. Such forward-looking statements involve known and unknown risks, uncertainties and other important factors, which could cause actual results, performance or achievements to differ materially from future results, performance or achievements. These forward-looking statements are based on our current beliefs, intentions and expectations. These statements are not guarantees or indicative of future performance. Important assumptions and other important factors that could cause actual results to differ materially from those forward-looking statements include, but are not limited to, those factors, risks and uncertainties described in Item 1A of this Annual Report on Form 10-K. Our future financial condition and results of operations, as well as any forward-looking statements, are subject to change and involve inherent risks and uncertainties. The forward-looking statements contained in this report are made only as of the date hereof. We undertake no obligation to update or revise information contained herein to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.

PART I

ITEM 1. BUSINESS

The Company

Hanover Capital Mortgage Holdings, Inc. (“Hanover”) is a real estate investment trust (“REIT”) formed to operate as a specialty finance company. Hanover has one primary subsidiary: Hanover Capital Partners 2, Ltd. (“HCP-2”). When we refer to the “Company,” we mean Hanover together with its consolidated subsidiaries.

The Company’s principal business is the REIT that generates net interest income on its portfolio of prime mortgage securities and mortgage loans on a leveraged basis. Secondarily, mortgage industry service and technology related income is earned through two separate divisions in HCP-2, Hanover Capital Partners (“HCP”) and HanoverTrade (“HT”). Effective January 12, 2007, the assets of HCP’s due diligence business, representing substantially all of the assets of HCP, were sold to Terwin Acquisition I, LLC, which also assumed certain liabilities related thereto. As a result, as of December 31,2006, the net assets and liabilities and results of operations of HCP have been presented as discontinued operations in the accompanying financial information and financial statements in this Form 10-K.

The Company’s principal executive offices are located at 200 Metroplex Drive, Suite 100, Edison, New Jersey 08817. The Company also maintains an office at 55 Broadway, Suite 3002, New York, NY 10006.

Business Segments

Company

The Company’s business is conducted through two lines of business that are each reported as business segments. They are: the REIT, operated through Hanover, and technology solutions and loan sale advisory services for the mortgage industry, operated by HT. As a result of the sale of HCP described above, the Company will no longer report a separate segment for the due diligence business.

The results of operations of HT include the results of Hanover Capital Securities, Inc., “HCS” and Pedestal Capital Markets, Inc. “Pedestal”, registered broker-dealers, organized for the purpose of facilitating infrequent sales of registered securities in the conduct of their businesses.

Hanover — The REIT

Hanover's principal business is to generate net interest income by investing in subordinate mortgage-backed securities, "Subordinate MBS", collateralized by pools of prime single-family mortgage loans, and purchasing prime whole single-family mortgage loans for investment, securitization and resale. Hanover does not take deposits or raise money in any way that would subject it to consumer lending or banking regulations and does not deal directly with consumers. Hanover also maintains a portfolio of whole-pool Fannie Mae and Freddie Mac mortgage-backed securities, "Agency MBS", primarily to satisfy certain exemptive provisions of the Investment Company Act of 1940 (the "40 Act"). Hanover attempts to increase the earnings potential in its investments by leveraging its purchases of mortgage securities with borrowings obtained primarily through the use of 30 day revolving Repurchase Agreements which are established by sales with agreements to repurchase. The borrowings under the Repurchase Agreements are generally at 50 to 97 percent of the security's fair market value, depending on the security, and are adjusted to market value each month as the Repurchase Agreements are re-established. Other mortgage security or mortgage loan financing is accomplished through the use of committed lines of credit, usually under repurchase agreements or through the creation of collateralized mortgage obligations, "CMOs". Hanover also, on occasion, receives income from real estate investment management services that can include asset management and administrative services.

HCP — Consulting and Outsourcing Services

During the third quarter of 2006, the Company's Board of Directors approved the sale of certain assets of our HCP due diligence business to Terwin Acquisitions I, LLC (now known as Edison Mortgage Decisioning Solutions, LLC) ("Buyer"). This sale was completed on January 16, 2007, with an effective date of January 12, 2007. The sale was effected through the sale of certain assets to the Buyer and the assumption by the Buyer of certain liabilities of HCP-2 which comprised all of our due diligence operations. As a result of the sale, we will no longer perform due diligence activities for third parties. The net assets and liabilities and the results of operations of our HCP business have been presented as discontinued operations in the accompanying consolidated financial statements and other information presented in this Form 10-K.

HCP provided services to commercial banks, mortgage banks, government agencies, credit unions and insurance companies. The services provided included: loan due diligence (credit and compliance) on a full range of mortgage products, quality control reviews of newly originated mortgage loans, operational reviews of loan origination and servicing operations, mortgage assignment services, loan collateral reviews, loan document rectification, and temporary staffing services.

The delivery of the HCP consulting and outsourcing services usually required an analysis of a block or pool of loans on a loan-by-loan basis. This required the use of technology developed and owned by HCP and operated by employees highly specialized and trained by HCP. HCP also performed certain due diligence services and analysis of mortgage assets acquired by Hanover.

HT — Technology Solutions and Loan Sale Advisory

HT generates income by providing technology software solutions and valuation services to the mortgage industry. The technology solutions operation earns licensing and related servicing fees by licensing proprietary software applications to the financial industry. HT markets web-based technology solutions to meet specific needs of the mortgage industry in the secure transmission, analysis, valuation, tracking and stratification of loan portfolios. The software technology is licensed to government agencies and financial institutions that originate and/or trade financial assets. Previously, through its Servicing Source division, HT also licensed and used applications to provide financial management of mortgage servicing rights including mark to market valuation, impairment testing, and credit and prepayment analysis to clients. On December 29, 2006, HT sold certain assets and the trade name of its Servicing Source division, including the financial management of mortgage services rights, to the Sextant Group, Inc., which also assumed certain liabilities related to these assets. The Sextant Group, Inc. will also maintain and support certain software license and servicing agreements retained by HT.

Prior to May 31, 2006, the loan sale advisory, "LSA", operation of HT earned fees by providing brokerage, asset valuation and consulting services. The brokerage service integrated varying degrees of traditional voice brokerage conducted primarily by telephone, web-enhanced brokerage and online auction hosting. HT also performed market price valuations for a variety of loan products and offered consulting advice on loan product pricing and business strategies. As a result of declining sales opportunities and the departure of certain personnel, we suspended the LSA operation as of May 31, 2006. The remaining personnel and their related costs, which represent substantially all of the remaining costs of the LSA operation, have been reassigned to the REIT.

HT is dependent on Hanover for working capital.

REIT Operations

General

In order to maximize the interest income from its investments, Hanover invests in mortgage securities or mortgage loans that will generate the highest possible earnings where such mortgage securities or mortgage loans fall within acceptable investment parameters established by Hanover's investment management team.

The parameters established by Hanover's investment management team vary by type of investment but emphasize securities collateralized by prime jumbo residential mortgages or mortgage loans that generally fall into this category of residential mortgages. The parameters do not allow and Hanover does not invest in sub-prime mortgage securities or mortgage loans.

The potentially higher earning mortgage securities are those series of Subordinate MBS with the higher credit risk, often referred to as the non-investment grade or first loss series or tranches. These securities trade in the marketplace at substantial discounts to par value and, therefore, the earnings potential of these securities is much greater. By way of example, if a $1,000 series security were purchased at a 50% discount to par, or $500, the security's stated interest rate would apply to the entire $1,000 until losses, if any, erode the principal amount. As a result, these securities provide a much higher effective return because Hanover paid less than par to acquire the security. Hanover believes that it has the experience, knowledge, and technical ability to actively evaluate and monitor the risks associated with these investments and, therefore, can minimize the losses that might otherwise be incurred by a passive or less knowledgeable investor, although there is no assurance Hanover's investment team will be successful.

Hanover may purchase mortgage loans that are offered for sale in pools of loans. Often these pools of loans contain a mixture of loans that meet Hanover's investment parameters and some that do not. By using Hanover's experience, knowledge, and technology to evaluate and stratify these mortgage loans, Hanover is able to identify and put into a separate pool, or pools, the loans that do not meet Hanover's investment parameters. These loans are sold in the marketplace and the pool of mortgage loans that remain, those that meet the investment parameters, are held for investment purposes.

Depending on market conditions and the quality of mortgage loans available for purchase in the marketplace, Hanover may pool certain investment mortgages, mortgages that have met Hanover's investment parameters, and cause them to become collateral for a CMO. The CMO is usually divided into several maturity classes, called series or tranches that are sold to investors and that have varying degrees of claims on any cash flows or losses on the mortgage loans held as collateral. In such securitizations, Hanover's intent is to hold or retain for investment purposes the highest risk series or tranches. The highest risk series often are charged with losses before the other series and receive cash flows after the other series with higher priority on cash flows are paid. The investment cost in these higher risk securities are substantially discounted from the par value and, consistent with the previous example, are a potentially higher interest earning security.

Hanover may also use a securitization such as Collateralized Debt Obligations "CDO's" as a source of funding for investments in Subordinate MBS. In such a securitization, investments in Subordinate MBS are sold to an independent securitization entity that creates securities backed by those assets, the CDO's, and sells these newly-created securities to both domestic and international investors. Most of the securities created and sold will receive the highest credit rating of AAA, so the interest paid out is relatively low. Hanover would expect to typically generate a profit from these securitization entities, consisting of the yield on the securitized assets less the interest payments made to the holders of the CDO securities sold. Hanover will also earn management fees from the securization entity.

Hanover invests in debt securities of Fannie Mae and Freddie Mac (Government Sponsored Enterprises), referred to as Agency MBS. Only Agency MBS that represent an entire pool of mortgages, not just part of a pool of mortgages, are purchased. These securities are purchased when Hanover’s monitoring model of limits for exemption under the 40 Act suggests that the total assets represented by qualifying real estate investments may need to be supported by additional purchases of Agency MBS. Such assets are sold when Hanover’s other qualifying real estate investments are of sufficient amounts to maintain the exemptive limits. These Agency MBS are readily marketable and contain guarantees by the sponsoring agency such that credit risks are minimal.

Investment Management

We believe that our portfolio management processes are influenced by three primary investment risks associated with the types of investments Hanover makes: credit risk (including counterparty risk), interest rate risk and prepayment risk. In order to maximize Hanover’s net interest income, we believe we have developed an effective asset/liability management program to provide a level of protection against the costs of credit, interest rate, and prepayment risks, however, no strategy can completely insulate us from these risks.

Credit Risk Management

We define credit risk as the risk that a borrower or issuer of a mortgage loan may not make the scheduled principal and interest payments required under the loan or a sponsor or servicer of the loan or mortgage security will not perform. We attempt to reduce our exposure to credit risk on our mortgage assets by:

- establishing investment parameters which concentrate on assets that are collateralized by prime single-family mortgage loans;
- reviewing all mortgage assets prior to purchase to ensure that they meet our investment parameters;
- employing early intervention, aggressive collection and loss mitigation techniques; and
- obtaining representations and warranties, to the extent possible, from sellers with whom we do business.

We do not set specific geographic diversification requirements, although we do monitor the geographic dispersion of the mortgage assets to make decisions about adding to or reducing specific concentrations. Concentration in any one geographic area will increase our exposure to the economic and natural hazard risks associated with that area.

When we purchase mortgage loans, the credit underwriting process varies depending on the pool characteristics, including loan seasoning or age, loan-to-value ratios, payment histories and counterparty representations and warranties. For a new pool of single-family mortgage loans, a due diligence review is undertaken, including a review of the documentation, appraisal reports and credit underwriting. Where required, an updated property valuation is obtained.

We attempt to reduce counterparty risk by periodically evaluating the creditworthiness of sellers, servicers, and sponsors of prime Subordinate MBS and mortgage loans.

Interest Rate Risk Management

Interest rate risk is the risk of changing interest rates in the market place. Rising interest rates may both decrease the market value of the portfolio and increase the cost of Repurchase Agreement financing. Management of these risks varies depending on the asset class. In general, we attempt to minimize the effect of rising interest rates through asset re-allocation, the use of interest rate caps and forward sales of Agency MBS.

Subordinate MBS — Our Subordinate MBS portfolio consists of both fixed-rate and adjustable-rate securities. We manage effects of rising interest rates on the financing of our Subordinate MBS portfolio through the purchase of long-term, out-of-the-money, interest rate caps indexed to the one-month London Interbank Offered Rate Index, “LIBOR”. Increases in one-month LIBOR will decrease our net interest spread until one-month LIBOR reaches the cap strike rate. Once one-month LIBOR is at or above the cap rate, the cap will pay us, on a monthly basis, the difference between the current one-month LIBOR rate and the cap strike rate.

Although there is an offsetting correlation to the change in the value of the one-month LIBOR caps to the change in the value of the Subordinate MBS as interest rates increase, it is not 100 percent effective. Additionally, because our interest rate caps are treated as freestanding derivatives, the changes in the value of the interest rate caps flow through our income statement while changes in the value of the asset are reflected as Other Comprehensive Income, to the extent such Subordinate MBS have been classified as available for sale securities.

Although we do not currently do so, we may use designated hedges such that the derivatives used will qualify for “hedge accounting” under the Financial Accounting Standards Board (“FASB”) Statement of Financial Accounting Standards (“SFAS”) No. 133. To receive such treatment requires extensive management and documentation but the costs associated with such processes may be justified compared to the mark to market consequences of not qualifying under SFAS 133 as occurs with our use of freestanding derivatives as discussed above. Under SFAS No. 133, Hanover would use qualifying hedges to meet strategic economic objectives, while maintaining adequate liquidity and flexibility, by managing interest rate risk mitigation strategies that should result in a lesser amount of earnings volatility under GAAP as occurs when using freestanding derivatives.

A rise in interest rates may also decrease the market value of the Subordinate MBS and thereby cause financing firms to require additional collateral. The unforeseen or under anticipated need to meet additional collateral requirements is known as “margin risk”. We manage margin risk with our liquidity policy, whereby a percentage of the financed amount is held in cash or cash equivalents or other readily marketable assets.

Mortgage Loans — Hanover’s mortgage loan investments consist of both fixed-rate and adjustable-rate mortgage loans. Rising interest rates may both decrease the market value of the mortgage loans and increase the cost of Repurchase Agreement financing.

A rise in interest rates may also cause a decrease in the market value of the mortgage loans and thereby may cause financing firms to require additional collateral. We manage the unforeseen or under anticipated need to meet additional collateral requirements with our liquidity policy, whereby a percentage of the financed amount is held in cash or cash equivalents or other readily marketable assets.

A pool or pools of mortgage loans may reach a size where hedging our borrowing rates that finance our mortgage loan purchases may be prudent in order to avoid the increased interest expense associated with rising interest rates. In such circumstances, although we do not currently do so, we may use designated hedges such that the derivatives used will qualify for “hedge accounting” under SFAS 133. To receive such treatment requires extensive management and documentation but the costs associated with such processes may be justified compared to the mark to market consequences of not qualifying under SFAS 133 as occurs with our Subordinate MBS and the use of freestanding derivatives as discussed above.

Agency MBS — Our Agency MBS portfolio consists solely of fixed-rate securities. We enter into forward commitments to sell a similar amount of Agency MBS with the same coupon rates on a to be announced basis, “TBA”. This is an economic hedging strategy and therefore cannot insulate us completely from interest rate risks.

In addition, economic hedging involves transaction and other costs which can increase, sometimes dramatically, as the period covered by the economic hedge increases. As a result, these hedging activities may significantly reduce our net interest income on Agency MBS.

Prepayment Risk Management

Prepayment risk is the risk that homeowners will pay more than their required monthly mortgage payments including payoff of mortgages. As prepayments occur, the amount of principal retained in the security declines faster than what may have been expected, thereby shortening the average life of the security by returning principal prematurely to the holder, potentially at a time when interest rates are low, as prepayment is usually associated with declining interest rates. Prepayments could cause losses if Hanover paid a premium for the security. We monitor prepayment risk through periodic reviews of the impact of a variety of prepayment scenarios on our revenues, net earnings, dividends, cash flow and net balance sheet market value.

Capital Allocation Guidelines (CAG) — Liquidity Policy

We have adopted capital allocation guidelines, which we refer to as “CAG”, to strike a balance in our ratio of debt to equity. Modifications to the CAG require the approval of a majority of the members of our Board of Directors. The CAG establishes a liquidity requirement and leverage criteria for each class of investment which is intended to keep our leverage balanced by:

- matching the amount of leverage to the level of risk (return and liquidity) of each investment; and
- monitoring the credit and prepayment performance of each investment to adjust the required capital.

Each quarter, we subtract the face amount of the financing used for the securities from the current market value of the mortgage assets to obtain our current equity positions. We then compare this value to the required capital as determined by our CAG. Management is required to maintain the guidelines established in the CAG and adjust the portfolio accordingly.

With approval of the Board of Directors, management may change the CAG criteria for a class of investments or for an individual investment based on its prepayment and credit performance relative to the market and our ability to predict or economically hedge the risk of the investments.

As a result of these procedures, the leverage of our balance sheet will change with the performance of our investments. Good credit or prepayment performance may release equity for purchase of additional investments. Poor credit or prepayment performance may cause additional equity to be allocated to existing investments, forcing a reduction in investments on the balance sheet. In either case, the periodic performance evaluation, along with the corresponding leverage adjustments, is intended to maintain an appropriate leverage and reduce the risk to our capital base.

Repurchase Agreements — Financing

We finance purchases of mortgage-related assets with equity and short-term borrowings through agreements where we sell the mortgage-related asset with a commitment to repurchase the asset at a later date. Generally, upon repayment of each borrowing, the mortgage asset used to secure the borrowing will immediately be pledged to secure a new Repurchase Agreement.

A Repurchase Agreement, although structured as a sale and repurchase obligation, is a financing transaction in which we pledge our mortgage-related assets as collateral to secure a short-term loan. Generally, the counterparty to the agreement will lend an amount equal to a percentage of the market value of the pledged collateral, ranging from 50% to 97% depending on the credit quality, liquidity and price volatility of the collateral pledged. At the maturity of the Repurchase Agreement, we repay the loan and reclaim our collateral or enter into a new Repurchase Agreement. Under Repurchase Agreements, we retain the incidents of beneficial ownership, including the right to distributions on the collateral and the right to vote on matters as to which certificate holders vote. If we default on a payment obligation under such agreements, the lending party may liquidate the collateral.

To reduce our exposure to the credit risk of Repurchase Agreements, we enter into these arrangements with several different counterparties. We monitor our exposure to the financial condition of the counterparty on a regular basis, including the percentage of our mortgage securities that are the subject of Repurchase Agreements with a single lender.

Our Repurchase Agreement borrowings bear short-term (one year or less) fixed interest rates indexed to LIBOR, plus a margin ranging from 0 to 200 basis points depending on the overall quality of the mortgage-related assets. Generally, the Repurchase Agreements require us to deposit additional collateral or reduce the amount of borrowings in the event the market value of existing collateral declines, which, in rising interest-rate markets, could require us to repay a portion of the borrowings, pledge additional collateral on the loan, or sell assets to reduce the borrowings. We attempt to minimize the impact of these severities by the use of the CAG discussed above.

Developments in 2006

Financing Agreement

On June 22, 2006, the Company and certain of its subsidiaries entered into a Master Repurchase Agreement with Deutsche Zentral-Genossenschaftsbank, Frankfurt am Main — New York Branch ("DZ") to finance the purchase of up to $200 million of prime residential mortgage loans. The Agreement has a five year term and provides financing of whole loans at a spread to LIBOR. The Company contemplates utilizing the facility to expand its investments in prime residential mortgage loans and facilitate the expansion of its Subordinate MBS collateralized by prime residential mortgage loans.

Sale of HCP

On January 16, 2007, the Company completed the sale of its due diligence business to Buyer, an affiliate of Terwin Holdings LLC (d/b/a The Winter Group). The transaction became effective on the Effective Date of January 12, 2007. The sale was effected through the sale of certain assets and assumption of certain liabilities ("Net Equity Amount") of HCP-2. Hanover is thus no longer in the business of providing due diligence services to the financial services industry and governmental agencies.

The cash expected to be realized from the transaction will be approximately $4.7 million. The Purchase Price was approximately $1.2 million, which is subject to further post-Closing adjustments pursuant to the terms of the Asset Purchase Agreement, while HCP retained all receivables and some minor assets of approximately $3.5 million. The Asset Purchase Agreement provides for a period of up to 60 days after the Closing Date to finalize the Net Equity Amount and adjust the Purchase Price, if necessary. Hanover expects to record a gain on the sale of the due diligence business in the first quarter of 2007.

The Company will continue to utilize the name Hanover Capital Partners 2, Ltd., and plans to continue to perform certain financial and technology functions and other services through this entity.

Resignation of Directors/Executives

In December 2006, two senior officers of the Company were separated from the Company under terms consistent with their existing employment agreements.

As of December 29, 2006, the Company entered into a Separation and General Release Agreement ("Ostendorf Termination Agreement") with George J. Ostendorf pursuant to which Mr. Ostendorf tendered, and the Company accepted, his resignation as a Senior Managing Director of the Company, as a member of the Company's Board of Directors, and as a member of the Board of Directors of each of the Company's affiliates of which he was a director. Pursuant to the terms of the Ostendorf Termination Agreement, Mr. Ostendorf will be paid one (1) year's salary, twelve (12) months of COBRA benefits, and certain other benefits in exchange for his agreement to certain non-competition, non-solicitation and non-disclosure conditions as well as a release in the Company's favor.

As of January 31, 2007, the Company entered into a Separation and General Release Agreement ("Mizerak Termination Agreement") with Joyce S. Mizerak pursuant to which Ms. Mizerak tendered, and the Company accepted, her resignation as President of Hanover Capital Partners 2, Ltd., as a Senior Managing Director of the Company, as a member of the Company's Board of Directors, and as a member of the Board of Directors of each of the Company's affiliates of which she was a director. Pursuant to the terms of the Mizerak Termination Agreement, Ms. Mizerak will be paid sixteen (16) months salary, eighteen (18) months COBRA benefits and certain other benefits in exchange for her agreement to certain non-disclosure conditions as well as a release in the Company's favor.

Warehouse Agreement

On August 28, 2006, the Company and Merrill Lynch International entered into a warehouse agreement for up to $125 million warehousing facility (the "Warehouse Agreement"), for the purpose of enhancing the Company's liquidity. The warehousing facility will enable the Company to acquire a diversified portfolio of mezzanine grade asset-backed securities, and certain other investments and assets in anticipation of the possible formation and issuance of a CDO. As of December 31, 2006, the Company had three securities outstanding under the warehousing facility.

Goodwill

As a result of three customers terminating the technology services they receive from HT during the latter part of 2006, we decided to re-perform the assessment of the goodwill balance for potential impairment using updated forecasted revenues and expenses as of December 31, 2006. The assessment indicated that the HT reporting unit had a fair value below its book value. In accordance with the second step of the assessment, we determined the fair value of the identifiable assets of the HT reporting unit and calculated the goodwill balance as the excess of the fair value of the entire reporting unit over the fair value of the identifiable assets of the reporting unit. The goodwill was fully impaired resulting in an impairment expense of $2.5 million.

Stock Repurchase

During March of 2006, our Board of Directors approved the adoption of a stock buyback plan that authorized the Company to buy back up to a maximum of 2 million shares of Company common stock. The repurchase program may be suspended or discontinued without prior notice. During the year ended December 31, 2006, we repurchased 263,100 shares of our common stock with a total purchase price of approximately $1,479,000.

Change in Fair Value Methodology

During the second quarter of 2006, Hanover changed the methodology by which it estimated fair value for its Subordinate MBS portfolio to an enhanced proprietary valuation model developed by Hanover. Hanover's management believes the estimates used and developed by its proprietary model reasonably reflect the values the Company may be able to receive for the securities in its Subordinate MBS portfolio should the Company choose to sell them. The impact of the change in estimate, done as of June 30, 2006, was to increase the estimated fair value of Hanover's Subordinate MBS by $7.1 million, decrease unrealized loss included in other comprehensive income (loss) by the same amount and increase book value per share by $0.86.

Regulation

HCS is a broker/dealer registered with the SEC and is a member of the National Association of Securities Dealers, Inc. Pedestal is also a broker/dealer registered with the SEC and a member of the National Association of Securities Dealers, Inc.

Competition

We compete with a variety of institutional investors for the acquisition of mortgage-related assets. These investors include other REITs, investment banking firms, savings banks, savings and loan associations, insurance companies, mutual funds, pension funds, banks and other financial institutions that invest in mortgage-related assets and other investment assets. Many of these investors have greater financial resources and access to lower costs of capital than we do. While there is generally a broad supply of liquid mortgage securities for companies like us to purchase, we cannot assure you that we will always be successful in acquiring mortgage-related assets that we deem most suitable for us, because of the number of other investors competing for the purchase of these securities. In our non-investment income operations, we compete with a variety of consulting and technology firms.

Employees

As of December 31, 2006, we had 53 full-time employees. We also utilized the services of subcontractors in HCP prior to its sale. After the sale of HCP, we have 27 full-time employees. To date, we believe we have been successful in our efforts to recruit qualified employees, but there is no assurance that we will continue to be successful in the future. None of our employees are subject to collective bargaining agreements.

Trademarks

We own five trademarks that have been registered with the United States Patent and Trademark Office.

Federal Income Tax Considerations

General

We have elected to be treated as a REIT for Federal income tax purposes, pursuant to the Internal Revenue Code of 1986, as amended (the "Code"). In brief, if certain detailed conditions imposed by the REIT provisions of the Code are met, entities that invest primarily in real estate investments and mortgage loans, and that otherwise would be taxed as corporations are, with certain limited exceptions, not taxed at the corporate level on their taxable income that is currently distributed to their shareholders. This treatment eliminates most of the "double taxation" (at the corporate level and then again at the shareholder level when the income is distributed) that typically results from the use of corporate investment vehicles. In the event that we do not qualify as a REIT in any year, we would be subject to Federal income tax as a domestic corporation and the amount of our after-tax cash available for distribution to our shareholders would be reduced. We believe we have satisfied the requirements for qualification as a REIT since commencement of our operations in September 1997. We intend at all times to continue to comply with the requirements for qualification as a REIT under the Code, as described below. At any time, the Federal income tax laws governing REITs or the administrative interpretations of those laws may be amended. Any of those new laws or interpretations thereof may take effect retroactively and could adversely affect us or our shareholders. Congress recently enacted legislation that reduced the Federal tax rate on both qualified dividend income and long-term capital gains for individuals to 15% through 2008. Because REITs generally are not subject to corporate income tax, this reduced tax rate does not generally apply to ordinary REIT dividends, which continue to be taxed at the higher tax rates applicable to ordinary income. The 15% tax rate applies to:

1. long-term capital gains recognized on the disposition of REIT shares;

2. REIT capital gain distributions and a shareholder's share of a REIT's undistributed net capital gains (except, in either case, to the extent attributable to real estate depreciation, in which case such distributions will be subject to a 25% tax rate);

3. REIT dividends attributable to dividends received by a REIT from non-REIT corporations, such as taxable REIT subsidiaries; and

4. REIT dividends attributable to income that was subject to corporate income tax at the REIT level (i.e., to the extent that a REIT distributes less than 100% of its taxable income).

These reduced rates could cause shares in non-REIT corporations to be a relatively more attractive investment to individual investors than shares in REITs. The legislation also could have an adverse effect on the market price of our securities.

Requirements for Qualification as a REIT

To qualify for income tax treatment as a REIT under the Code, we must meet certain tests which are described briefly below. We believe that we satisfy all of the requirements to remain qualified as a REIT.

Ownership of Common Stock

For all taxable years after our first taxable year, our shares of capital stock must be held by a minimum of 100 persons for at least 335 days of a 12-month year (or a proportionate part of a short tax year). In addition, at any time during the second half of each taxable year, no more than 50% in value of our capital stock may be owned directly or indirectly by five or fewer individuals, taking into account complex attribution of ownership rules. We are required to maintain records regarding the actual and constructive ownership of our shares, and other information, and to demand statements from persons owning above a certain level of our shares regarding their ownership of shares. We must keep a list of those shareholders who fail to reply to such a demand. We are required to use (and do use) the calendar year as our taxable year for income tax reporting purposes.

Nature of Assets

On the last day of each calendar quarter, we must satisfy three tests relating to the nature of our assets. First, at least 75% of the value of our assets must consist of real estate mortgage loans, certain interests in real estate mortgage loans, real estate, certain interests in real estate, shares (or transferable certificates of beneficial interest) in other REITs, government securities, cash and cash items (“Qualified REIT Assets”). We expect that substantially all of our assets will continue to be Qualified REIT Assets. Second, not more than 25% of our assets may consist of securities that are not Qualified REIT Assets. Third, except as noted below, investments in securities that are not Qualified REIT Assets are further limited as follows:

(i) not more than 20% of the value of our total assets can be represented by securities of one or more Taxable REIT Subsidiaries (as defined below),

(ii) the value of any one issuer’s securities may not exceed 5% by value of our total assets,

(iii) we may not own securities possessing more than 10% of the total voting power of any one issuer’s outstanding voting securities, and

(iv) we may not own securities having a value of more than 10% of the total value of any one issuer’s outstanding securities.

Clauses (ii), (iii) and (iv) of the third asset test do not apply to securities of a Taxable REIT Subsidiary. A “Taxable REIT Subsidiary” is any corporation in which a REIT owns stock, directly or indirectly, if the REIT and such corporation jointly elect to treat such corporation as a Taxable REIT Subsidiary. The amount of debt and rental payments from a Taxable REIT Subsidiary to a REIT are limited to ensure that a Taxable REIT Subsidiary is subject to an appropriate level of corporate tax.

In 2003, Congress enacted legislation under which, in certain circumstances, we may be able to avoid being disqualified as a REIT as a result of a failure to satisfy one or more of the foregoing asset tests provided that we satisfy certain conditions including, in some cases, the payment of an amount equal to the greater of $50,000 or an amount bearing a certain relationship to the particular violation. Notwithstanding the legislation, pursuant to our compliance guidelines, we intend to monitor closely the purchase and holding of our assets in order to comply with the foregoing asset tests.

Sources of Income

We must meet the following two separate income-based tests each year:

75% income test

At least 75% of our gross income for the taxable year must be derived from certain real estate sources including interest on obligations secured by mortgages on real property or interests in real property. Certain temporary investment income will also qualify under the 75% income test. The investments that we have made and expect to continue to make will give rise primarily to mortgage interest qualifying under the 75% income test.

95% income test

In addition to deriving 75% of our gross income from the sources listed above, at least an additional 20% of our gross income for the taxable year must be derived from those sources, or from dividends, interest or gains from the sale or disposition of stock or other securities that are not dealer property. We intend to limit substantially all of the assets that we acquire to assets that can be expected to produce income that qualifies under the 75% Income Test. Our policy to maintain REIT status may limit the types of assets, including hedging contracts and other securities, that we otherwise might acquire.

Distributions

We must distribute to our shareholders on a pro rata basis each year an amount equal to at least;

(i) 90% of our taxable income before deduction of dividends paid and excluding net capital gains, plus

(ii) 90% of the excess of the net income from foreclosure property over the tax imposed on such income by the Code, less

(iii) certain “excess noncash income.”

We intend to make distributions to our shareholders in sufficient amounts to meet this 90% distribution requirement.

If we fail to distribute to our shareholders with respect to each calendar year at least the sum of;

(i) 85% of our REIT ordinary income of the year,

(ii) 95% of our REIT capital gain net income for the year, and

(iii) any undistributed taxable income from prior years,

we will be subject to a 4% excise tax on the excess of the required distribution over the amounts actually distributed.

State Income Taxation

We file corporate income tax returns in various states. These states treat the income of a REIT in a similar manner as for Federal income tax purposes. Certain state income tax laws with respect to REITs are not necessarily the same as Federal law. Thus, differences in state income taxation as compared to Federal income taxation may exist in the future.

Taxation of Hanover’s Shareholders

For any taxable year in which we are treated as a REIT for Federal income tax purposes, amounts distributed by us to our shareholders out of current or accumulated earnings and profits will be includable by the shareholders as ordinary income for Federal income tax purposes unless properly designated by us as capital gain dividends. Dividends declared during the last quarter of a calendar year and actually paid during January of the immediately following calendar year are generally treated as if received by the shareholders on December 31 of the calendar year during which they were declared. Our dividend distributions will not generally be qualified dividend income eligible for the 15% maximum rate applicable to such income received by individuals during the period 2003 through 2008. Our distributions will not be eligible for the dividends received deduction for corporations. Shareholders may not deduct any of our net operating losses or capital losses. If we designate one or more dividends, or parts thereof, as a capital gain dividend in a written notice to the shareholders, the shareholders shall treat as long-term capital gain the lesser of (i) the aggregate amount so designated for the taxable year or (ii) our net capital gain for the taxable year. Each shareholder will include in his long-term capital gains for the taxable year such amount of our undistributed as well as distributed net capital gain, if any, for the taxable year as is designated by us in a written notice. We will be subject to a corporate level tax on such undistributed gain and the shareholder will be deemed to have paid as an income tax for the taxable year his distributive share of the tax paid by us on the undistributed gain.

Any loss on the sale or exchange of shares of our common stock held by a shareholder for six months or less will be treated as a long-term capital loss to the extent of any capital gain dividends received (or undistributed capital gain included) with respect to the common stock held by such shareholder.

If we make distributions to our shareholders in excess of our current and accumulated earnings and profits, those distributions will be considered first a tax-free return of capital, reducing the tax basis of a shareholder's shares until the tax basis is zero. Such distributions in excess of the tax basis will be taxable as gain realized from the sale of our shares. We will withhold 30% of dividend distributions to shareholders that we know to be foreign persons unless the shareholder provides us with a properly completed IRS form claiming a reduced withholding rate under an applicable income tax treaty.

In general, dividend income that a tax-exempt entity receives from us should not constitute unrelated business taxable income, or "UBTI", as defined in Section 512 of the Code. If, however, we realize certain excess inclusion income and allocate it to stockholders, a stockholder cannot offset such income by net operating losses and, if the stockholder is a tax-exempt entity, then such income would be fully taxable as UBTI under Section 512 of the Code. If the stockholder is foreign, then it would be subject to Federal income tax withholding on such excess inclusion income without reduction pursuant to any otherwise applicable income tax treaty. Excess inclusion income would be generated if we were to issue debt obligations with two or more maturities and the terms of the payments on these obligations bore a relationship to the payments received on the mortgage related assets securing those debt obligations. Our borrowing arrangements are generally structured in a manner designed to avoid generating significant amounts of excess inclusion income. We do, however, enter into various Repurchase Agreements that have differing maturity dates and afford the lender the right to sell any pledged mortgage securities upon default. The IRS may determine that these borrowings give rise to excess inclusion income that should be allocated among stockholders. Furthermore, some types of tax-exempt entities, including, without limitation, voluntary employee benefit associations and entities that have borrowed funds to acquire their shares of our common stock, may be required to treat a portion or all of the dividends they may receive from us as UBTI. We believe that our shares of stock will be treated as publicly offered securities under the plan asset rules of the Employment Retirement Income Security Act ("ERISA") for Qualified Plans. However, in the future, we may hold REMIC residual interests that would give rise to UBTI for pension plans and other tax exempt entities.

Errors have been made in the reporting of tax components of distributions to our shareholders for each year in the five year period ended 2006. The errors relate to the change in estimates used in computation of our tax earnings and profits for those years and had the effect of misstating the return of capital component of our distributions and correspondingly the dividend income component. In order to address the incorrect reporting of these distributions, corrected Forms 1099-DIV have been or will be sent to our shareholders as considered appropriate. The IRS can assess penalties against us for delivering inaccurate Forms 1099-DIV, ranging from $50 to $100 for each incorrect Form 1099-DIV sent to shareholders. However, the IRS can also waive any penalty upon a showing by us that the error was due to reasonable cause and not willful neglect. The imposition by the IRS of penalties to which the inaccurate Forms 1099-DIV may be subject could adversely affect the results of operations.

The provisions of the Code are highly technical and complex and are subject to amendment and interpretation from time to time. This summary is not intended to be a detailed discussion of all applicable provisions of the Code, the rules and regulations promulgated thereunder, or the administrative and judicial interpretations thereof. We have not obtained a ruling from the IRS with respect to tax considerations relevant to Hanover's organization or operations.

Available Information

The Company makes available on its website, www.hanovercapitalholdings.com, at no cost, electronic filings with the SEC including Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, current reports on Form 8-K, other documents and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, as soon as reasonably practicable after they are electronically filed. In addition, through the same link, the Company makes available certain of its Corporate

Governance documents including the Audit Committee Charter, Compensation Committee Charter, Nominating Committee Charter, Code of Conduct and Business Ethics, and the Code of Ethics for Principal Executive and Senior Financial Officers. Information on our website is not incorporated by reference into this report.

ITEM 1A. RISK FACTORS

Risks Related to Our Business

Mortgage-related assets are subject to risks, including borrower defaults or bankruptcies, special hazard losses, declines in real estate values, delinquencies and fraud.

During the time we hold mortgage related assets we will be subject to the risks on the underlying mortgage loans from borrower defaults and bankruptcies and from special hazard losses, such as those occurring from earthquakes or floods that are not covered by standard hazard insurance. If a default occurs on any mortgage loan we hold, or on any mortgage loan collateralizing mortgage-backed securities we own, we may bear the risk of loss of principal to the extent of any deficiency between the value of the mortgaged property plus any payments from any insurer or guarantor, and the amount owing on the mortgage loan. Defaults on mortgage loans historically coincide with declines in real estate values, which are difficult to anticipate and may be dependent on local economic conditions. Increased exposure to losses on mortgage loans can reduce the value of our investments. In addition, mortgage loans in default are generally not eligible collateral under our usual borrowing facilities and may have to be funded by us until liquidated.

In addition, if borrowers are delinquent in making payments on the mortgage loans underlying our mortgage-related assets, or if the mortgage loans are unenforceable due to fraud or otherwise, we might not be able to recoup the entire investment in such assets.

We may be unable to renew our borrowings at favorable rates or maintain longer-term financing, which may affect our profitability.

Our ability to achieve our investment objectives depends not only on our ability to borrow money in sufficient amounts and on favorable terms, but also on our ability to renew or replace on a continuous basis our maturing short-term borrowings or to refinance such borrowings with longer-term financings. If we are not able to renew or replace maturing borrowings, or obtain longer-term financing, we would have to sell some or all of our assets, possibly under adverse market conditions. In addition, the failure to renew or replace maturing borrowings, or obtain longer-term financing, may require us to terminate hedge positions, which could result in further losses. Any number of these factors in combination may cause difficulties for us, including a possible liquidation of a major portion of our portfolio at possibly disadvantageous prices with consequent losses, which, in the extreme, may render us insolvent.

Our profitability depends on the availability and prices of mortgage assets that meet our investment criteria.

The availability of mortgage assets that meet our criteria depends on, among other things, the size and level of activity in the real estate lending markets. The size and level of activity in these markets, in turn, depends on the level of interest rates, regional and national economic conditions, appreciation or decline in property values and the general regulatory and tax environment as it relates to mortgage lending. In addition, we expect to compete for these investments with other REITs, investment banking firms, savings banks, savings and loan associations, banks, insurance companies, mutual funds, other lenders and other entities that purchase mortgage-related assets, many of which have greater financial resources than we do. If we cannot obtain sufficient mortgage loans or mortgage securities that meet our criteria, at favorable yields, our business will be adversely affected.

We are subject to various obligations related to our use of, and dependence on, debt.

If we violate covenants in any debt agreements, we could be required to repay all or a portion of our indebtedness before maturity at a time when we might be unable to arrange financing for such repayment on attractive terms, if at all. Violations of certain debt covenants may result in our being unable to borrow unused amounts under a line of credit, even if repayment of some or all borrowings is not required.

A violation under one debt agreement may also trigger defaults in other debt agreements requiring repayments or imposing further restrictions. This could force us to sell portions of our portfolio at a time when losses could result. In any event, financial covenants under our current or future debt obligations could impair our planned business strategies by limiting our ability to borrow.

Our use of repurchase agreements to borrow funds may give our lenders greater rights in the event that either we or they file for bankruptcy.

Our borrowings under repurchase agreements may qualify for special treatment under the bankruptcy code, giving our lenders the ability to avoid the automatic stay provisions of the bankruptcy code and to take possession of and liquidate our collateral under the repurchase agreements without delay in the event that we file for bankruptcy. Furthermore, the special treatment of repurchase agreements under the bankruptcy code may make it difficult for us to recover our pledged assets in the event that a lender files for bankruptcy. Thus, our use of repurchase agreements will expose our pledged assets to risk in the event of a bankruptcy filing by either a lender or us.

We may engage in hedging transactions, which can limit our gains and increase exposure to losses.

We may enter into hedging transactions to protect us from the effects of interest rate fluctuations on floating rate debt and also to protect our portfolio of mortgage assets from interest rate and prepayment rate fluctuations. Our hedging transactions may include entering into interest rate swap agreements or interest rate cap or floor agreements, purchasing or selling futures contracts, purchasing put and call options on securities or securities underlying futures contracts, or entering into forward rate agreements. There are no assurances that our hedging activities will have the desired impact on our results of operations or financial condition.

Interest rate fluctuations may adversely affect our net income.

Interest rates are highly sensitive to many factors, including governmental monetary and tax policies, domestic and international economic and political considerations and other factors beyond our control. Interest rate fluctuations can adversely affect our income.

The relationship between short-term and longer-term interest rates is often referred to as the “yield curve.” Variances in the yield curve may reduce our net income. Short-term interest rates are ordinarily lower than longer-term interest rates. If short-term interest rates rise disproportionately relative to longer-term interest rates (a flattening of the yield curve) or short-term interest rates exceed longer-term interest rates (a yield curve inversion), our borrowing costs may increase more rapidly than the interest income earned on our assets. Because our assets generally bear interest based on longer-term rates than our borrowings, a flattening or inversion of the yield curve would tend to decrease our net income. Additionally, the spread between the yields earned on any new investments and available borrowing rates may decline, which would likely decrease our net income.

The loss of any of our executive officers could adversely affect our operating performance.

Our operations and financial performance depend heavily upon the efforts of our executive and investment personnel. We cannot give assurances that these executive officers can be retained or replaced with equally skilled and experienced professionals. The loss of any one of these individuals could have an adverse effect upon our business and results of operations at least for a short time.

We may hold title to real property, which could cause us to incur costly liabilities.

We may be forced to foreclose on a defaulted mortgage loan in order to recoup part of our investment, which means we might hold title to the underlying property until we are able to arrange for resale and will therefore be subject to the liabilities of property owners. For example, we may become liable for the costs of removal or remediation of hazardous substances. These costs may be significant and may exceed the value of the property. In addition, current laws may materially limit our ability to resell foreclosed properties, and future laws, or more stringent interpretations or enforcement policies of existing requirements, may increase our exposure to liability. Further, foreclosed property is not financed and may require considerable amounts of capital before sold, thereby reducing our opportunities for alternate investments that could produce greater amounts of income.

Our business could be adversely affected if we are unable to safeguard the security and privacy of the personal financial information of borrowers to which we have access.

In connection with certain of our loan file reviews and other activities with respect to mortgage loans in our portfolio, we have access to the personal non-public financial information of the borrowers. In addition, in operating an Internet exchange for trading mortgage loans, HT sometimes has access to borrowers' personal non-public financial information, which it may provide to potential third party investors in the mortgage loans. This personal non-public financial information is highly sensitive and confidential, and if a third party were to misappropriate this information, we potentially could be subject to both private and public legal actions. Although we have policies and procedures designed to safeguard confidential information, we cannot give complete assurances that these policies and safeguards are sufficient to prevent the misappropriation of confidential information or that our policies and safeguards will be deemed compliant with any existing Federal or state laws or regulations governing privacy, or with those laws or regulations that may be adopted in the future.

Risks Related to Our Status as a REIT and Our 40 Act Exemption

If we do not maintain our status as a REIT, we will be subject to tax as a regular corporation and face substantial tax liability.

We believe that we currently qualify, and expect to continue to qualify, as a REIT under the Code. However, qualification as a REIT involves the application of highly technical and complex Code provisions for which only a limited number of judicial or administrative interpretations exist. Even a technical or inadvertent mistake could jeopardize our REIT status. Furthermore, new tax legislation, administrative guidance or court decisions, in each instance potentially with retroactive effect, could make it more difficult or impossible for us to qualify as a REIT. If we fail to qualify as a REIT in any tax year, then:

- we would be taxed as a regular domestic corporation, which, among other things, means we would be unable to deduct distributions made to stockholders in computing taxable income and would be subject to Federal income tax on our taxable income at regular corporate rates;
- our tax liability could be substantial and would reduce the amount of cash available for distribution to stockholders; and
- unless we were entitled to relief under applicable statutory provisions, we would be disqualified from treatment as a REIT for the four taxable years following the year during which we lost our qualification, and our cash available for distribution to stockholders would be reduced for each of the years during which we did not qualify as a REIT.

If we fail to comply with rules governing our ownership interests in "taxable REIT subsidiaries," we will lose our REIT qualification.

On January 1, 2001, the REIT Modernization Act became effective. Among other things, it allows REITs, subject to certain limitations, to own, directly or indirectly, up to 100% of the stock of a "taxable REIT subsidiary" that can engage in businesses previously prohibited to a REIT. In particular, the Act permitted us to restructure our operating subsidiaries as taxable REIT subsidiaries. As a result, for periods ending after June 30, 2002, through December 31, 2006, the financial statements of certain subsidiaries were consolidated with Hanover's financial statements, and it is intended that we will continue to do so with the newly-merged entity Hanover Capital Partners 2, Ltd. However, the taxable REIT subsidiary provisions are complex and impose several conditions on the use of taxable REIT subsidiaries, which are generally designed to ensure that taxable REIT subsidiaries are subject to an appropriate level of corporate taxation. Further, no more than 20% of the fair market value of a REIT's assets may consist of securities of taxable REIT subsidiaries, and no more than 25% of the fair market value of a REIT's assets may consist of non-qualifying assets, including securities of taxable REIT subsidiaries and other taxable subsidiaries. In addition, the REIT Modernization Act legislation provides that a REIT may not own more than 10% of the voting power or value of a taxable subsidiary that is not treated as a taxable REIT subsidiary. If our investments in our subsidiaries do not comply with these rules, we would fail to qualify as a REIT and we would be taxed as a regular corporation. Furthermore, certain transactions between us and a taxable REIT subsidiary that are not conducted on an arm's length basis would be subject to a tax equal to 100% of the amount of deviance from an arm's length standard.

Complying with REIT requirements may limit our ability to hedge effectively.

The REIT provisions of the Code may substantially limit our ability to hedge mortgage assets and related borrowings by requiring us to limit our income in each year from qualified hedges, together with any other income not generated from qualified real estate assets, to no more than 25% of our gross income. In addition, we must limit our aggregate income from nonqualified hedging transactions, from our provision of services and from other non-qualifying sources to no more than 5% of our annual gross income. As a result, we may have to limit our use of advantageous hedging techniques. This could result in greater risks associated with changes in interest rates than we would otherwise want to incur. If we violate the 25% or 5% limitations, we may have to pay a penalty tax equal to the amount of income in excess of those limitations, multiplied by a fraction intended to reflect our profitability. If we fail to observe these limitations, unless our failure was due to reasonable cause and not due to willful neglect, we could lose our REIT status for Federal income tax purposes. The fair market value of a hedging instrument will not be counted as a qualified asset for purposes of satisfying the requirement that, at the close of each calendar quarter, at least 75% of the total value of our assets be represented by real estate and other qualified assets.

REIT requirements may force us to forgo or liquidate otherwise attractive investments.

In order to qualify as a REIT, we must ensure that at the end of each calendar quarter at least 75% of the fair market value of our assets consists of cash, cash items, government securities and qualified REIT real estate assets. The remainder of our investment in securities (other than government securities and qualified real estate assets) generally cannot include more than 10% of the outstanding voting securities of any one issuer or more than 10% of the total value of the outstanding securities of any one issuer. In addition, in general, no more than 5% of the value of our assets (other than government securities and qualified real estate assets) can consist of the securities of any one issuer and no more than 20% of the value of our total securities can be represented by securities of one or more taxable REIT subsidiaries. Our efforts to comply with the rules might force us to pass up opportunities to acquire otherwise attractive investments. If we fail to comply with these requirements at the end of any calendar quarter, we may be able to correct such failure within 30 days after the end of the calendar quarter in order to avoid losing our REIT status and suffer adverse tax consequences. As a result, we may be required to liquidate otherwise attractive investments.

Complying with REIT requirements may force us to borrow or liquidate assets to make distributions to stockholders.

As a REIT, we must distribute at least 90% of our annual taxable income (subject to certain adjustments) to our stockholders. From time to time, we may generate taxable income greater than our net income for financial reporting purposes, or our taxable income may be greater than our cash flow available for distribution to stockholders. If we do not have other funds available in these situations, we could be required to borrow funds, sell a portion of our mortgage securities at disadvantageous prices or find another alternative source of funds in order to make distributions sufficient to enable us to pay out enough of our taxable income to satisfy the distribution requirement. These alternatives could increase our costs or reduce our equity.

Regulation as an investment company could materially and adversely affect our business; efforts to avoid regulation as an investment company could limit our operations.

We intend to conduct our business in a manner that allows us to avoid being regulated as an investment company under the 40 Act. Investment company regulations, if they were deemed applicable to us, would prevent us from conducting our business as described in this report by, among other things, limiting our ability to use borrowings.

The 40 Act exempts entities that are primarily engaged in purchasing or otherwise acquiring mortgages and other liens on and interests in real estate. Under the SEC's current interpretation, in order to qualify for this exemption we must maintain at least 55% of our assets directly in qualifying real estate interests and an additional 25% of our assets in real estate related assets. However, mortgage-backed securities that do not represent all of the certificates issued with respect to an underlying pool of mortgages may be treated as securities separate from the underlying mortgage loans and, thus, may not be counted towards our satisfaction of the 55% requirement. Generally investments in the subordinated tranches of securitized loan pools do not constitute "qualifying real estate interests" unless certain qualifying abilities to govern the control of any foreclosures are in place. Our ownership of these mortgage-backed securities, therefore, may be limited to the extent that servicers of the loans in the pools do not grant such abilities to Hanover.

If the SEC changes its position on the interpretations of the exemption, we could be required to sell assets under potentially adverse market conditions in order to meet the new requirements and also have to purchase lower-yielding assets to comply with the 40 Act.

An emerging issue with the Financial Accounting Standards Board could have a major impact on our ability to operate as a REIT and retain our exemption under the 40 Act.

The Emerging Issues Task Force (EITF) of the Financial Accounting Standards Board (FASB) has deferred making a decision on a potential new issue pending a decision by the FASB to add to its agenda a project to provide guidance on the issue. That issue could have a major impact on Hanover.

That issue deals with the accounting from the perspective of both the buyer and the seller of financial assets that are the subject of a repurchase agreement with the same parties.

Example Transaction — Hanover's primary current practice
Hanover (the buyer) purchases a financial asset (mortgage loans or mortgage-backed securities) and simultaneously enters into a repurchase agreement with an investment bank or securities broker (the seller) to finance the transaction. The purchase and repurchase agreement may be settled net (no gross cash movements) with Hanover paying a deposit amount, as part of the collateral requirements of the repurchase agreement, equal to a percentage of the principal amount of the financial asset (in Hanover's situations, amounts ranging from 30 to 50 percent).

Current Industry Practice
Hanover believes that most buyers have accounted for these transactions as described in the Hanover example transaction (and similar transactions) as a purchase and subsequent financing (as Hanover has done) and that there is currently minimal diversity in this practice.

The Issue
The issue is how to apply the criterion in paragraph 9(a) of SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, in accounting for transactions involving the purchase of financial assets and simultaneous repurchase of the same financial assets with the seller.

Paragraph 9(a) requires "isolation" from the transferor (seller). If the isolation requirement is met, the seller meets the requirements in paragraph 9(a) of SFAS No. 140 and the transaction qualifies as a sale by the seller and a purchase and financing by the buyer, as Hanover has done. If the isolation requirement is not met, the transaction is not a sale by the seller and paragraph 12 of SFAS No. 140 would require the buyer to record the transaction as a financing to the extent of the cash or other assets that were transferred. The classification of the resulting financing transaction(s) if the isolation requirement is not met would most likely be that of a derivative instrument.

There is a view, contrary to current industry and Hanover practice, that since the seller has continuing involvement through the repo, as in the above example, the transferred assets have not been isolated from the seller and therefore, the isolation requirement is not met. Those with this view also believe that demonstrating isolation legally is not possible without a legal opinion and such opinions would be too vague to meet the isolation requirement. This contrary view is what the EITF has been asked to consider.

Impact on Hanover if the isolation requirement of paragraph 9(a) is not met
The accounting classification of the resulting derivative instruments held by Hanover, a REIT, if the isolation requirement of paragraph 9(a) is not met, might impact Hanover's REIT tax exempt status. A REIT must hold at least 75% of its total assets in *qualified real estate assets* and derive at least 75% of its gross income from *real property* (for example, rent or mortgage interest). Derivative instruments are not qualified assets. Further, we could find that our ability to remain exempt under the provisions of the 40 Act could be weakened as we will have to determine the appropriate treatment for the resulting derivative instruments.

Risks Related to Our Corporate Organization and Structure

Our charter limits ownership of our capital stock and attempts to acquire our capital stock.

To facilitate maintenance of our REIT qualification and for other strategic reasons, our charter prohibits direct or constructive ownership by any person of more than 7.5% (except in the case of John A. Burchett, our Chairman, Chief Executive Officer and President, who can acquire up to 20%) in value of the outstanding shares of our capital stock. Our charter's constructive ownership rules are complex and may cause the outstanding stock owned by a group of related individuals or entities to be deemed to be constructively owned by one individual or entity. As a result, the acquisition of less than 7.5% of the outstanding stock by an individual or entity could cause that individual or entity to own constructively in excess of 7.5% of the outstanding stock, and thus be subject to our charter's ownership limit. Any attempt to own or transfer shares of our capital stock in excess of the ownership limit without the consent of the Board of Directors will be void, and could result in the shares being transferred by operation of law to a charitable trust.

Provisions of our charter which inhibit changes in control, could prevent stockholders from obtaining a premium price for our common stock.

Provisions of our charter may delay or prevent a change in control of the Company or other transactions that could provide stockholders with a premium over the then-prevailing market price of our common stock or that might otherwise be in the best interests of the stockholders. These include a staggered board of directors, our share ownership limit described above and our stockholders rights plan.

Our Board of Directors could adopt the limitations available under Maryland law on changes in control that could prevent transactions in the best interests of stockholders.

Certain provisions of Maryland law applicable to us prohibit "business combinations", including certain issuances of equity securities, with any person who beneficially owns 10% or more of the voting power of our outstanding shares, or with an affiliate of ours who, at any time within the two-year period prior to the date in question, was the beneficial owner of 10% or more of the voting power of our outstanding voting shares (which is referred to as a so-called "interested stockholder"), or with an affiliate of an interested stockholder. These prohibitions last for five years after the most recent date on which the stockholder became an interested stockholder. After the five-year period, a business combination with an interested stockholder must be approved by two super-majority stockholder votes unless, among other conditions, our common stockholders receive a minimum price for their shares and the consideration is received in cash or in the same form as previously paid by the interested stockholder for its shares of common stock. Our Board of Directors has opted out of these business combination provisions. As a result, the five-year prohibition and the super-majority vote requirements will not apply to a business combination involving the Company. Although it has no current plans to do so, our Board of Directors may, however, repeal this election in most cases and cause the Company to become subject to these provisions in the future.

We are dependent on external sources of capital, which may not be available.

To qualify as a REIT, we must, among other things, distribute to our stockholders each year at least 90% of our REIT taxable income (excluding any net capital gains). Because of these distribution requirements, we likely will not be able to fund all future capital needs with income from operations. We therefore will have to rely on third-party sources of capital, including possible future equity offerings, which may or may not be available on favorable terms or at all. Our access to third-party sources of capital depends on a number of things, including the market's perception of our growth potential and our current and potential future earnings. Moreover, additional equity offerings may result in substantial dilution of stockholders' interests, and additional debt financing may substantially increase leverage.

We may change our policies without stockholder approval.

Our Board of Directors and management determine all of our policies, including our investment, financing and distribution policies. Although they have no current plans to do so, they may amend or revise these policies at any time without a vote of our stockholders. Policy changes could adversely affect our financial condition, results of operations, the market price of our common stock or our ability to pay dividends or distributions.

Our business could be adversely affected if we have deficiencies in our disclosure controls and procedures or internal control over financial reporting.

The design and effectiveness of our disclosure controls and procedures and internal control over financial reporting may not prevent all errors, misstatements or misrepresentations. While management continues to review the effectiveness of our disclosure controls and procedures and internal control over financial reporting, there can be no assurance that our disclosure controls and procedures or internal control over financial reporting will be effective in accomplishing all control objectives all of the time. Deficiencies, particularly material weaknesses, in internal control over financial reporting which may occur in the future could result in misstatements of our results of operations, restatements of our financial statements, a decline in our stock price, or otherwise materially and adversely affect our business, reputation, results of operation, financial condition, or liquidity.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

Our operations are conducted in several leased office facilities throughout the United States. A summary of the office leases is shown below:

Location	Segment	Office Space (sq. ft.)	Current Annual Rental	Expiration Date	Office Use
Edison, New Jersey	Hanover and HT	10,128	$ 191,672	September 2010	Executive, Administration and Technology Operations
Edison, New Jersey (1)	Hanover	21,293	402,083	October 2010	Administration, Due Diligence Operations
New York, New York	Hanover	2,500	87,154	December 2010	Executive, Administration, Investment Operations
Chicago, Illinois	Hanover	423	9,400	January 2009	Marketing
Total		34,344	$ 690,309		

(1) This facility and corresponding lease agreement were assigned to Terwin Acquisition I, LLC., in connection with the sale of the Company's HCP business effective January 12, 2007.

We believe that these facilities are adequate for our foreseeable office space needs and that lease renewals and/or alternate space at comparable rental rates are available, if necessary. During the normal course of our business, additional facilities may be required to accommodate growth.

ITEM 3. LEGAL PROCEEDINGS

On or about January 11, 2006, the Company received a Complaint filed on behalf of its former CFO, J. Holly Loux, claiming the Company and its current CEO, John A. Burchett, wrongfully terminated her employment. The action is titled Loux v Hanover Capital Mortgage Holdings, Inc. Civil Action No. 06-0122 (KSM), and is currently pending in the United States District Court for the District of New Jersey. By her Complaint, Ms. Loux seeks reinstatement, attorney's fees and costs, and an undetermined amount of damages. The Company and Mr. Burchett deny her allegations and they are vigorously defending the claims made by Ms. Loux. The matter is still in the discovery stages. A settlement conference was held on March 9, 2007. The parties were unable to resolve the case at the settlement conference.

From time to time, we are involved in litigation incidental to the conduct of our business. Except for the Loux matter noted above, we are not currently a party to any lawsuit or proceeding which, in the opinion of management, is likely to have a material adverse effect on our business, financial condition, or results of operation.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

Not applicable.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Our common stock trades on the American Stock Exchange under the symbol "HCM." As of March 13, 2007, there were 142 record holders, and approximately 6,377 beneficial owners, of our common stock.

The following table sets forth, for the periods indicated, the high and low sales prices per share of our common stock as reported by the American Stock Exchange:

	2006		2005	
	High	Low	High	Low
1st Quarter	$ 7.20	$ 4.34	$ 11.89	$ 10.40
2nd Quarter	6.50	5.00	11.75	9.60
3rd Quarter	7.09	5.25	10.68	6.88
4th Quarter	6.64	4.85	8.40	6.20

The following graph compares the cumulative 5-year total return provided to shareholders on Hanover Capital Mortgage Holdings, Inc.'s common stock relative to the cumulative total returns of the S & P 500 index, and a customized peer group of six companies that includes: Capstead Mortgage Corp., Dynex Capital Inc, Impac Mortgage Holdings Inc, Indymac Bancorp Inc, Redwood Trust Inc and Thornburg Mortgage Inc. An investment of $100 (with reinvestment of all dividends) is assumed to have been made in our common stock, in the peer group, and the index on 12/31/2001 and its relative performance is tracked through 12/31/2006.

COMPARISON OF 5 YEAR CUMULATIVE TOTAL RETURN*
Among Hanover Capital Mortgage Holdings, Inc., The S & P 500 Index
And A Peer Group

* $100 invested on 12/31/01 in stock or index-including reinvestment of dividends. Fiscal year ending December 31.

	12/01	12/02	12/03	12/04	12/05	12/06
Hanover Capital Mortgage Holdings, Inc.	**100.00**	**99.71**	**198.32**	**197.21**	**138.07**	**116.00**
S & P 500	**100.00**	**77.90**	**100.24**	**111.15**	**116.61**	**135.03**
Peer Group	**100.00**	**105.11**	**174.20**	**215.92**	**191.16**	**227.27**

The following table lists the cash dividends we declared on each share of our common stock for the periods indicated:

	Cash Dividends Declared Per Share
2006	
Fourth Quarter ended December 31, 2006	$ 0.15
Third Quarter ended September 30, 2006	0.15
Second Quarter ended June 30, 2006	0.20
First Quarter ended March 31, 2006	0.20
2005	
Fourth Quarter ended December 31, 2005	$ 0.25
Third Quarter ended September 30, 2005	0.25
Second Quarter ended June 30, 2005	0.30
First Quarter ended March 31, 2005	0.30

We intend to pay quarterly dividends and other distributions to our shareholders of all or substantially all of our REIT taxable income in each year to qualify for the tax benefits accorded to a REIT under the Code. All distributions will be made at the discretion of our Board of Directors and will depend on our earnings, both GAAP and tax, financial condition, maintenance of REIT status and such other factors as the Board of Directors deems relevant.

ITEM 6. SELECTED FINANCIAL DATA

The following tables set forth our selected financial data as of and for the year ended December 31, for each of the years indicated. The selected financial data for the years ended December 31, 2006, 2005 and 2004, and as of December 31, 2006 and 2005, have been derived from our audited Consolidated Financial Statements included elsewhere in this report. The financial information for the years ended December 31, 2003 and 2002 and as of December 31, 2004, 2003 and 2002, have been derived from our audited Consolidated Financial Statements not included in this report. The historical selected consolidated financial data may not be indicative of our future performance. The selected financial data should be read in conjunction with the more detailed information contained in our Consolidated Financial Statements and Notes thereto and "Management's Discussion and Analysis of Financial Condition and Results of Operations" included elsewhere in this Annual Report on Form 10-K.

Statement of Operations Highlights
(dollars in thousands, except per share data)

	Years Ended December 31,				
	2006	2005 (2)	2004	2003	2002 (1)
Net interest income	$ 10,336	$ 7,986	$ 9,935	$ 6,336	$ 5,990
Gain on sale and mark to market of mortgage assets	(1,362)	1,980	6,248	8,432	2,445
Loan brokering, technology and other	2,885	5,303	5,799	6,165	3,031
Total revenues	11,859	15,269	21,982	20,933	11,466
Total expenses	13,913	15,008	14,503	13,244	7,650
Operating income (loss)	(2,054)	261	7,479	7,689	3,816
Equity in income (loss) of equity method investees:					
Hanover Capital Partners Ltd.	—	—	—	—	(143)
HanoverTrade, Inc.	—	—	—	—	511
HDMF-I LLC	—	(215)	445	1	157
Hanover Capital Partners 2, Inc.	—	—	—	—	(19)
HST-I	53	42	—	—	—
HST-II	57	8	—	—	—
	110	(165)	445	1	506
Minority interest in loss of consolidated affiliate	(5)	(57)	—	—	—
Income (loss) from continuing operations before income tax provision (benefit)	(1,939)	153	7,924	7,690	4,322
Income tax provision (benefit)	12	2	(26)	180	58
Income (loss) from continuing operations	(1,951)	151	7,950	7,510	4,264
Discounted Operations:					
Income (loss) from discontinued operations before income tax provision (benefit)	(917)	1,387	108	794	865
Income tax provision (benefit) from discontinued operations	58	172	(63)	264	(9)
Income (loss) from discontinued operations	(975)	1,215	171	530	874
Net income (loss)	$ (2,926)	$ 1,366	$ 8,121	$ 8,040	$ 5,138
Basic earnings per share:					
Income (loss) from continuing operations	$ (0.23)	$ 0.02	$ 0.96	$ 1.29	$ 0.97
Net income (loss)	$ (0.35)	$ 0.16	$ 0.98	$ 1.38	$ 1.16
Diluted earnings per share:					
Income (loss) from continuing operations	$ (0.23)	$ 0.02	$ 0.95	$ 1.26	$ 0.95
Net income (loss)	$ (0.35)	$ 0.16	$ 0.97	$ 1.35	$ 1.15
Dividends declared per share	$ 0.70	$ 1.10	$ 1.60	$ 1.35	$ 1.00

(1) Information prior to July 1, 2002 does not include the consolidation of Hanover Capital Partners Ltd., HanoverTrade, Inc., and Hanover Capital Partners 2, Inc. with Hanover.

(2) Information prior to June 1, 2005 does not include the consolidation of HDMF-I with Hanover.

Balance Sheet Highlights
(dollars in thousands, except per share data)

	December 31,				
	2006	2005	2004	2003	2002
Cash and cash equivalents	$ 13,982	$ 30,492	$ 20,601	$ 32,586	$ 10,605
Mortgage loans	9,736	24,135	41,101	58,985	103,164
Mortgage securities	265,957	197,488	164,580	81,564	23,903
Other subordinate security	2,757	2,703	—	—	—
Other assets	11,837	17,369	15,856	15,856	16,449
Total assets	$ 304,269	$ 272,187	$ 242,138	$ 188,991	$ 154,121
Repurchase agreements	$ 193,247	$ 154,268	$ 130,102	$ 55,400	$ 6,283
CMO borrowing	7,384	11,438	35,147	52,164	102,589
Liability to Trusts	41,239	41,239	—	—	—
Other liabilities	4,816	5,622	5,670	6,608	3,935
Total liabilities	246,686	212,567	170,919	114,172	112,807
Minority interest	—	189	—	—	—
Stockholders' equity	57,583	59,431	71,219	74,819	41,314
Total liabilities and stockholders' equity	$ 304,269	$ 272,187	$ 242,138	$ 188,991	$ 154,121
Number of common shares outstanding	8,233,062	8,496,162	8,381,583	8,192,903	4,474,222
Book value per common share	$ 6.99	$ 7.00	$ 8.50	$ 9.13	$ 9.23

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Summary

For the year ended December 31, 2006, our net income (loss) of $(2.9) million was $4.3 million lower than the previous year's net income of $1.4 million. This decrease is primarily attributable to a goodwill impairment charge for HT of $2.5 million and lower operating income of our REIT segment. The majority of our operating income in the years 2006 and 2005 is attributable to the REIT. The REIT's decline in operating income in 2006 is primarily the result of lower gains earned in 2006 than we experienced in 2005 in our Subordinate MBS portfolio and impairments on real estate owned by HDMF-I. The REIT's gains in 2006 were $0.8 million compared to $4.1 million in 2005. We had impairments of real estate owned of $1.2 million during 2006.

For the year ended December 31, 2005, our net income of $1.4 million was $6.7 million lower than the previous year's net income of $8.1 million. This is primarily attributable to lower operating income of our REIT segment. The majority of our net income in the years 2005 and 2004 is attributable to the REIT. The REIT's decline in operating income in 2005 is primarily the result of lower gains earned in 2005 than we experienced in 2004 in our Subordinate MBS portfolio. The REIT's gains in 2005 from our Subordinate MBS portfolio were $4.1 million compared to $10.4 million in 2004.

A review of our operations for the years ended December 31, 2006, 2005 and 2004 is set forth below by operating segment. Since our two operating segments have generated substantially all of our net income we have concentrated our discussion and analysis on these components.

Selected Components of Operating Income by Segment
(dollars in thousands)

	Year Ended December 31, 2006	2005	2004
Hanover — REIT			
Total revenues	$ 9,733	$ 10,731	$ 16,593
Total expenses	8,251	8,287	7,848
Operating income (loss)	1,482	2,444	8,745
HT			
Total revenues	2,232	4,603	5,446
Total expenses	5,768	6,786	6,712
Operating income (loss)	(3,536)	(2,183)	(1,266)
Operating income (loss), as reported	$ (2,054)	$ 261	$ 7,479

Our operating income (loss) declined in 2006 by $2.3 million from our 2005 operating income. The decline was the result of a decline in our REIT operating income of $1.0 million from 2005 and an increase in our HT operating loss of $1.4 million from 2005.

Our operating income declined in 2005 by $7.2 million from our 2004 operating income. That decline was the result of a decline in our REIT operating income of $6.3 million from 2004 and a $0.9 million increase in the operating loss of HT.

Significant changes in our financial position for 2006 are primarily related to further investments from the proceeds of our issuance of junior subordinated notes of $40 million issued in conjunction with the creation of two statutory trusts discussed further under the Liquidity and Capital Resources section of this Item.

Critical Accounting Estimates

The significant accounting policies used in preparation of our Consolidated Financial Statements are described in Note 2 to our Consolidated Financial Statements included in this report. Certain critical accounting policies are complex and involve significant judgment by our management, including the use of estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses. As a result, changes in these estimates and assumptions could significantly affect our financial position or our results of operations. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities.

Change in Estimate of Fair Value

During the second quarter of 2006, we changed the methodology by which we determine estimated fair value for our Subordinate MBS portfolio to an enhanced proprietary valuation model we developed from a model used for several years as a bench-mark for evaluating independent third-party estimates of fair value.

Through the first quarter of 2006, we used the lower of independent third-party valuations or our valuations as the fair value of our Subordinate MBS. Over time, as the portfolio of these securities has changed in size, complexity, and age or maturity, historical sales data suggested that the fair values developed under this methodology were, overall, too low.

As part of our normal quarterly activities related to fair value estimates, we conducted a review of our Subordinate MBS sales for the years 2004 and 2005 and the first two quarters of 2006 and compared prices obtained in the sales to the corresponding independent third-party estimates of fair value and the estimates determined by our enhanced internal model. The review disclosed that our enhanced model was a more accurate indicator of fair value especially as the nature of the portfolio has changed through increased size and concentration into these securities and the portfolio of Subordinate MBS has aged. Although the independent third-party estimates are useful as a comparison tool, we believe they are no longer representative of fair value. Further, we do not believe independent third-parties are willing to consistently provide valuations that are more robust in nature and therefore a more representative estimate of fair value of our Subordinate MBS without considerable cost to us.

Our Subordinate MBS securities are not readily marketable with quoted market prices. To obtain the best estimate of fair value requires a current knowledge of the Subordinate MBS attributes, characteristics related to the underlying mortgages collateralizing the securities and the market of these securities. We maintain extensive data related to the collateral of our Subordinate MBS and as a result are able to apply this data and all other relevant market data to our estimates of fair value. We believe the estimates used reasonably reflect the values we may be able to receive should we choose to sell them. Many factors must be considered in order to estimate market values, including, but not limited to interest rates, prepayment rates, amount and timing of credit losses, supply and demand, liquidity, and other market factors. Accordingly, our estimates are inherently subjective in nature and involve uncertainty and judgment to interpret relevant market and other data. Amounts realized in actual sales may differ from the fair values presented.

The following schedule shows the impact of the change in estimate as of June 30, 2006 (dollars in thousands, except per share amounts):

	Estimated Fair Value of Subordinate MBS	Difference in Estimated Fair Value and Adjusted Cost Basis Included In Accumulated Other Comprehensive Income Unrealized Gain (Loss)	Book Value per Share
Newly adopted methodology	$ 145,746	$ 340	$ 7.59
Previous methodology	138,610	(6,796)	6.73
Impact of change	$ 7,136	$ 7,136	$ 0.86

Amortization of Purchase Discounts on Mortgage Securities

Purchase discounts on mortgage securities are recognized in earnings as adjustments to interest income (accretable yield) using the effective yield method over the estimated lives of the related securities as prescribed under the Emerging Issues Task Force of the Financial Accounting Standards Board 99-20, *Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets* (EITF 99-20). Estimates and judgments related to future levels of mortgage prepayments, mortgage default assumption rates and timing and amount of credit losses are critical to this determination. Mortgage prepayment expectations, default rate assumptions, and timing and amount of credit losses can vary considerably from period to period based on current and projected changes in interest rates and other factors such as portfolio composition. Management estimates mortgage prepayments, defaults and credit losses based on past experiences with specific investments within the portfolio and current market expectations for changes in the interest rate environment. Management's estimates could vary widely from that ultimately experienced and, such variances could be material.

Change in Accounting Estimate for Capitalized Software Costs

As of January 1, 2006, we increased the remaining estimated useful life of our capitalized software costs, as the underlying software components and modules are expected to have a useful life in excess of the original estimation. The net balance as of December 31, 2005 was originally estimated to be substantially amortized by the end of 2007 and that net balance will now be amortized over a three year period beginning on January 1, 2006. This change in estimate resulted in reducing amortization expense and increasing the Company's net income by approximately $294,000 and increasing diluted earnings per share by $0.04 for the year ended December 31, 2006.

Real Estate Owned

We record our Real Estate Owned, "REO", at the lower of cost or estimated fair value, less anticipated costs to sell. The estimated fair value is determined through real estate appraisals, broker pricing and home inspections, which are updated on a periodic basis. For the year ended December 31, 2006, we have recorded approximately $1.2 million of impairment expense related to REO based upon these estimated fair values.

Goodwill Analysis for HT

During the second quarter of 2006, we performed an assessment of the goodwill balance assigned to HT for potential impairment. We determined HT had a fair value in excess of its book value as of June 30, 2006 and, therefore, the goodwill was not impaired. The fair value determination was performed using an income approach based upon the discounted cashflow method. The projected cashflows were estimated by tax-effecting forecasted revenue and expenses for several future periods. These projections include estimated revenue from our existing customers and additional revenue from new customers.

Subsequent to our valuation performed as of June 30, 2006, we received notices from three customers terminating the services they receive from us. As part of the valuation analysis, we anticipated all of these customers to continue to receive services from us for several years into the future and one of these customers represented a significant portion of the projected revenue.

As a result of these terminations, we decided to re-perform the assessment of the goodwill balance for potential impairment using updated forecasted revenues and expenses. The assessment indicated that the HT reporting unit had a fair value below its book value. In accordance with the second step of the assessment, we determined the fair value of the identifiable assets of the HT reporting unit and calculated the goodwill balance as the excess of the fair value of the entire reporting unit over the fair value of the identifiable assets of the reporting unit. The goodwill was fully impaired resulting in an impairment expense of $2.5 million.

Same Party Transactions

The accounting profession has recently raised an issue concerning the current industry practice for recording a purchase of mortgage-backed securities from a counterparty with a subsequent financing of the security through a repurchase agreement with the same counterparty "Same Party Transactions". The majority of our financings of our Agency MBS and Subordinate MBS portfolios was transacted through Same Party Transactions and recorded following current industry practice and accepted accounting guidelines. We recorded the purchase of these securities as an asset, and recorded the subsequent financing as a liability on our consolidated balance sheet. In addition, the corresponding interest income earned on these securities and interest expense incurred on the related repurchase agreements are reported gross on our consolidated statements of income.

The issue surrounds a technical interpretation of the provisions of SFAS No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities", which states that Same Party Transactions may not qualify as a purchase by us because the mortgage-backed securities we purchased in Same Party Transactions may not be determined to be legally isolated from the counterparty in such transactions. If the isolation requirement is not met in connection with Same Party Transactions, we would be required to record the transaction on a net basis, recording only an asset equal to the amount of the security, net of the related financing. In addition, we would also record the corresponding interest income and interest expense on a net basis. As the transaction would not qualify as a purchase, the resulting asset would be considered, and classified as, a freestanding derivative, with the corresponding change in the fair value of such derivative in the income statement. The value of the derivative created by this type of transaction would reflect the value of the underlying security and the value of the underlying financing provided by the counterparty.

While the FASB has identified this issue as a current project, a resolution, specific guidance, or a change in the accounting standards for Same Party Transactions has not been provided. As such, we have not performed a complete assessment of the impact on our financial position, results of operations or cash flows. As of December 31, 2006, the carrying value of our Agency and Subordinate MBS portfolios subject to Same Party Transactions totaled approximately $240,429,000, or 90.40%, of the carrying value of our total Agency and Subordinate MBS portfolios. The corresponding amounts borrowed under repurchase agreements were approximately $184,929,000.

Financial Condition

The most significant changes in our balance sheet as of December 31, 2006, compared to December 31, 2005, are reflected in the net increase of our investment portfolio and changes in related accounts including the decrease in our cash balances. The tables below present the primary assets of our investment portfolio, net of related financing, as of December 31, 2006 and December 31, 2005 (dollars in thousands):

December 31, 2006	Principal Balance	Carrying Value	Financing	Net Equity
Mortgage Loans:				
Held for sale	$ —	$ —	$ —	$ —
Collateral for CMOs	10,149	9,736	8,082	1,654
	10,149	9,736	8,082	1,654
Subordinate MBS:				
Available for sale	230,751	154,599	89,959	64,640
Agency MBS:				
Trading	106,479	105,104	102,590	2,514
Held to maturity	5,845	6,254	—	6,254
	112,324	111,358	102,590	8,768
Total	$ 353,224	$ 275,693	$ 200,631	$ 75,062

December 31, 2005	Principal Balance	Carrying Value	Financing	Net Equity
Mortgage Loans:				
Held for sale	$ 10,190	$ 10,061	$ 3,474	$ 6,587
Collateral for CMOs	14,537	14,074	12,201	1,873
	24,727	24,135	15,675	8,460
Subordinate MBS:				
Available for sale	174,737	106,967	69,644	37,323
Agency MBS:				
Trading	83,505	82,487	80,387	2,100
Held to maturity	7,460	8,034	—	8,034
	90,965	90,521	80,387	10,134
Total	$ 290,429	$ 221,623	$ 165,706	$ 55,917

During the second quarter of 2006, all of our mortgage loans that were not collateral for CMOs were either sold or the outstanding principal was paid in full. Although we have a facility for $200 million of financing for mortgage loans, the current interest rate environment has significantly reduced the potential interest income we can earn on these loans in excess of the interest expense incurred on the financing. When the interest rate environment improves, we may invest in this portfolio type. As this portfolio type meets certain compliance needs related to exemption under the 40 Act, investment in this portfolio type will allow us to reduce our investments in the Agency MBS Portfolio.

Our Subordinate MBS portfolio has increased in principal balance by $56.0 million and our equity increased by $27.3 million as we continue our strategy to increase and optimize our investment in this primary category of our investment portfolio. In addition, this balance partially increased due to the change in estimate of determining the fair value of these investments.

The Agency MBS classified as trading is held primarily to meet certain compliance needs related to exemption under the 40 Act and has increased due to increases in compliance needs. The Agency MBS classified as held to maturity continues to be held without financing and qualifies for our internal liquidity reserve while earning better than short term money rates.

Our book value per common share as of December 31, 2006 was $6.99 compared to $7.00 as of December 31, 2005. The decrease in book value for the year ended December 31, 2006 is primarily attributable to our net loss of $2.9 million and dividends declared of $5.8 million, partially offset by other comprehensive income of $8.3 million.

Results of Operations

Hanover — The REIT

Comparison of 2006 to 2005 Total Revenues

Revenues by Portfolio Type
(dollars in thousands)

	Years Ended December 31, 2006	Years Ended December 31, 2005	2006 Favorable (Unfavorable)
Mortgage Loans including CMO Collateral			
Interest income	$ 1,048	$ 2,179	$ (1,131)
Interest expense	(722)	(1,640)	918
Net interest income	326	539	(213)
Gains (losses) on sale	94	377	(283)
Loan loss reserve	—	(26)	26
Mark to market	15	(201)	216
Total	435	689	(254)
Subordinate MBS			
Interest income	16,847	8,471	8,376
Interest expense	(5,365)	(2,184)	(3,181)
Net interest income	11,482	6,287	5,195
Gains (losses) on sale	849	4,138	(3,289)
Mark to market	(389)	(562)	173
Other	—	33	(33)
Total	11,942	9,896	2,046
Agency MBS			
Interest income	5,020	4,908	112
Interest expense	(4,202)	(2,774)	(1,428)
Net interest income	818	2,134	(1,316)
Gains (losses) on sale	(109)	—	(109)
Mark to market	1,714	(2,300)	4,014
Freestanding derivatives	(2,214)	234	(2,448)
Total	209	68	141
Other			
Interest income	2,179	1,358	821
Interest expense	(3,653)	(1,685)	(1,968)
Net interest income	(1,474)	(327)	(1,147)
Mark to market	(1,192)	348	(1,540)
Freestanding derivatives	(130)	(54)	(76)
Other	(57)	111	(168)
Total	(2,853)	78	(2,931)
Total	$ 9,733	$ 10,731	$ (998)

Net interest income from our Mortgage Loan portfolio decreased for the year ended December 31, 2006 compared to the same period of 2005 primarily due to a decrease in the level of collateral for CMOs and related financing in 2006 and the sale of mortgage loans classified as held for sale during April of 2006.

For our Subordinate MBS portfolio, interest income increased for the year ended December 31, 2006 compared to the same period of 2005 due to the significant increase in the size of this portfolio and, to a lesser extent, increases in the interest rate for adjustable rate securities. For this same portfolio and related periods, interest expense increased as we increased financings to correspond with the increase in the portfolio and because the one-month LIBOR rate, the basis for all of the financings, has increased consistently through 2005 and 2006. We had gains on sales of securities of $0.8 million for the year ended December 31, 2006 compared to $4.1 million for the same period of 2005. This decrease in gains is the result of our long-term strategy shift that began in the middle of 2005, to focus on net interest income rather than gains on sale of securities. We sold 15 and 19 securities during the second and third quarter of 2006, respectively, as part of a minor portfolio reorganization and anticipation of potential credit issues. These sales do not modify our intent to reduce our reliance on gains.

Generally, our Agency MBS classified as trading are financed via repurchase agreements and are hedged through forward sales of similar securities. The net revenue generated from this portfolio is heavily dependent upon changes in the short-term and long-term interest rates and the spread between these two rates. The net change in the performance of this portfolio is due to the timing of differences arising from the changes in the interest rates and minor differences between the principal amount of the securities and the notional amount of the hedging activity. In addition, the 2006 net revenue is positively impacted by the interest income generated from Agency MBS classified as held to maturity, which were not hedged through forward sales and were not financed for the majority of 2006, as these securities were not acquired until the fourth quarter of 2005.

Other interest income is primarily interest earned on the note receivable from HCP-2 which increased for the year ended December 31, 2006 compared to the same period of 2005 as the prime rate, the basis for the note, has increased throughout 2005 and 2006 and the outstanding amount of the note increased during 2005 into 2006. Although this note and related interest income and expense are eliminated in consolidation, the interest income is a component of the REIT’s taxable income distributable to shareholders. Other interest expense is primarily interest incurred on the subordinated debt issued to our subsidiary trusts, HST-I and HST-II. This debt was issued in March and November of 2005, respectively, and therefore, a lesser amount of interest expense was incurred for the year ended December 31, 2005.

Other mark to market for the year ended December 31, 2006 represents a write-down of REO carried in HDMF-I and included in other assets. The local economy for a portion of these properties has had a significant downturn, which has depressed the value of these properties. We are actively trying to sell these properties through local real estate brokers with incentive commissions. However, a large number of other properties are listed for sale in the same geographic area, which has hampered our ability to sell these properties. At December 31, 2006, we have nineteen remaining properties to be sold with a total carrying value of approximately $788,000.

Other freestanding derivatives represents the mark to market of our interest rate caps used to hedge the financing costs of our portfolio. The expense from the change in the market value of these derivatives increased for the year ended December 31, 2006 compared to the same period in 2005. These reductions in market value are due to the passage of time and one-month LIBOR remaining substantially at or below the strike rate of the interest rate caps.

Comparison of 2005 to 2004 Total Revenues

Revenues by Portfolio Type
(dollars in thousands)

	Years Ended December 31, 2005	Years Ended December 31, 2004	2005 Favorable (Unfavorable)
Mortgage Loans including CMO Collateral			
Interest income	$ 2,179	$ 3,093	$ (914)
Interest expense	(1,640)	(2,260)	620
Net interest income	539	833	(294)
Gains (losses) on sale	377	38	339
Loan loss reserve	(26)	(36)	10
Mark to market	(201)	18	(219)
Other	—	46	(46)
Total	689	899	(210)
Subordinate MBS			
Interest income	8,471	7,386	1,085
Interest expense	(2,184)	(887)	(1,297)
Net interest income	6,287	6,499	(212)
Gains (losses) on sale	4,138	10,362	(6,224)
Mark to market	(562)	(1,125)	563
Other	33	—	33
Total	9,896	15,736	(5,840)
Agency MBS			
Interest income	4,908	3,569	1,339
Interest expense	(2,774)	(1,124)	(1,650)
Net interest income	2,134	2,445	(311)
Mark to market	(2,300)	1,344	(3,644)
Freestanding derivatives	234	(4,047)	4,281
Total	68	(258)	326
Other			
Interest income	1,358	542	816
Interest expense	(1,685)	—	(1,685)
Net interest income	(327)	542	(869)
Mark to market	348	—	348
Freestanding derivatives	(54)	(342)	288
Other	111	16	95
Total	78	216	(138)
Total	$ 10,731	$ 16,593	$ (5,862)

The REIT’s total revenues declined to $10.7 million for the year ended December 31, 2005 from $16.6 million for the year ended December 31, 2004. The decline of $5.9 million is primarily due to a decrease of $5.8 million in revenue on our Subordinate MBS.

The Mortgage Loans portfolio is comprised of mortgage loans we own that are either funded via term CMO debt or a one-year committed financing facility. In June 2005, we exercised our call rights and retired our 1999-A CMO and retained the underlying mortgage loan collateral. A portion of the 1999-A related mortgage loans are financed on a one year committed financing facility and a portion of the remainder of the portfolio is financed via a CMO borrowing: Hanover 1999-B.

Total revenues for the Mortgage Loans portfolio decreased $0.2 million to $0.7 million for the year ended December 31, 2005 from $0.9 million for the year ended December 31, 2004. The decline in revenue is the result of a reduction of $0.3 million in net interest income due to the declining principal balance of the portfolio combined with increased financing costs associated with the rise in the one-month LIBOR rate during 2005. Both the 1999-B CMO debt and the facility used to finance the mortgage loans we retained from the call and retirement of our 1999-A CMO are indexed to one-month LIBOR. The $0.3 million decline in net interest income was partially offset by a gain of $0.2 million realized resulting from the call and retirement of our 1999-A CMO and subsequent Fannie Mae MBS securitization of a portion of the retained 1999-A mortgage loans.

The Subordinate MBS portfolio consists primarily of non-investment grade securities collateralized by prime residential mortgage loans. Total revenues for the Subordinate MBS portfolio declined $5.8 million in 2005 to $9.9 million from $15.7 million in 2004. The decline is principally due to a $6.2 million decrease in gain of sales of securities from 2005 to 2004 that was partially offset by a reduction of $0.6 million in impairment expense for the comparable period. Net interest income also declined $0.2 million for the year ended December 31, 2005, as compared to the year ended December 31, 2004.

The decline in the gain on sale revenue is the result of narrowing between the average cost basis and market value of our Subordinate MBS portfolio as well as lower sales volume in 2005 compared to 2004. The narrowing is due to a combination of factors, most importantly a rise in short term interest rates and a decrease in prepayment rates. In 2005 we sold 98 securities having a total principal balance of $87.5 million compared to 149 securities with a total principal balance of $119.6 million in 2004. The reduction in impairment expense is due to sales of bonds with unfavorable credit characteristics.

The $0.2 million decline in net interest income on our Subordinate MBS portfolio is due to a marginally greater increase in interest expense than interest income. For the year ended December 31, 2005, interest income totaled $8.5 million as compared to $7.4 million for the year ended December 31, 2004. Interest expense for the year ended December 31, 2005 totaled $2.2 million as compared to $0.9 million for the year ended December 31, 2004. The overall increase in both interest income and expense from 2004 to 2005 is the result of an increase in asset size of the Subordinate MBS portfolio. The proportionally greater increase in interest expense compared to interest income is to due to a greater rise in the short term interest rates of our financings relative to the longer term asset yields on our Subordinate MBS holdings. This mismatch is primarily due to the “flattening” of the yield curve as short term interest rates increased more than long term interest rates during 2005.

The Agency MBS portfolio includes whole pool Fannie Mae or Freddie Mac issued mortgage-backed securities that are held primarily as qualifying assets for purposes of satisfying certain exemptive provisions of the 40 Act. With the exception of the Fannie Mae MBS securities collateralized by 1999-A CMO loans, which total $8.0 million of the $90.5 million asset value of the Agency MBS portfolio, the Agency MBS portfolio is hedged with forward sales of like-characteristic Agency MBS securities. Earnings on our Agency MBS portfolio consist of net interest income and gains or losses on mark to market of the Agency MBS that are substantially economically offset by gains or losses from forward sales of like-characteristic Agency MBS securities.

For the year ended December 31, 2005, total revenue for the Agency MBS portfolio was $0.1 million as compared to a loss of $0.3 million for the year ended December 31, 2004. The increase is principally the consequence of not financing certain securities during portions of 2005 due to excess liquidity as the result of the trust preferred stock issuance.

Other interest income consists largely of earnings on our cash and cash equivalents and loans to subsidiaries that are eliminated in consolidation, interest expense related to our trust preferred stock issuance and the mark to market of our interest rate caps. For the year ended December 31, 2005, other interest income was $0.1 million as compared to $0.2 million for the year ended December 31, 2004. The decline is the result of a $0.9 million reduction in net interest income that is primarily related to the issuance of trust preferred stock. This net interest decrease was partially offset by a reduction of $0.3 million in realized losses on our interest rate caps. Our interest rate caps are used to manage the interest rate risk on our financings and are classified as freestanding derivatives.

HT

For the year ended December 31, 2006, HT's operating loss increased by $1.4 million from the same period in 2005. This increase is due to a goodwill impairment charge of $2.5 million and a decline in the LSA operation, partially offset by improvement in the technology operation.

As a result of three customers terminating the services they receive from HT during the latter part of 2006, we decided to perform an assessment of the goodwill balance for potential impairment using updated forecasted revenues and expenses as of December 31, 2006. The assessment indicated that the HT reporting unit had a fair value below its book value. In accordance with the second step of the assessment, we determined the fair value of the identifiable assets of the HT reporting unit and calculated the goodwill balance as the excess of the fair value of the entire reporting unit over the fair value of the identifiable assets of the reporting unit. The goodwill was fully impaired resulting in an impairment expense of $2.5 million.

Revenue for the LSA operation for the year ended December 31, 2006 was significantly lower than the comparable periods of 2005 due to the reduction in loan sale advisory opportunities in the whole loan secondary market resulting from the flattening of the yield curve and the reduction in mortgage originations. This decrease in revenue was partially offset by reduced headcount and a restructuring of the salary and commission structure for certain sales personnel. As a result of the declining sales opportunities and the departure of certain personnel, we suspended the LSA operation as of May 31, 2006. The remaining personnel and their related costs, which represents substantially all of the remaining costs of the LSA operation, have been reassigned to the REIT.

On December 29, 2006, HT sold certain assets and trade name of its Servicing Source division, including the financial management of mortgage services rights, to the Sextant Group, Inc., which also assumed certain liabilities related to these assets. The Sextant Group, Inc. will also maintain and support certain software license and servicing agreements retained by HT.

Although the technology revenue decreased by $0.2 million for the year ended December 31, 2006 compared to the same period in 2005, personnel costs, technology, and amortization costs decreased by a greater amount for the same comparable periods. The personnel costs decreased due to reductions in headcount that occurred during the fourth quarter of 2005 and the first quarter of 2006. Technology costs decreased due to customization costs incurred in connection with the implementation of a technology solution for a new customer in June 2005 and other various smaller projects for existing customers in 2005 that did not occur in 2006. The amortization costs decreased as several components of the capitalized software have reached the end of their estimated useful life and the estimated useful life for other components has been extended.

Revenue for the year ended December 31, 2005 decreased from the prior period primarily because of lower loan sale advisory services. These services decreased as the number of customer accounts decreased due to mergers and consolidations in the marketplace. In addition, there has been a continuing reduction in loan sale advisory opportunities put forth by the Federal Deposit Insurance Corporation and other agencies which historically over past years have made up a significant portion of the loan sale advisory revenue. These decreases were partially offset by increases in technology revenue, resulting from new implementations and deployments and related professional services. Operating income decreased over the same periods due to a higher cost structure associated with the technology revenue. In addition, loan sale advisory personnel costs did not decrease at the same rate as the decrease in revenue.

Operating Expenses

The following table details operating expenses for the Company on a consolidated basis (dollars in thousands):

	Years Ended December 31,			Years Ended December 31,		
	2006	2005	Increase/ (Decrease)	2005	2004	Increase/ (Decrease)
Personnel	$ 4,239	$ 6,428	$ (2,189)	$ 6,428	$ 7,355	$ (927)
Legal and professional	2,777	2,810	(33)	2,810	2,904	(94)
General and administrative	1,183	1,259	(76)	1,259	1,211	48
Depreciation and amortization	708	1,220	(512)	1,220	912	308
Occupancy	315	347	(32)	347	283	64
Technology	1,109	1,575	(466)	1,575	820	755
Goodwill impairment	2,478	—	2,478	—	—	—
Other	1,104	1,369	(265)	1,369	1,018	351
Total expenses	$ 13,913	$ 15,008	$ (1,095)	$ 15,008	$ 14,503	$ 505

Operating expenses for the year ended December 31, 2006 decreased by $1.1 million from the same period in 2005. The major changes within operating expenses were in personnel, depreciation and amortization, technology and goodwill impairment.

- Personnel costs decreased $2.2 million due to compensation expense recorded in June 2005 for two of the Company's executive officers pursuant to a 1997 contribution agreement that was not incurred during 2006 and the reduction in headcount in the HT operation during the fourth quarter of 2005 and the first quarter of 2006.
- The decrease in depreciation and amortization is due to a reduction in the amortization of capitalized software costs, as several components of the capitalized software have reached the end of their estimated useful life and the estimated useful life for other components has been extended.
- Technology costs decreased due to customization costs incurred in connection with the implementation of a technology solution for a new customer in June 2005 and other various smaller projects for existing customers and minor modifications to the software technology in 2005 that did not occur in 2006.
- The goodwill impairment expense incurred for the year ended 2006 represents complete impairment of the goodwill balance associated with the HT business. There were no impairments recorded during the prior periods.

The increase in operating expenses for the year ended December 31, 2005, compared to the same period in 2004, is primarily due to the following:

- an increase in technology costs in connection with the implementation of additional technology solutions;
- an increase in insurance premiums arising from additional and more effective coverage and overall increases in the marketplace;
- an increase in amortization expense arising from additional capitalized software amortization and the amortization of deferred financing costs of HST-I and HST-II;
- inclusion of the financing costs of the line of credit of HDMF-I in the consolidated results of operations for the last six months of 2005.

These increases are partially offset by a decrease in personnel costs primarily from a reduction in bonuses and an executive that terminated employment with the Company in the middle of 2005.

Equity in Income (Loss) of Unconsolidated Affiliates

HDMF-I is a limited liability company whose objective is to purchase, service and manage pools of primarily sub-and non-performing one-to-four family residential whole loans. In June 2005, through a series of transactions, the Company increased its ownership in HDMF-I. The Company's consolidated financial statements include the results of operation of HDMF-I from the date of acquisition.

For the year ended December 31, 2005, we recognized $(0.2) million in equity in (loss) income of HDMF-I, as compared to $0.4 million in 2004. This decrease was primarily attributable to a reduction in the size of the portfolio of distressed mortgage loans.

Discontinued Operations

Income (loss) from discontinued operations includes the results of operations of the HCP business that was sold in January of 2007.

Income (loss) decreased by $2.2 million for the year ended December 31, 2006 from the same period in 2005 primarily due to decreases in revenue from HCP's largest customer and a negative shift in product mix. Unfavorable market conditions have resulted in reduced mortgage loan acquisitions for HCP's largest customer, thereby resulting in reduced due diligence services performed by HCP. In addition, operating costs increased as HCP increased its headcount and occupancy structure during the latter half of 2005 to ensure available resources for anticipated revenue growth during 2006 and thereafter that failed to occur.

Income (loss) increased by $1.0 million for the year ended December 31, 2005 from the same period in 2004 primarily due to increased revenue from due diligence reviews for HCP's largest customer. HCP successfully focused on expanding the business relationship with this customer during 2005 through customer attention, long-term servicing discussions, and minor pricing considerations. In addition, HCP expanded its on-site loan processing operations, allowing a greater volume of activity at a lower cost.

Additional Analysis of REIT Investment Portfolio

Investment Portfolio Assets and Related Liabilities

The following table reflects the average balances for each major category of our investment portfolio as well as associated liabilities with the corresponding effective yields and rates of interest (dollars in thousands):

	Years Ended December 31,					
	2006		2005		2004	
	Average Balance	Effective Rate	Average Balance	Effective Rate	Average Balance	Effective Rate
Investment portfolio assets:						
Mortgage Loans						
Held for sale	$ 2,866	7.85%	$ 11,301	5.53%	$ 259	7.74%
Collateral for CMO (1)	12,286	6.70%	26,104	5.86%	49,567	6.14%
Agency MBS	89,516	5.61%	97,103	5.06%	71,984	4.95%
Subordinate MBS	136,443	12.35%	74,256	11.41%	58,072	12.72%
Other subordinate security	2,728	13.34%	542	15.51%	—	0.00%
	243,839	9.55%	209,306	7.44%	179,882	7.79%
Investment portfolio liabilities:						
CMO borrowing (1)	9,515	6.50%	21,691	5.59%	42,808	5.18%
Repurchase Agreements on:						
Mortgage Loans held for sale	795	6.67%	6,569	5.72%	—	0.00%
Collateral for CMO	736	6.93%	1,037	5.00%	1,340	3.21%
Agency MBS	80,678	5.21%	84,613	3.28%	69,669	1.61%
Subordinate MBS	84,048	6.38%	45,089	4.84%	28,136	3.15%
	175,772	5.85%	158,999	4.11%	141,953	3.01%
Net investment portfolio assets	$ 68,067		$ 50,307		$ 37,929	
Net interest spread		3.70%		3.33%		4.78%
Yield on net portfolio assets (2) (3)		19.08%		17.94%		25.70%
Ratio of portfolio liabilities to net investment		258%		316%		374%

(1) Loan loss provisions are included in such calculations.

(2) Yield on net portfolio assets is computed by dividing the applicable net interest income (after loan loss provision, with respect to CMOs only) by the average daily balance of net portfolio assets.

(3) The yields on net portfolio assets do not include the hedging cost on the Agency MBS portfolio.

The yield on net portfolio assets increased to 19.08% for the year ended December 31, 2006 from 17.94% for the year ended December 31, 2005. This increase in yield is the result of additional investment in our Subordinate MBS portfolio, which is the highest yielding asset. This increase is partially offset by an increase in the one-month LIBOR, which is the basis for substantially all of our financing.

The yield on net portfolio assets decreased to 17.94% for the year ended December 31, 2005 from 25.7% for the year ended December 31, 2004. The decrease in the yield on net portfolio assets is primarily the result of the decrease in leverage in 2005 as compared to the leverage in 2004.

Average net investment portfolio assets increased to $68.1 million for the year ended December 31, 2006 from $50.3 million for the year ended December 31, 2005 and $37.9 million for the year ended December 31, 2004. This increase is primarily due to the deployment of proceeds raised in 2005 in connection with the issuance of trust preferred securities, which was primarily invested in Subordinate MBS and Agency MBS. These proceeds were invested throughout 2005 and the first quarter of 2006. These proceeds were fully vested by March 31, 2006.

Mortgage Loans

The following table provides details of the net interest income generated on our Mortgage Loan portfolio (dollars in thousands):

	Years Ended December 31,		
	2006	2005	2004
Average asset balance	$ 15,152	$ 37,405	$ 49,567
Average CMO borrowing balance	9,515	21,691	42,808
Average balance — Repurchase Agreements	1,531	7,606	1,340
Net investment	4,106	8,108	5,419
Average leverage ratio	72.90%	78.32%	89.07%
Effective interest income rate	6.92%	5.83%	6.21%
Effective interest expense rate — CMO borrowing	6.50%	5.59%	5.18%
Effective interest expense rate — Repurchase Agreements	6.79%	5.62%	3.21%
Net interest spread	0.38%	0.23%	1.09%
Interest income	$ 1,048	$ 2,179	$ 3,079
Interest expense — CMO borrowing	618	1,212	2,218
Interest expense — Repurchase Agreements	104	428	43
Net interest income	$ 326	$ 539	$ 818
Yield	7.94%	6.65%	15.10%

Our Mortgage Loan portfolio net interest income declined each of the two years ended December 31, 2006. This decline in net interest income is due to the declining principal balance of our Mortgage Loan portfolio due to scheduled and unscheduled principal payments which reduced the mortgage loan balance and the rise in the interest expense related to one-month LIBOR. In 2005, the decline increased when we called and retired our 1999-A CMO and purchased the underlying loans, of which a significant portion were in turn securitized in Fannie Mae issues. In April of 2006, we sold all remaining mortgage loans that we purchased from the call and retirement of our 1999-A CMO.

Subordinate MBS

The following table provides details of the net interest income generated on our Subordinate MBS portfolio (dollars in thousands):

	Years Ended December 31, 2006	2005	2004
Average asset balance	$ 136,443	$ 74,256	$ 58,072
Average balance — Repurchase Agreements	84,048	45,089	28,136
Net investment	52,395	29,167	29,936
Average leverage ratio	61.60%	60.72%	48.45%
Effective interest income rate	12.35%	11.41%	12.72%
Effective interest expense rate — Repurchase Agreements	6.38%	4.84%	3.15%
Net interest spread	5.97%	6.57%	9.57%
Interest income	$ 16,847	$ 8,471	$ 7,386
Interest expense — Repurchase Agreements	5,365	2,184	887
Net interest income	$ 11,482	$ 6,287	$ 6,499
Yield	21.91%	21.56%	21.71%

The Subordinate MBS portfolio's net interest income increased to $11.5 million for the year ended December 31, 2006 from $6.3 million for the year ended December 31, 2005 due to the significant increase in investment in this portfolio during the latter part of 2005 and 2006.

The Subordinate MBS portfolio's net interest spread decreased to 5.97% for the year ended December 31, 2006 from 6.57% for the year ended December 31, 2005 due to an increase in the effective interest expense rate, partially offset by an increase in the effective interest income rate. The increase in the effective interest expense rate is due to increases in one-month LIBOR throughout 2005 and 2006. The increase in the interest income rate is due to purchase of securities in the latter part of 2005 and 2006 with effective interest rates higher than our existing securities, as overall interest rates have increased.

The Subordinate MBS portfolio's net interest income decreased to $6.3 million for the year ended December 31, 2005 from $6.5 million for the year ended December 31, 2004. This decrease in revenues was attributable to the decline in the average net interest earning assets to $29.2 million for the year ended December 31, 2005 from $29.9 million for the year ended December 31, 2004.

The Subordinate MBS portfolio's net interest spread decreased to 6.57% for the year ended December 31, 2005 from 9.57% for the year ended December 31, 2004. The reduction in the net interest spread was due to a decline in the effective interest income rate to 11.41% for the year ended December 31, 2005 from 12.72% for the year ended December 31, 2004 and an increase in the effective interest expense rate to 4.84% for the year ended December 31, 2005 from 3.15% for the year ended December 31, 2004. The decrease in the effective interest income rate was due to a combination of a shift in the Subordinate MBS portfolio to higher-rated securities coupled with an increase in adjustable rate securities relative to fixed rate securities. The increase in the effective interest expense rate is due to increases in the rate of one-month LIBOR offset partially by lower financing rates due to a shift to higher-rated securities.

Agency MBS

The following table provides details of the net interest income generated on the Agency MBS portfolio (dollars in thousands):

	Years Ended December 31, 2006	2005	2004
Average asset balance	$ 89,516	$ 97,103	$ 71,984
Average balance — Repurchase Agreements	80,678	84,613	69,669
Net investment	8,838	12,490	2,315
Average leverage ratio	90.13%	87.14%	96.78%
Effective interest income rate	5.61%	5.06%	4.95%
Effective interest expense rate — Repurchase Agreements	5.21%	3.28%	1.61%
Net interest spread	0.40%	1.78%	3.34%
Interest income	$ 5,020	$ 4,908	$ 3,569
Interest expense — Repurchase Agreements	4,202	2,774	1,124
Net interest income	$ 818	$ 2,134	$ 2,445
Yield	9.26%	17.09%	105.62%

The Agency MBS portfolio's net interest income decreased to $0.8 million for the year ended December 31, 2006 from $2.1 million for the year ended December 31, 2005. In addition, the Agency MBS portfolio's net interest spread decreased to 0.40% for the year ended December 31, 2006 from 1.78% for the year ended December 31, 2005. Both of these decreases were due to an increase in interest expense arising from increases in one-month LIBOR throughout 2005 and 2006. These decreases are partially offset by the purchase of several securities during 2006 with effective interest income rates higher than our existing securities, as overall interest rates have increased.

The Agency MBS portfolio's net interest income decreased to $2.1 million for the year ended December 31, 2005 from $2.4 million for the year ended December 31, 2004. The decrease is primarily due to the decrease in net interest spread from 3.34% during 2004 to 1.78% during 2005, partially offset by the growth of the portfolio in 2005. The decrease in the net interest spread was due to the increase in the effective interest expense rate to 3.28% for the year ended December 31, 2005 from 1.61% for the year ended December 31, 2004 that was partially offset by the increase in the effective interest income rate to 5.06% for the year ended December 31, 2005 from 4.95% for the year ended December 31, 2004. The increase in the effective interest expense rate was due to increases in the rate of one-month LIBOR.

We attempt to fully economically hedge our Agency MBS portfolio to potentially offset any gains or losses in our portfolio with losses or gains from our forward sales of like-kind Agency MBS. Earnings on our Agency MBS portfolio consist of net interest income and gains or losses on mark to market of the Agency MBS. However, these earnings are substantially economically offset by gains or losses from forward sales of like coupon Agency MBS.

The table below reflects the net economic impact of our Agency MBS portfolio for the year ended December 31, 2006 (dollars in thousands):

Net interest income	$ 818
Gain on mark to market of mortgage assets	1,714
Gains (losses) on sale	(109)
Other gain (forward sales)	(2,214)
Total	$ 209

Dividends

We operate as a REIT and are required to pay dividends equal to at least 90% of our REIT taxable income. We intend to pay quarterly dividends and other distributions to our shareholders of all or substantially all of our taxable income in each year to qualify for the tax benefits accorded to a REIT under the Code. All distributions will be made at the discretion of our Board of Directors and will depend on our earnings, both tax and GAAP, financial condition, maintenance of REIT status and such other factors as the Board of Directors deems relevant.

We typically announce earnings and dividends in early May, August and November following the filing of our quarterly reports on Form 10-Q for the calender quarters. A fourth quarter dividend is usually announced in December.

Taxable Income

Taxable income (loss) for the year ended December 31, 2006 was approximately $(0.5) million. Taxable income (loss) differs from net income (loss) because of timing differences (refers to the period in which elements of net income can be included in taxable income) and permanent differences (refers to an element of net income that must be included or excluded from taxable income).

The following table reconciles net income (loss) to estimated taxable income (loss) for the year ended December 31, 2006 (dollars in thousands):

Net income (loss) — year ended December 31, 2006	$ (2,926)
Add (deduct) differences:	
Loss on mark to market of mortgage assets	(1,336)
Sale of mortgage securities	(1,072)
Mark to market of freestanding derivatives	(994)
Losses in subsidiaries not consolidated for tax purposes — net	6,209
Other	(380)
Estimated taxable loss — year ended December 31, 2006	$ (499)

As a REIT, we are required to pay dividends amounting to 85% of each year’s taxable ordinary income and 95% of the portion of each year’s capital gain net income that is not taxed at the REIT level, by the end of each calendar year and to have declared dividends amounting to 90% of our REIT taxable income for each year by the time we file our Federal tax return. Therefore, a REIT generally passes through substantially all of its earnings to shareholders without paying Federal income tax at the corporate level.

Liquidity and Capital Resources

Traditional cash flow analysis may not be applicable for us as we have significant cash flow variability due to our investment activities. Our primary non-discretionary cash uses are our operating costs, pay-down of CMO debt, dividend payments and interest payments on our outstanding junior subordinated notes. We expect to meet our future short-term and longer-term liquidity requirements generally from our existing working capital, cash flow provided by operations, Repurchase Agreements and other possible sources of longer-term financing. We consider our ability to generate cash to be adequate to meet operating requirements both in the short-term and the longer-term. However, as a REIT, we are required to pay dividends equal to 90% of our taxable income and therefore must depend on raising new sources of capital for growth.

We have exposure to market-driven liquidity events due to our use of short-term financing. If a significant decline in the market value of our investment portfolio should occur, our available liquidity from existing sources and ability to access additional sources of credit could be reduced. As a result of such a reduction in liquidity, we may be forced to sell certain investments. If required, these sales could be made at prices lower than the carrying value of such assets, which could result in losses. As of December 31, 2006, we had $210 million of committed repurchase lines of credit, which were not fully utilized. In addition, as of

December 31, 2006, we had $184.8 million outstanding under uncommitted repurchase lines of credit. We may seek to establish additional committed and uncommitted lines of credit in the future.

Our cash and cash equivalents as of December 31, 2006 decreased by $16.5 million from December 31, 2005. We have reduced our cash and cash equivalents balance through additional investment in our Subordinate MBS portfolio. We are satisfying a portion of our internal liquidity reserve with certain Agency MBS that are not financed.

In June of 2006, we entered into a master repurchase agreement with an outside lending institution for up to $200 million. We will utilize this facility primarily for the purchase of prime residential whole mortgage loans. Pursuant to the terms of the agreement, we will pay interest to the lending institution, based on one-month LIBOR plus an interest rate margin, plus various facility fees. We are required to maintain $5.0 million of cash and cash equivalents on hand at all times and a minimum level of tangible net worth, as defined. In addition, we are required to meet certain monthly net income requirements, as defined.

We have no current commitments for any material capital expenditures. We primarily invest our available capital in our investment portfolio. We have invested a limited amount of our capital in the development of our software products, but have no future commitments to invest further in this area.

Off-Balance Sheet Arrangements

On August 28, 2006, we entered into a warehouse agreement for up to a $125 million warehousing facility, which is established and financed by a third party. The warehousing facility will enable us to acquire a diversified portfolio of mezzanine grade asset-backed securities, and certain other investments and assets in anticipation of the possible formation and issuance of a collateralized debt obligation. As of December 31, 2006, we have sold 3 securities into the warehousing facility with total sales proceeds of $4.1 million. If we do not form and issue a collateralized debt obligation within a contractual timeframe, the warehouse agreement will expire and we will be liable for any losses incurred by the counterparty in connection with closing the warehousing facility and selling these securities. The term of the warehouse agreement as of December 31, 2006, is day-to-day or closing and issuance of the collateralized debt obligation.

We have forward commitments to sell mortgage-backed securities. As of December 31, 2006, we had a commitment to sell $106.4 million of TBA Securities in January 2007. The excess of the futures sales price over the market value of the securities as of December 31, 2006 is approximately $649,000, which is recorded in other assets. The forward sale commitments were settled in January 2007 with offsetting purchase commitments.

We have interest rate caps to manage adverse changes in floating interest rates of our debt instruments. At December 31, 2006, we had two interest rate caps indexed to one-month LIBOR with a total notional amount of $60 million.

As of December 31, 2006, we retained the credit risk on $3.4 million of mortgage securities that we sold with recourse in a prior year. Accordingly, we are responsible for credit losses, if any, with respect to these securities.

Contractual Obligations

The following are our contractual obligations as of December 31, 2006 (dollars in thousands):

Contractual Obligations	Total	Less than 1 Year	1-3 Years	3-5 Years	More than 5 Years
Long-term debt	$ 48,623	$ —	$ —	$ —	$ 48,623
Operating leases	1,152	301	594	257	—
Total	$ 49,775	$ 301	$ 594	$ 257	$ 48,623

Long-term debt is reflected at its stated maturity date although principal pay-downs received from the related mortgage loans held as collateral for CMOs will reduce the amount of debt outstanding.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

Qualitative Disclosure about Market Risk

Our primary investments are our Mortgage Loan, Subordinate MBS and Agency MBS portfolios. We divide market risk into the four following areas: credit, interest rate, market value and prepayment. Within each of these risk areas, we seek to maintain a risk management process to protect the Company's assets and maintain the dividend policy.

Credit Risk

We believe the principal risk to our investment strategy is the credit performance of the domestic, residential mortgage market. The credit exposure generally represents the amount of the mortgage loan in excess of the underlying real estate value, if any, and the carrying and maintenance costs that cannot be recouped from the homeowner for severely delinquent mortgage loans and foreclosures.

We employ a combination of pre-purchase due diligence, ongoing surveillance, internal and third party risk analysis models and a pro-active disposition strategy to manage credit risk. This analysis includes review of the loan to value ratio of the mortgage loans and the credit rating of the homeowner. Additionally, we continually assess exogenous economic factors including housing prices and unemployment trends, on both national and regional levels.

Increased credit risk manifests itself through a combination of increasing mortgage loan delinquencies and decreasing housing prices. Over the past several years, the domestic residential housing market has experienced rapid and sustained housing price gains. Should housing prices decline, we believe our investments would be subject to increased risk of credit losses. Also over the past several years, mortgage loan delinquencies have been at historically low levels and a rise in delinquency rates would increase our risk of credit losses.

Additionally, mortgage lenders increasingly have been originating and securitizing new loan types such as interest-only, negative amortization and payment option loans. The lack of historical data on these loan types increases the uncertainty with respect to investments in these mortgages. The increased percentage of adjustable-rate, as opposed to fixed-rate, mortgage loans may have increased the credit risk profile of the residential mortgage market.

Historically, we experienced nominal credit losses on our investments. However, there can be no guarantee that our favorable historical experience is predictive of future credit trends or actual results.

Mortgage Loan Portfolio

We have leveraged credit risk in our Mortgage Loan portfolio as we issued CMO debt and retained the lower-rated bond classes. As with our all of our portfolios, pre-purchase due diligence and ongoing surveillance is performed. To the extent the individual mortgage loans are in a CMO, we are not able to selectively sell these mortgage loans. A loan loss allowance has been established for our Mortgage Loan portfolio and is reviewed on at least a quarterly basis.

The following table describes the credit performance of our Mortgage Loan portfolio securitizations:

Mortgage Loan Portfolio Credit Performance
(dollars in thousands)

1999-B Securitization

	December 31,							
	2006				2005			
	Principal Balance	%	# of Loans	%	Principal Balance	%	# of Loans	%
Current	$ 9,311	91.7%	265	82.5%	$ 13,174	90.6%	386	79.1%
30-59 days delinquent	554	5.5%	41	12.8%	1,024	7.1%	72	14.8%
60-89 days delinquent	71	0.7%	5	1.6%	115	0.8%	13	2.7%
90+ days delinquent	21	0.2%	4	1.2%	102	0.7%	10	2.0%
Foreclosure	160	1.6%	5	1.6%	122	0.8%	7	1.4%
Real Estate Owned	32	0.3%	1	0.3%	—	—	—	—

Losses allocated to our retained subordinate bonds for 2006 were approximately $9,000 compared to $0 for 2005. The loan loss allowance as of December 31, 2006 totaled $0.3 million.

Subordinate MBS Portfolio

We have leveraged credit risk in our Subordinate MBS portfolio through investments in the non-investment grade classes of securities, which are collateralized by high-quality jumbo residential mortgage loans. These classes are the first to be impacted by losses on the underlying mortgage loans as their par values are written down by losses before higher-rated classes. Effectively, we are the guarantor of the higher-rated bonds, to the extent of the carrying value on the Subordinate MBS portfolio. On occasion, we will purchase subordinate bonds without owning the corresponding lower-rated class(es).

We generally purchase the securities in our Subordinate MBS portfolio with a significant purchase discount, which has an implicit loss component. Generally, to the extent any losses incurred are less than the implicit loss in the purchase discount, the credit losses will not have a significant impact on our operating results or the carrying value of the securities. However, any credit losses could have an impact on the overall cashflow projections for the securities and reduce the overall income potential of the securities.

We manage credit risk through detailed investment analysis both before purchasing subordinate securities and on an ongoing basis. Before subordinate securities are purchased we analyze the collateral using both internally developed and third party analytics, review deal structures and issuance documentation, review the servicer for acceptability and verify that the bonds are modeled on a widely used valuation system. Updated loan level collateral files are received on a monthly basis and are analyzed for favorable and unfavorable credit performance and trends. Bonds that do not meet our credit criteria may be sold via an arms-length competitive bidding process.

Expected credit losses are established by analyzing each subordinate security and are designated as a portion of the difference between the securities par value and amortized cost. Expected credit losses, including both timing and severity, are updated on a monthly basis based upon current collateral data.

The following table shows the credit performance of the principal balance of underlying collateral of our Subordinate MBS portfolio:

Subordinate MBS Portfolio Credit Performance
(dollars in thousands)

	December 31, 2006 Principal Balance	%	# of Loans	%	2005 Principal Balance	%	# of Loans	%
Current	$ 46,111,855	99.4%	85,783	99.4%	$ 35,292,095	99.5%	71,088	99.5%
30-59 days delinquent	189,117	0.4%	361	0.5%	155,176	0.5%	322	0.5%
60-89 days delinquent	36,315	0.1%	67	0.1%	17,323	—	35	—
90+ days delinquent	20,779	0.1%	44	—	7,424	—	16	—
Foreclosure	18,208	—	44	—	6,759	—	15	—
Real Estate Owned	3,441	—	6	—	1,025	—	2	—

We had nominal losses allocated to our Subordinate MBS portfolio for the years ended December 31, 2006 and 2005.

The following table describes the distribution of our Subordinate MBS portfolio by rating:

Subordinate MBS Portfolio Credit Ratings
(dollars in thousands)

	December 31, 2006 Principal Balance	2006 Carrying Value	2005 Principal Balance	2005 Carrying Value
BB-rated	$ 52,335	$ 46,626	$ 38,225	$ 32,380
B-rated	102,666	78,953	82,906	58,407
Non-rated	75,750	29,020	53,606	16,180
Total Subordinate MBS Portfolio	$ 230,751	$ 154,599	$ 174,737	$ 106,967

Agency MBS Portfolio

The securities held in our Agency MBS portfolio are guaranteed by Fannie Mae or Freddie Mac. As these are United States government-sponsored entities, we deem it unnecessary to take credit reserves on these securities.

Interest Rate Risk (Excluding the Impact on Market Price)

To the extent that our investments are financed with liabilities that re-price with different frequencies or benchmark indices, we are exposed to volatility in our net interest income. In general, we protect the interest rate spread on all of our investments through two interest rate caps that are indexed to one-month LIBOR with a total notional amount of $60 million.

Mortgage Loan Portfolio

Our Mortgage Loan portfolio has one outstanding CMO, 1999-B, and a securitization, 2000-A, that is collateralized by certificates from 1999-B.

In the 1999-B CMO, the Mortgage Loans were match funded on a maturity basis with one-month LIBOR indexed floating rate CMO debt where we retained only the subordinate certificates. The Mortgage Loans for

1999-B are a mixture of both fixed-rate and adjustable-rate loans with the subordinate certificates receiving the difference between the net coupon on the loans and the CMO debt coupon rate, known as spread.

The retained subordinate certificates from our 1999-B CMO constitute the collateral for our 2000-A CMO. The 2000-A securitization consists of two groups of certificates, one group collateralized by fixed-rate certificates and the other group collateralized by variable-rate certificates. For each group, the 2000-A bonds match the maturity of the underlying certificates but have a floating rate coupon indexed to one-month LIBOR.

Subordinate MBS Portfolio

Our Subordinate MBS portfolio is funded with Repurchase Agreements that generally re-price monthly at a rate equal to one-month LIBOR plus an interest rate margin. Therefore, to the extent that a subordinate security is not also re-pricing on a monthly basis to one-month LIBOR, there is the potential for variability in our net interest income.

Agency MBS Portfolio

Our Agency MBS trading portfolio consists of fixed-rate bonds generally financed under one-month Repurchase Agreements that re-price monthly. To protect against potential losses due to a rise in interest rates, we have entered into forward commitments to sell a similar amount of to be announced Fannie Mae and Freddie Mac Agency MBS with the same coupon interest rates as our whole pools.

Prepayment Risk

Prepayments have a direct effect on the amortization of purchase discounts/premiums and the market value of mortgage assets. In general, in a mortgage portfolio, as interest rates increase, prepayments will decline and as interest rates decrease, prepayments will increase. For our investments purchased at a discount, a decrease in prepayments will delay the accretion of the discount, which reduces the effective yield and lowers the market value of the investment. For our investments purchased at a premium, a decrease in prepayments will delay the amortization of the premium, which increases the effective yield and increases the market value of the investment.

Market Value Risk

The market values of our investments are determined by a combination of interest rates, credit performance, prepayment speeds and asset specific performance attributes, such as loan to value ratios. In general, increases in interest rates and deteriorating credit performance will cause the value of the assets to decline. Changes in the market value of assets have two specific negative effects: increased financing margin requirements and, depending on an asset's classification, a charge to income or to accumulated other comprehensive income.

We manage the market value risk through management of the other market risks described above and analysis of other asset specific attributes. We selectively sell assets that do not meet our risk management guidelines and/or performance requirements. We manage the risk of increased financing margin requirements by maintaining a liquidity reserve policy that is based upon an analysis of interest rate and credit spread volatility. We maintain liquidity under our liquidity policy to enable us to meet increased margin requirements if the value of our assets decline.

Mortgage Loan Portfolio

A portion of our Mortgage Loan portfolio is term financed via CMO borrowings and, therefore, changes in the market value of that portion of the mortgage loan portfolio cannot trigger margin requirements. Mortgage Loans that are securitized in a CMO are classified as collateral for CMOs. Mortgage loans that are designated as held for sale are reported at the lower of cost or market, with unrealized losses reported as a charge to earnings in the current period. Mortgage Loans designated as held for investment and CMO collateral are reported at amortized cost, net of allowance for loan losses, if any. Therefore, only changes in market value that are deemed permanent impairments would be charged to income. Determination of market value is established by third party market prices or internal projections. As of December 31, 2006, one bond from the 2000-A securitization is financed via a $0.7 million Repurchase Agreement and is subject to margin requirements. A liquidity reserve is maintained per our liquidity policy.

Subordinate MBS Portfolio

Securities in our Subordinate MBS portfolio are generally classified as available for sale and, therefore, changes in the market value are reported as a component of accumulated other comprehensive income. Any losses deemed other than temporary would be charged to income. Determination of market value is established through internally generated valuations.

Agency MBS Portfolio

Securities in our Agency MBS portfolio are generally classified as either trading or held to maturity. Changes in market value on our trading securities are included in income. Our trading securities are economically hedged with forward sales of like coupon Agency MBS and, therefore, changes in the market value of these assets will be substantially offset by similar changes in the value of the forward sold securities. Agency securities classified as held to maturity are reported at amortized cost.

Quantitative Disclosure about Market Risk

Agency MBS Portfolio

Our Agency MBS portfolio consists of market risk sensitive instruments classified as trading and held to maturity securities. The following tables describe the Agency MBS portfolio instruments and the forward sales used to economically hedge the trading securities in this portfolio, as of December 31, 2006 (dollars in thousands):

Agency MBS Portfolio Assets

	December 31, 2006				
Security Type	Principal Balance	Carrying Value	Fair Value	Coupon	Weighted Average Maturity
Freddie Mac Gold MBS 30 Year Fixed Rate	$ 53,880	$ 53,285	$ 53,285	5.50%	351 months
Freddie Mac Gold MBS 30 Year Fixed Rate	23,907	23,643	23,643	5.50%	349 months
Freddie Mac Gold MBS 30 Year Fixed Rate	12,365	12,240	12,240	5.50%	326 months
Fannie Mae MBS 30 Year Fixed Rate	9,754	9,430	9,430	5.00%	310 months
Freddie Mac Gold MBS 30 Year Fixed Rate	6,573	6,506	6,506	5.50%	323 months
Fannie Mae MBS 30 Year Fixed Rate	2,174	2,324	2,305	8.00%	176 months
Fannie Mae MBS 30 Year Fixed Rate	1,542	1,622	1,624	7.50%	200 months
Fannie Mae MBS 30 Year Fixed Rate	1,441	1,559	1,542	9.00%	139 months
Fannie Mae MBS 15 Year Fixed Rate	688	749	755	10.00%	110 months
Total	$ 112,324	$ 111,358	$ 111,330		

Agency MBS Portfolio Forward Sales

Security Type	December 31, 2006 Principal Balance	Contractual Forward Sale Amount	Market Value	Coupon	Weighted Average Maturity
Freddie Mac Gold MBS 30 Year Fixed Rate	$ 96,650	$ 96,137	$ 95,578	5.5%	TBA Security
Fannie Mae MBS 30 Year Fixed Rate	9,750	9,502	9,412	5.0%	TBA Security
Total	$ 106,400	$ 105,639	$ 104,990		

Subordinate MBS Portfolio

Our Subordinate MBS portfolio consists of market risk sensitive instruments entered into for purposes other than trading purposes. We believe the principal risk to our Subordinate MBS portfolio is the credit performance of the individual securities. The following tables present the principal balance and weighted-average portfolio coupon rate as of December 31, 2006 and loss sensitivities (future projected principal balance reductions and weighted-average portfolio coupon rate under different loss scenarios). The loss scenarios are month-by-month projected loss amounts that incorporate many assumptions and, as such, actual loss amounts may vary considerably.

The 100% Loss Scenario represents median expected losses. In projecting future cash flows, we utilized forward rates as of December 31, 2006.

Subordinate MBS Portfolio (dollars in thousands):

	December 31, 2006
Principal Balance	$ 230,751
Carrying Value	154,599
Weighted-Average Coupon Rate	5.39%

Subordinate MBS Portfolio Loss Sensitivity (dollars in thousands):

Loss Scenario		2007	2008	2009	2010	2011	Thereafter
0%	Total Principal Reduction	$ 1,937	$ 8,338	$ 32,331	$ 33,367	$ 28,447	$ 126,331
	Total Losses	0	0	0	0	0	0
	Weighted-Average Coupon Rate	5.40%	5.45%	5.54%	5.78%	6.01%	6.15%
50%	Total Principal Reduction	2,669	9,924	34,459	35,091	29,237	119,371
	Total Losses	737	2,093	2,916	2,841	2,257	6,088
	Weighted-Average Coupon Rate	5.40%	5.45%	5.53%	5.78%	6.01%	6.14%
100%	Total Principal Reduction	3,042	11,877	36,635	36,517	29,553	113,127
	Total Losses	1,475	4,185	5,833	5,681	4,514	12,071
	Weighted-Average Coupon Rate	5.40%	5.45%	5.54%	5.78%	6.01%	6.15%
150%	Total Principal Reduction	4,134	13,799	38,245	37,753	30,045	106,775
	Total Losses	2,212	6,277	8,750	8,521	6,770	18,847
	Weighted-Average Coupon Rate	5.40%	5.45%	5.54%	5.78%	6.01%	6.13%
200%	Total Principal Reduction	4,867	15,683	39,952	39,126	30,569	100,554
	Total Losses	2,949	8,369	11,667	11,357	9,522	25,691
	Weighted-Average Coupon Rate	5.40%	5.45%	5.54%	5.78%	6.00%	6.13%

Mortgage Loan Portfolio — CMO

Our Mortgage Loan portfolio consists of market risk sensitive instruments classified as held for investment. We believe the principal risk to our Mortgage Loan portfolio is the credit performance of the individual mortgage loans. The following tables present the principal balance and weighted-average portfolio coupon rates as of December 31, 2006 and loss sensitivities (future projected principal balance reductions and weighted-average portfolio coupons under different loss scenarios). The loss scenarios are month-by-month projected loss amounts that incorporate many assumptions and, as such, actual loss amounts may vary considerably. The 100% Loss Scenario represents median expected losses. In projecting future cash flows, we utilized forward rates as of December 31, 2006.

Mortgage Loan Portfolio: 1999-B Assets (dollars in thousands):

	December 31, 2006
Principal Balance	$ 10,149
Carrying Value	9,736
Fair Value	10,025
Weighted-Average Coupon Rate	6.85%

Mortgage Loan Portfolio: 1999-B Assets Loss Sensitivity (dollars in thousands):

Loss Scenario		2007	2008	2009	2010	2011	Thereafter
0%	Total Principal Reduction	$ 2,816	$ 2,096	$ 1,547	$ 1,134	$ 821	$ 1,735
	Total Losses	0	0	0	0	0	0
	Weighted-Average Coupon Rate	7.08%	6.98%	6.94%	6.96%	6.97%	6.89%
50%	Total Principal Reduction	2,818	2,101	1,550	1,136	819	1,725
	Total Losses	2	7	6	6	2	4
	Weighted-Average Coupon Rate	7.08%	6.97%	6.94%	6.96%	6.97%	6.89%
100%	Total Principal Reduction	2,820	2,106	1,554	1,138	817	1,714
	Total Losses	4	14	13	12	5	8
	Weighted-Average Coupon Rate	7.08%	6.97%	6.94%	6.96%	6.97%	6.89%
150%	Total Principal Reduction	2,823	2,111	1,557	1,139	816	1,703
	Total Losses	7	20	19	17	7	12
	Weighted-Average Coupon Rate	7.08%	6.97%	6.94%	6.96%	6.96%	6.89%
200%	Total Principal Reduction	2,825	2,117	1,560	1,141	814	1,692
	Total Losses	9	27	26	23	10	16
	Weighted-Average Coupon Rate	7.08%	6.97%	6.94%	6.96%	6.96%	6.89%

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Our financial statements and related notes, together with the Reports of Independent Registered Public Accounting Firms thereon, begin on page F-1 of this Report on Form 10-K.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

Not applicable.

ITEM 9A. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

As of the end of the period covered by this report, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, of our disclosure controls and procedures, as such term is defined under Rule 13a-15 of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Based on that evaluation, our Chief Executive Officer and our Chief Financial Officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this annual report.

Management's Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act). Our internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

Our internal control over financial reporting includes those policies and procedures that:

- pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of our assets;
- provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that our receipts and expenditures are being made only in accordance with authorizations of our management and directors; and
- provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of our assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Projections of any evaluation of effectiveness to future periods are subject to the risks that controls may become inadequate because of changes in conditions or that the degree of compliance with the policies or procedures may deteriorate.

Management assessed the effectiveness of our internal control over financial reporting as of December 31, 2006. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") in Internal Control-Integrated Framework. Based on our assessment and those criteria, management believes that the Company maintained effective internal control over financial reporting as of December 31, 2006.

The Company's independent registered public accounting firm has audited and issued their report on management's assessment of the Company's internal control over financial reporting. This report appears on page F-3 of this Annual Report on Form 10-K.

Changes in Internal Control Over Financial Reporting

There have been no changes in our internal control over financial reporting that occurred during the fourth quarter of 2006 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

ITEM 9B. OTHER INFORMATION

Not applicable.

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The information required by Item 10 is incorporated herein by reference to our definitive Proxy Statement for the 2007 Annual Meeting of Stockholders, to be filed with the SEC within 120 days after the end of our fiscal year.

We have adopted a Code of Ethics for Principal Executive and Senior Financial Officers which applies to our principal executive officer, principal financial and accounting officers and controller or persons performing similar functions. This Code of Ethics for Principal Executive and Senior Financial Officers is publicly available on our website at www.hanovercapitalholdings.com. If we make substantive amendments to this Code of Ethics for Principal Executive and Senior Financial Officers or grant any waiver, including any implicit waiver, we intend to disclose these events on our website.

ITEM 11. EXECUTIVE COMPENSATION

The information required by Item 11 is incorporated herein by reference to our definitive Proxy Statement for the 2007 Annual Meeting of Stockholders, to be filed with the SEC within 120 days after the end of our fiscal year.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information required by Item 12 is incorporated herein by reference to our definitive Proxy Statement for the 2007 Annual Meeting of Stockholders, to be filed with the SEC within 120 days after the end of our fiscal year.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

The information required by Item 13 is incorporated herein by reference to our definitive Proxy Statement for the 2007 Annual Meeting of Stockholders, to be filed with the SEC within 120 days after the end of our fiscal year.

ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

The information required by Item 14 is incorporated herein by reference to our definitive Proxy Statement for the 2007 Annual Meeting of Stockholders, to be filed with the SEC within 120 days after the end of our fiscal year.

PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a) (1) Financial Statements
See Part II, Item 8 hereof.

(2) Financial Statement Schedules
See Part II, Item 8 hereof.

(3) Exhibits
Exhibits required to be filed by Item 601 of Regulation S-K are listed in the Exhibit Index attached hereto, which is incorporated herein by reference.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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, on March 16, 2007.

Hanover Capital Mortgage Holdings, Inc.

By: /s/ Harold F. McElraft
Harold F. McElraft
Chief Financial Officer and Treasurer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities indicated on March 16, 2007.

Signature	Title
/s/ John A. Burchett John A. Burchett	Chairman of the Board of Directors, President and Chief Executive Officer (Principal Executive Officer)
/s/ Irma N. Tavares Irma N. Tavares	Chief Operating Officer, Senior Managing Director and a Director
/s/ John A. Clymer John A. Clymer	Director
/s/ Joseph J. Freeman Joseph J. Freeman	Director
/s/ Douglas L. Jacobs Douglas L. Jacobs	Director
/s/ John N. Rees John N. Rees	Director
/s/ James F. Stone James F. Stone	Director
/s/ Harold F. McElraft Harold F. McElraft	Chief Financial Officer and Treasurer (Principal Financial and Accounting Officer)

EXHIBIT INDEX

Exhibit	Description
2.1(7)	Stock Purchase Agreement dated as of July 1, 2002 by and between Registrant and John A. Burchett, Joyce S. Mizerak, George J. Ostendorf and Irma N. Tavares
3.1(8)	Amended Articles of Incorporation of Registrant, as amended
3.2(1)	Bylaws of Registrant
4.1(1)	Specimen Common Stock Certificate of Registrant
4.2(15)	Amended and Restated Trust Agreement, dated as of March 15, 2005, among Registrant, as depositor, JPMorgan Chase Bank, National Association, as property trustee, Chase Bank USA, National Association, as Delaware trustee, the administrative trustees named therein and the holders from time to time of individual beneficial interests in the assets of the trust
4.3(15)	Junior Subordinated Indenture, dated as of March 15, 2005, between JPMorgan Chase Bank, National Association, and Registrant
4.4(15)	Form of Junior Subordinated Note Due 2035, issued March 15, 2005
4.5(15)	Form of Preferred Security of Hanover Statutory Trust I, issued March 15, 2005
4.6(19)	Amended and Restated Declaration of Trust, dated as of November 4, 2005, among Registrant, as depositor, Wilmington Trust Company, as Institutional trustee and Delaware trustee, the administrative trustees named therein and the holders from time to time of the individual beneficial interests in the asset of the trust
4.7(19)	Junior Subordinated Indenture, dated as of November 4, 2005, between Wilmington Trust Company and Registrant.
4.8(19)	Form of Junior Subordinated Debt Security due 2035, issued November 4, 2005
4.9(19)	Form of Floating Rate TRUPS® Certificate issued November 4, 2005
10.3(1)	Registration Rights Agreement dated as of September 19, 1997 by and between Registrant and John A. Burchett, Joyce S. Mizerak, George J. Ostendorf and Irma N. Tavares
10.5(1)	Agreement and Plan of Recapitalization dated as of September 8, 1997 by and between Hanover Capital Partners Ltd. and John A. Burchett, Joyce S. Mizerak, George J. Ostendorf and Irma N. Tavares
10.6(1)	Bonus Incentive Compensation Plan dated as of September 9, 1997
10.7(1)	1997 Executive and Non-Employee Director Stock Option Plan
10.7.1(3)	1999 Equity Incentive Plan
10.8(7)	Amended and Restated Employment Agreement effective as of July 1, 2002, by and between Registrant and John A. Burchett
10.8.1(7)	Stock Option Agreement effective as of July 1, 2002 between Registrant and John A. Burchett
10.9(7)	Amended and Restated Employment Agreement effective as of July 1, 2002, by and between Registrant and Irma N. Tavares
10.9.1(7)	Stock Option Agreement effective as of July 1, 2002 between Registrant and Irma N. Tavares
10.10(7)	Amended and Restated Employment Agreement effective as of July 1, 2002, by and between Registrant and Joyce S. Mizerak
10.10.1(7)	Stock Option Agreement effective as of July 1, 2002 between Registrant and Joyce S. Mizerak
10.10.2(25)	Separation and General Release Agreement dated January 31, 2007 between Joyce S. Mizerak and Registrant.
10.11(7)	Amended and Restated Employment Agreement effective as of July 1, 2002, by and between Registrant and George J. Ostendorf
10.11.1(7)	Stock Option Agreement effective as of July 1, 2002 between Registrant and George J. Ostendorf

Exhibit	Description
10.11.2.(25)	Separation and General Release Agreement dated December 29, 2006 between George J. Ostendorf and Registrant.
10.11.2(6)	Employment Agreement dated as of January 1, 2000 by and between Registrant and Thomas P. Kaplan
10.11.3(9)	Stock Purchase Agreement as of December 13, 2002 between Thomas P. Kaplan and Registrant
10.11.4(10)	Stock Purchase Agreement as of March 31, 2003 between John A. Burchett and Registrant
10.11.5(10)	Stock Purchase Agreement as of March 31, 2003 between George J. Ostendorf and Registrant
10.12(16)	Employment Agreement dated as of April 14, 2005 by and between Registrant and Harold F. McElraft
10.13(1)	Office Lease Agreement, dated as of March 1, 1994, by and between Metroplex Associates and Hanover Capital Mortgage Corporation, as amended by the First Modification and Extension of Lease Amendment dated as of February 28, 1997
10.13.1(9)	Second Modification and Extension of Lease Agreement dated April 22, 2002 by and between Metroplex Associates and Hanover Capital Mortgage Corporation
10.13.2(9)	Third Modification of Lease Agreement dated May 8, 2002 by and between Metroplex Associates and Hanover Capital Mortgage Corporation
10.13.3(9)	Fourth Modification of Lease Agreement dated November 2002 by and between Metroplex Associates and Hanover Capital Mortgage Corporation
10.13.4(12)	Fifth Modification of Lease Agreement dated October 9, 2003 by and between Metroplex Associates and Hanover Capital Partners Ltd.
10.13.5(18)	Sixth Modification of Lease Agreement dated August 3, 2005 by and between Metroplex Associates and HanoverTrade Inc.
10.13.6(19)	Seventh Modification of Lease Agreement dated December 16. 2005 by and between Metroplex Associates and Hanover Capital Partners 2, Ltd.
10.14(3)	Office Lease Agreement, dated as of February 1, 1999, between LaSalle-Adams, L.L.C. and Hanover Capital Partners Ltd.
10.14.1(12)	First Amendment to Lease dated January 5, 2004 between LaSalle-Adams L.L.C. and Hanover Capital Partners Ltd.
10.15(9)	Office Lease Agreement, dated as of September 3, 1997, between Metro Four Associates Limited Partnership and Pamex Capital Partners, L.L.C., as amended by the First Amendment to Lease dated May 2000
10.15.1(12)	Sublease Agreement dated as of April 2004 between EasyLink Services, Inc. and HanoverTrade, Inc.
10.15.2(15)	Second Amendment to Lease, dated as of May 14, 2004, between Metro Four Associates Limited Partnership, as Landlord, and HanoverTrade, Inc. as Tenant
10.16(10)	Office Lease Agreement, dated as of July 10, 2002, between 233 Broadway Owners, LLC and Registrant
10.17(18)	Office Lease Agreement dated August 3, 2005 by and between Metroplex Associates and HanoverTrade Inc.
10.25(1)	Contribution Agreement dated September 19, 1997 by and among Registrant, John A. Burchett, Joyce S. Mizerak, George J. Ostendorf and Irma N. Tavares
10.25.1(7)	Amendment No. 1 to Contribution Agreement entered into as of July 1, 2002 by and between Registrant, John A. Burchett, Joyce S. Mizerak, George J. Ostendorf and Irma N. Tavares
10.25.2(13)	Amendment No. 2 to Contribution Agreement entered into as of May 20, 2004 by and between Registrant, John A. Burchett, Joyce S. Mizerak, George J. Ostendorf and Irma N. Tavares
10.26(1)	Participation Agreement dated as of August 21, 1997 by and among Registrant, John A. Burchett, Joyce S. Mizerak, George J. Ostendorf and Irma N. Tavares

Exhibit	Description
10.27(1)	Loan Agreement dated as of September 19, 1997 between Registrant and each of John A. Burchett, Joyce S. Mizerak, George J. Ostendorf and Irma N. Tavares
10.29(2)	Management Agreement, dated as of January 1, 1998, by and between Registrant and Hanover Capital Partners Ltd.
10.30(3)	Amendment Number One to Management Agreement, dated as of September 30, 1999
10.31(4)	Amended and Restated Master Loan and Security Agreement by and between Greenwich Capital Financial Products, Inc., Registrant and Hanover Capital Partners Ltd. dated March 27, 2000
10.31.3(9)	Amendment Number Six dated as of March 27, 2003 to the Amended and Restated Master Loan and Security Agreement dated as of March 27, 2000 by and among Registrant, Hanover Capital Partners, Ltd. and Greenwich Capital Financial Products, Inc.
10.31.4(10)	Amendment Number Seven dated as of April 27, 2003 to the Amended and Restated Master Loan and Security Agreement dated as of March 27, 2000 by and among Registrant, Hanover Capital Partners, Ltd. and Greenwich Capital Financial Products, Inc.
10.31.5(12)	Amendment Number Eight dated as of April 26, 2004 to the Amended and Restated Master Loan and Security Agreement dated as of March 27, 2000 by and among Registrant, Hanover Capital Partners, Ltd. and Greenwich Capital Financial Products, Inc.
10.31.6(18)	Amendment Number Nine dated as of April 18, 2005 to the Amended and Restated Master Loan and Security Agreement dated as of March 27, 2000 by and among Registrant, Hanover Capital Partners, Ltd. and Greenwich Capital Financial Products, Inc.
10.31.7(18)	Amendment Number Ten dated as of May 5, 2005 to the Amended and Restated Master Loan and Security Agreement dated as of March 27, 2000 by and among Registrant, Hanover Capital Partners, Ltd. and Greenwich Capital Financial Products, Inc.
10.31.8(18)	Amendment Number Eleven dated as of May 16, 2005 to be Amended and Restated Master Loans and Security Agreement dated as of March 27, 2000 by and among Registrant Hanover Capital Partners, Ltd. and Greenwich Financial Products, Inc.
10.31.9(19)	Amendment Number Twelve Dated as of January 31, 2006 of the Amended and Restated Master Loan and Security Agreement dated as of March 27, 2000, by and among Registrant, Hanover Capital Partners 2, Ltd. and Greenwich Financial Products, Inc.
10.31.10(20)	Amendment Number Thirteen Dated as of March 31, 2006, of the Amended and Restated Master Loan and Security Agreement dated as of March 27, 2000, by and among Registrant and Greenwich Financial Products, Inc.
10.31.11(21)	Amendment Number Fourteen dated as of May 18, 2006, of the Amended and Restated Master Loan and Security Agreement dated as of March 27, 2000, by and among the Registrant and Greenwich Financial Products, Inc.
10.31.12(21)	Amendment Number Fifteen dated as of June 14, 2006, of the Amended and Restated Master Loan and Security Agreement dated as of March 27, 2000, by and among the Registrant and Greenwich Financial Products, Inc.
10.33(5)	Stockholder Protection Rights Agreement dated as of April 11, 2000 by and between Registrant and State Street Bank & Trust Company, as Rights Agent
10.33.1(7)	Amendment to Stockholder Protection Rights Agreement effective as of September 26, 2001, by and among Registrant, State Street Bank and Trust Company and EquiServe Trust Company, N.A.
10.33.2(7)	Second Amendment to Stockholder Protection Rights Agreement dated as of June 10, 2002 by and between Registrant and EquiServe Trust Company, N.A.
10.34(6)	Asset Purchase Agreement, dated as of January 19, 2001 by and among HanoverTrade.com, Inc., Registrant, Pamex Capital Partners, L.L.C. and the members of Pamex Capital Partners, L.L.C.

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Exhibit	Description
10.35(9)	Amended and Restated Limited Liability Agreement as of November 21, 2002 by and among BTD 2001 HDMF-1 Corp., Registrant and Provident Financial Group, Inc.
10.36.1(14)	Indemnity Agreement by and between Registrant and John A. Burchett, dated as of July 1, 2004
10.36.2(14)	Indemnity Agreement by and between Registrant and John A. Clymer, dated as of July 1, 2004
10.36.3(14)	Indemnity Agreement by and between Registrant and Joseph J. Freeman, dated as of July 1, 2004
10.36.4(14)	Indemnity Agreement by and between Registrant and Roberta M. Graffeo, dated as of July 1, 2004
10.36.6(14)	Indemnity Agreement by and between Registrant and Douglas L. Jacobs, dated as of July 1, 2004
10.36.7(14)	Indemnity Agreement by and between Registrant and Harold F. McElraft, dated as of July 1, 2004
10.36.8(14)	Indemnity Agreement by and between Registrant and Richard J. Martinelli, dated as of July 1, 2004
10.36.9(14)	Indemnity Agreement by and between Registrant and Joyce S. Mizerak, dated as of July 1, 2004
10.36.10(14)	Indemnity Agreement by and between Registrant and Saiyid T. Naqvi, dated as of July 1, 2004
10.36.11(14)	Indemnity Agreement by and between Registrant and George J. Ostendorf, dated as of July 1, 2004
10.36.12(14)	Indemnity Agreement by and between Registrant and John N. Rees, dated as of July 1, 2004
10.36.13(14)	Indemnity Agreement by and between Registrant and David K. Steel, dated as of July 1, 2004
10.36.14(14)	Indemnity Agreement by and between Registrant and James F. Stone, dated as of July 1, 2004
10.36.15(14)	Indemnity Agreement by and between Registrant and James C. Strickler, dated as of July 1, 2004
10.36.16(14)	Indemnity Agreement by and between Registrant and Irma N. Tavares, dated as of July 1, 2004
10.36.17(16)	Indemnity Agreement by and between Registrant and Harold F. McElraft, dated as of April 14, 2005
10.36.18(19)	Indemnity Agreement by and between Registrant and Suzette Berrios, dated as of November 28, 2005
10.37(15)	Purchase Agreement, dated February 24, 2005, among Registrant, Hanover Statutory Trust I and Taberna Preferred Funding I, Ltd.
10.38(17)	Master Repurchase Agreement between Sovereign Bank, as Buyer, and Registrant and Hanover Capital Partners Ltd, as Seller, dated as of June 28, 2005
10.38.2(19)	Assignment, Assumption and Recognition Agreement dated January 20, 2006 among the Registrant, Hanover Capital Partners 2, Ltd. and Sovereign Bank
10.38.3(19)	Assignment, Assumption and Recognition Agreement dated January 20, 2006 among the Registrant, Hanover Capital Partners 2, Ltd., Sovereign Bank and Deutsche Bank National Trust Company
10.38.4(20)	ISDA Master Agreement dated April 3, 2006, by and among Registrant and SMBC Derivative Products Limited
10.38.5(22)	Master Repurchase Agreement dated June 22, 2006, by and among Registrant and Deutsche Zentral-Genossenschaftsbank, Frankfurt am Main AG
10.38.6(23)	Warehouse Agreement between Merrill Lynch International and Hanover Capital Mortgage Holdings, Inc., dated as of August 28, 2006.
10.38.7 (25)	Asset Purchase Agreement by and between Registrant and Terwin Acquisition I, LLC, dated as of January 12, 2007

Exhibit	Description
16.1(11)	Letter from Deloitte & Touche LLP, dated February 23, 2004
21(25)	Subsidiaries of Hanover Capital Mortgage Holdings, Inc.
23.1(25)	Consent of Independent Registered Public Accounting Firm (Grant Thornton LLP)
31.1(25)	Certification by John A. Burchett pursuant to Securities Exchange Act Rule 13a-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2(25)	Certification by Harold F. McElraft pursuant to Securities Exchange Act Rule 13a-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1(26)	Certification by John A. Burchett pursuant to 18 U.S.C. Section 1350), as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2(26)	Certification by Harold F. McElraft pursuant to 18 U.S.C. Section 1350), as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

(1) Incorporated herein by reference to Registrant's Registration Statement on Form S-11, Registration No. 333-29261, as amended, which became effective under the Securities Act of 1933, as amended, on September 15, 1997.

(2) Incorporated herein by reference to Registrant's Form 10-K for the year ended December 31, 1997, as filed with the Securities and Exchange Commission on March 31, 1998.

(3) Incorporated herein by reference to Registrant's Form 10-K for the year ended December 31, 1999, as filed with the Securities and Exchange Commission on March 30, 2000.

(4) Incorporated herein by reference to Registrant's Form 10-Q for the quarter ended March 31, 2000, as filed with the Securities and Exchange Commission on May 15, 2000.

(5) Incorporated herein by reference to Registrant's report on Form 8-K filed with the Securities and Exchange Commission on April 24, 2000.

(6) Incorporated herein by reference to Registrant's Form 10-K for the year ended December 31, 2000, as filed with the Securities and Exchange Commission on April 2, 2001.

(7) Incorporated herein by reference to Registrant's Form 8-K filed with the Securities and Exchange Commission on July 16, 2002.

(8) Incorporated herein by reference to Registrant's Form 10-Q for the quarter ended June 30, 2002, as filed with the Securities and Exchange Commission on August 14, 2002.

(9) Incorporated herein by reference to Registrant's Form 10-K for the year ended December 31, 2002, as filed with the Securities and Exchange Commission on March 28, 2003.

(10) Incorporated herein by reference to Registrant's Form 10-Q for the quarter ended March 31, 2003, as filed with the Securities and Exchange Commission on May 15, 2003.

(11) Incorporated herein by reference to Registrant's Form 8-K filed with the Securities and Exchange Commission on February 23, 2004.

(12) Incorporated herein by reference to Registrant's Form 10-Q for the quarter ended March 31, 2004, as filed with the Securities and Exchange Commission on May 24, 2004.

(13) Incorporated herein by reference to Registrant's Form 10-Q for the quarter ended June 30, 2004, as filed with the Securities and Exchange Commission on August 12, 2004.

(14) Incorporated herein by reference to Registrant's Form 10-Q for the quarter ended September 30, 2004, as filed with the Securities and Exchange Commission on November 9, 2004.

(15) Incorporated herein by reference to Registrant's Form 10-K for the year ended December 31, 2004, as filed with the Securities and Exchange Commission on March 31, 2005.

(16) Incorporated herein by reference to Registrant's Form 10-Q for the quarter ended March 31, 2005, as filed with the Securities and Exchange Commission on March 16, 2005.

(17) Incorporated herein by reference to Registrant's Form 8-K filed with the Securities and Exchange Commission on August 4, 2005.

(18) Incorporated herein by reference to Registrant's Form 10-Q for the quarter ended June 30, 2005, as filed with the Securities and Exchange Commission on August 9, 2005.

(19) Incorporated herein by reference to Registrant's Form 10K for the year ended December 31, 2005, as filed with the Securities and Exchange Commission on March 16, 2006.

(20) Incorporated herein by reference to Registrant's Form 10K for the year ended December 31, 2005, as filed with the Securities and Exchange Commission on May 10, 2006.

(21) Incorporated herein by reference to Registrant's Form 8-K filed with the Securities and Exchange Commission on June 20, 2006.

(22) Incorporated herein by reference to Registrant's Form 8-K filed with the Securities and Exchange Commission on June 28, 2006.

(23) Incorporated herein by reference to Registrant's Form 8-K filed with the Securities and Exchange Commission on September 1, 2006.

(24) Incorporated herein by reference to Registrant's Form 10-Q for the quarter ended September 30, 2006, as filed with the Securities and Exchange Commission on November 9, 2006.

(25) Filed herewith.

(26) Furnished herewith.

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HANOVER CAPITAL MORTGAGE HOLDINGS, INC. AND SUBSIDIARIES

Board of Directors and Stockholders
Hanover Capital Mortgage Holdings, Inc. and Subsidiaries

We have audited the accompanying consolidated balance sheets of Hanover Capital Mortgage Holdings, Inc. and Subsidiaries (the “Company”) as of December 31, 2006 and 2005, and the related consolidated statements of operations, other comprehensive income (loss), stockholders’ equity, and cash flows for each of the three years in the period ended December 31, 2006. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Hanover Capital Mortgage Holdings, Inc. and Subsidiaries as of December 31, 2006 and 2005 and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2006 in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Hanover Capital Mortgage Holdings, Inc. and Subsidiaries’ internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 13, 2007 expressed an unqualified opinion on management’s assessment.

/s/ GRANT THORNTON LLP

New York, New York
March 13, 2007

HANOVER CAPITAL MORTGAGE HOLDINGS, INC. AND SUBSIDIARIES

Board of Directors and Stockholders
Hanover Capital Mortgage Holdings, Inc. and Subsidiaries

We have audited management's assessment, included in Management's Report on Internal Control Over Financial Reporting, that Hanover Capital Mortgage Holdings, Inc. and Subsidiaries (the "Company") maintained effective Internal Control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO criteria"). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that the Company maintained effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on the COSO criteria. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of the Company as of December 31, 2006 and 2005, and the related consolidated statements of operations, other comprehensive income (loss), stockholders' equity, and cash flows for each of the three years ended December 31, 2006 and our report dated March 13, 2007 expressed an unqualified opinion on those financial statements.

/s/ GRANT THORNTON LLP

New York, New York
March 13, 2007

HANOVER CAPITAL MORTGAGE HOLDINGS, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS
(in thousands, except share and per share data)

	December 31, 2006	December 31, 2005
ASSETS		
Cash and cash equivalents	$ 13,982	$ 30,492
Accrued interest receivable	1,652	1,367
Mortgage loans		
Held for sale	—	10,061
Collateral for CMOs	9,736	14,074
	9,736	24,135
Mortgage securities ($254,482 and $188,398 pledged under Repurchase Agreements as of December 31, 2006 and 2005, respectively)		
Trading	105,104	82,487
Available for sale	154,599	106,967
Held to maturity	6,254	8,034
	265,957	197,488
Other subordinate security, held to maturity	2,757	2,703
Equity investments in unconsolidated affiliates	1,399	1,289
Other assets	6,237	10,705
Other assets of discontinued operations	2,549	4,008
	$ 304,269	$ 272,187
LIABILITIES		
Repurchase agreements	$ 193,247	$ 154,268
Collateralized mortgage obligations (CMOs)	7,384	11,438
Dividends payable	1,236	2,124
Accounts payable, accrued expenses and other liabilities	2,757	2,651
Liability to subsidiary trusts issuing preferred and capital securities	41,239	41,239
Other liabilities of discontinued operations	823	847
	246,686	212,567
Contingencies	—	—
Minority interest in equity of consolidated affiliate	—	189
STOCKHOLDERS' EQUITY		
Preferred stock, $0.01 par value, 10 million shares authorized, no shares issued and outstanding	—	—
Common stock, $0.01 par value, 90 million shares authorized, 8,233,062 and 8,496,162 shares issued and outstanding as of December 31, 2006 and 2005, respectively	82	85
Additional paid-in capital	102,598	104,231
Cumulative earnings	8,699	11,625
Cumulative distributions to shareholders	(56,173)	(50,362)
Deferred stock-based compensation	—	(205)
Accumulated other comprehensive income (loss)	2,377	(5,943)
	57,583	59,431
	$ 304,269	$ 272,187

See notes to consolidated financial statements

HANOVER CAPITAL MORTGAGE HOLDINGS, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except share and per share data)

	Years Ended December 31, 2006	2005	2004
REVENUES			
Interest income	$ 24,278	$ 16,296	$ 14,242
Interest expense	13,942	8,284	4,271
Net interest income before loan loss provision	10,336	8,012	9,971
Loan loss provision	—	26	36
Net interest income	10,336	7,986	9,935
Gain on sale of mortgage assets	834	4,515	10,400
Gain (loss) on mark to market of mortgage assets	148	(2,715)	237
(Loss) gain on freestanding derivatives	(2,344)	180	(4,389)
Technology	2,857	3,054	2,794
Loan brokering and advisory services	105	1,647	2,700
Other income (loss)	(77)	602	305
Total revenues	11,859	15,269	21,982
EXPENSES			
Personnel	4,239	6,428	7,355
Legal and professional	2,777	2,810	2,904
General and administrative	1,183	1,259	1,211
Depreciation and amortization	708	1,220	912
Occupancy	315	347	283
Technology	1,109	1,575	820
Goodwill impairment	2,478	—	—
Other	1,104	1,369	1,018
Total expenses	13,913	15,008	14,503
Operating income (loss)	(2,054)	261	7,479
Equity in income (loss) of unconsolidated affiliates	110	(165)	445
Minority interest in loss of consolidated affiliate	(5)	(57)	—
Income (loss) from continuing operations before income tax provision (benefit)	(1,939)	153	7,924
Income tax provision (benefit)	12	2	(26)
Income (loss) from continuing operations	(1,951)	151	7,950
DISCONTINUED OPERATIONS			
Income (loss) from discontinued operations before income tax provision (benefit)	(917)	1,387	108
Income tax provision (benefit) from discontinued operations	58	172	(63)
Income (loss) from discontinued operations	(975)	1,215	171
NET INCOME (LOSS)	$ (2,926)	$ 1,366	$ 8,121
Net income (loss) per common share — Basic			
Income (loss) from continuing operations	$ (0.23)	$ 0.02	$ 0.96
Income (loss) from discontinued operations	(0.12)	0.14	0.02
Net income (loss) per common share — Basic	$ (0.35)	$ 0.16	$ 0.98
Net income (loss) per common share — Diluted			
Income (loss) from continuing operations	$ (0.23)	$ 0.02	$ 0.95
Income (loss) from discontinued operations	(0.12)	0.14	0.02
Net income (loss) per common share — Diluted	$ (0.35)	$ 0.16	$ 0.97
Weighed average shares outstanding — Basic	8,358,433	8,443,744	8,288,405
Weighed average shares outstanding — Diluted	8,358,433	8,460,903	8,344,741

See notes to consolidated financial statements

HANOVER CAPITAL MORTGAGE HOLDINGS, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OTHER COMPREHENSIVE INCOME (LOSS)
(in thousands)

	Years Ended December 31, 2006	2005	2004
Net income (loss)	$ (2,926)	$ 1,366	$ 8,121
Other comprehensive income (loss), net of tax effect of $0:			
Net unrealized gain (loss) on mortgage securities classified as available-for-sale	6,994	(5,556)	(736)
Reclassification adjustment for net gain (loss) included in net income	1,326	242	(116)
Other comprehensive income (loss)	8,320	(5,314)	(852)
Comprehensive income (loss)	$ 5,394	$ (3,948)	$ 7,269

See notes to consolidated financial statements

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HANOVER CAPITAL MORTGAGE HOLDINGS, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

(in thousands, except share data)

	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Notes Receivable from Related Parties	Cumulative Earnings	Cumulative Distributions To Shareholders	Deferred Stock-Based Compensation	Accumulated Other Comprehensive Income (Loss)	Total
BALANCE, JANUARY 1, 2004	8,192,903	$ 82	$ 101,279	$ (1,167)	$ 2,138	$ (27,736)	$ —	$ 223	$ 74,819
Common stock paid for acquisition	35,419	—	494	—	—	—	—	—	494
Forgiveness of notes receivable from four executive officers (Principals)	—	—	—	584	—	—	—	—	584
Common stock earned by Principals	72,222	1	848	—	—	—	—	—	849
Exercise of stock options	75,646	1	424	—	—	—	—	—	425
Stock issued under Executive Compensation Plan	5,393	—	81	—	—	—	—	—	81
Net income	—	—	—	—	8,121	—	—	—	8,121
Other comprehensive income (loss)	—	—	—	—	—	—	—	(852)	(852)
Dividends declared	—	—	—	—	—	(13,302)	—	—	(13,302)
BALANCE, DECEMBER 31, 2004	8,381,583	84	103,126	(583)	10,259	(41,038)	—	(629)	71,219
Forgiveness of notes receivable from four executive officers (Principals)	—	—	—	583	—	—	—	—	583
Common stock earned by Principals	72,222	1	761	—	—	—	—	—	762
Common stock grants to key employees	22,000	—	236	—	—	—	(236)	—	—
Amortization of deferred stock grant to key employees	—	—	—	—	—	—	31	—	31
Exercise of stock options	18,000	—	83	—	—	—	—	—	83
Stock issued under Executive Compensation Plan	2,357	—	25	—	—	—	—	—	25
Net income	—	—	—	—	1,366	—	—	—	1,366
Other comprehensive income (loss)	—	—	—	—	—	—	—	(5,314)	(5,314)
Dividends declared	—	—	—	—	—	(9,324)	—	—	(9,324)
BALANCE, DECEMBER 31, 2005	8,496,162	85	104,231	—	11,625	(50,362)	(205)	(5,943)	59,431
Reclassification of deferred stock-based compensation	—	—	(205)	—	—	—	205	—	—
Amortization of deferred stock grant to key employees	—	—	47	—	—	—	—	—	47
Stock option issued to director	—	—	1	—	—	—	—	—	1
Repurchase of common stock	(263,100)	(3)	(1,476)	—	—	—	—	—	(1,479)
Net income (loss)	—	—	—	—	(2,926)	—	—	—	(2,926)
Other comprehensive income (loss)	—	—	—	—	—	—	—	8,320	8,320
Dividends declared	—	—	—	—	—	(5,811)	—	—	(5,811)
BALANCE, DECEMBER 31, 2006	8,233,062	$ 82	$ 102,598	$ —	$ 8,699	$ (56,173)	$ —	$ 2,377	$ 57,583

See notes to consolidated financial statements

HANOVER CAPITAL MORTGAGE HOLDINGS, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

	Years Ended December 31, 2006	2005	2004
OPERATING ACTIVITIES			
Income (loss) from continuing operations	$ (1,951)	$ 151	$ 7,950
Adjustments to reconcile income (loss) from continuing operations to net cash (used in) provided by operating activities of continuing operations:			
Depreciation and amortization	708	1,220	912
Common stock issued to Principals	—	762	849
Stock-based compensation	35	22	—
Accretion of net discount	(5,771)	(2,665)	(2,332)
Loan loss provision	—	26	36
(Gain) loss recognized from mark to market of mortgage assets	(148)	2,715	(237)
Undistributed (earnings) losses of unconsolidated affiliates — net	(110)	165	(445)
Minority interest in earnings (loss) of consolidated affiliate	(5)	(57)	—
Gain on sale of mortgage assets	(834)	(4,515)	(10,400)
Loss (gain) on disposition of real estate owned	85	62	(27)
Gain on paid-in-full mortgage loans	—	—	(19)
Goodwill impairment	2,478	—	—
Purchase of mortgage securities classified as trading	(77,023)	—	(80,127)
Principal collections on mortgage securities classified as trading	10,262	25,207	—
Proceeds from sale of mortgage securities classified as trading	45,860	—	—
Purchase of mortgage loans classified as held for sale	—	(20,139)	—
Principal collections on mortgage loans classified as held for sale	780	4,593	—
Proceeds from sale of mortgage loans classified as held for sale	9,418	—	—
Decrease (increase) in accounts receivable	337	450	(606)
Increase in accrued interest receivable	(285)	(346)	(10)
(Increase) decrease in other assets	(1,544)	511	(942)
Decrease in accounts payable, accrued expenses and other liabilities	(142)	(282)	(766)
Net cash (used in) provided by operating activities of continuing operations	(17,850)	7,880	(86,164)
Net cash provided by operating activities of discontinued operations	473	32	2,129
INVESTING ACTIVITIES			
Purchase of mortgage securities classified as available for sale	(78,158)	(113,054)	(77,272)
Purchase of other securities classified as held to maturity	—	(2,681)	—
Proceeds from the closing of CMOs	—	20,799	—
Principal collections on mortgage securities classified as available for sale	1,434	861	10,903
Principal collections on mortgage securities classified as held to maturity	1,614	—	—
Principal collections on CMO collateral	4,378	6,533	17,491
Proceeds from sale of mortgage securities classified as available for sale	43,420	60,772	75,915
Proceeds from disposition of real estate owned	1,526	912	44
Cash acquired in (paid for) acquisitions	(118)	1,158	—
Capital investment in unconsolidated affiliates	—	(2,225)	(537)
Net cash (used in) provided by investing activities of continuing operations	(25,904)	(26,925)	26,544
FINANCING ACTIVITIES			
Proceeds from issuance of junior subordinated notes to subsidiary trusts issuing preferred and capital securities	—	41,239	—
Proceeds from exercise of stock options	—	83	425
Increase in borrowings using repurchase agreements	38,979	24,166	74,702
Repayment of borrowings on line of credit	—	(3,681)	—
Payments on CMOs	(4,054)	(23,772)	(16,959)
Payment of dividends	(6,699)	(9,714)	(13,246)
Repurchase of common stock	(1,455)	—	—
Decrease in notes receivable from related party	—	583	584
Net cash provided by financing activities of continuing operations	26,771	28,904	45,506
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(16,510)	9,891	(11,985)
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR	30,492	20,601	32,586
CASH AND CASH EQUIVALENTS AT END OF YEAR	$ 13,982	$ 30,492	$ 20,601

See notes to consolidated financial statements

HANOVER CAPITAL MORTGAGE HOLDINGS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years Ended December 31, 2006, 2005 and 2004

1. ORGANIZATION AND BASIS OF PRESENTATION

Hanover Capital Mortgage Holdings, Inc. (“Hanover”) was incorporated in Maryland on June 10, 1997. Hanover is a real estate investment trust (“REIT”) formed to operate as a specialty finance company. Hanover has one primary subsidiary: Hanover Capital Partners 2, Ltd. (“HCP-2”). References to the “Company” mean Hanover together with its consolidated subsidiaries.

The Company’s principal business is the REIT that generates net interest income on its portfolio of mortgage securities and mortgage loans on a leveraged basis. Secondarily, mortgage industry service and technology related income is earned through two separate divisions in HCP-2, Hanover Capital Partners (“HCP”) and HanoverTrade (“HT”).

As more fully described in Note 3, the assets and liabilities and results of operation of HCP, which represents all of the Company’s due diligence operations, are classified as discontinued operations for all periods presented.

On March 1, 2006, the Company acquired the remaining minority interest in HDMF-I, LLC (“HDMF-I”) which was formed to purchase, service, manage and ultimately re-sell or otherwise liquidate pools of sub- and non-performing one-to-four family residential mortgage loans. The acquisition price of $118,000 equaled the former member’s ownership interest. As a result of this transaction, the Company now owns 100% of HDMF-I and has consolidated 100% of the operating results of HDMF-I since the date of acquisition and has consolidated 100% of the assets and liabilities as of December 31, 2006.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation

The consolidated financial statements of the Company include the accounts of Hanover Capital Mortgage Holdings, Inc. and its wholly-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated.

Basis of Presentation

The consolidated financial statements of the Company are prepared on the accrual basis of accounting in accordance with accounting principles generally accepted in the United States of America (“GAAP”). All adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of certain assets and liabilities, disclosure of contingent assets and liabilities, and the reported amounts of certain revenues and expenses. Estimates, by their nature, are based on judgment and available information. Actual results could differ from the estimates. The Company’s estimates and assumptions arise primarily from risks and uncertainties associated with the determination of the fair value of, and recognition of interest income and impairment on, its mortgage securities. For purposes of determining the fair value of its mortgage securities, the Company defines the term fair value as the price which the mortgage securities may bring when they are offered for sale by one who is willing, but not obligated, to sell them, and are bought by one who is willing, or desires, to purchase, but is not compelled to do so. Although management is not currently aware of any factors that would significantly change its estimates and assumptions, it is possible that prices received through sales of the Company’s mortgage securities would differ from the Company’s estimates of fair value.

Cash and Cash Equivalents

Cash and cash equivalents include cash on hand, U.S. Treasury bills, overnight investments deposited with banks and money market mutual funds primarily invested in government securities and commercial paper with weighted maturities less than 90 days.

Mortgage Loans

Mortgage loans that are securitized in a collateralized mortgage obligation ("CMO") are classified as collateral for CMOs. Mortgage loans classified as collateral for CMOs are carried at amortized cost, net of allowance for loan losses. Mortgage loans classified as held for sale are carried at the lower of cost or market, with any unrealized losses included in operating income. Purchase discounts are not amortized for mortgage loans classified as held for sale.

Mortgage loan transactions are recorded on the date the mortgage loans are purchased or sold. Mortgage loans are classified as held for sale at the time of purchase until a review of the individual loans is completed (generally three to nine months). At the completion of this review, the loans may be sold, grouped into pools of loans, and/or reclassified to other than held for sale.

The accrual of interest on impaired loans is discontinued when, in management's opinion, the borrower may be unable to meet payments as they become due. Interest income is subsequently recognized only to the extent cash payments are received.

Mortgage Securities

The Company invests in subordinate mortgage-backed securities ("Subordinate MBS") issued by third parties that are collateralized by pools of prime single-family mortgage loans. These loans are primarily jumbo mortgages, which are residential mortgages with principal balances that exceed limits imposed by Fannie Mae, Freddie Mac and Ginnie Mae. Subordinate MBS have a high concentration of credit risk and generally absorb losses prior to all senior tranches of mortgage-backed securities in the same issue. These securities are generally rated below investment-grade and, as a result, are typically purchased at a substantial discount. The purchase discount is accreted as interest income using the effective yield method. The objective of the effective yield method is to arrive at periodic interest income or expense at a constant effective yield over each security's remaining effective life. For the Company's Subordinate MBS, an initial effective yield is calculated by estimating the cash flows associated with each Subordinate MBS. The Company continues to update the estimate of cash flows over the life of the Subordinate MBS. If the estimated future cash flows change, the effective yield is recalculated and the periodic accretion of the purchase discount is adjusted over the remaining life of the Subordinate MBS. If the fair value of the Subordinate MBS declines below its carrying amount, and the decline is determined to be an other-than-temporary decline, then an other-than-temporary impairment charge is included in current period earnings.

The Company's policy is to generally classify Subordinate MBS as available for sale as they are acquired. Management reevaluates the propriety of its classification of the mortgage securities on a quarterly basis.

Mortgage securities designated as available for sale are reported at estimated fair value, with unrealized gains and losses included in comprehensive income. Unrealized losses considered to be other-than-temporary impairments are reported as a component of gain (loss) on mark to market of mortgage assets.

The Company also invests in mortgage-backed securities issued by Fannie Mae and Freddie Mac, ("Agency MBS"). Although not rated, Agency MBS carry an implied "AAA" rating. Generally, the Company purchases Agency MBS at a premium. Purchase premiums are amortized as a component of net interest income using the effective yield method.

The Company's policy is to generally classify Agency MBS as trading as they are acquired. Management re-evaluates the property of its classification on a quarterly basis.

Mortgage securities designated as trading are reported at estimated fair value. Gains and losses resulting from changes in estimated fair value are recorded as a component of gain (loss) on mark to market of mortgage assets.

Mortgage securities and other subordinate securities designated as held to maturity are reported at amortized cost unless a decline in value is deemed other-than-temporary, in which case an unrealized loss is recognized as a component of gain (loss) on mark to market of mortgage assets. The amortization of premiums or accretion of discounts are included as a component of net interest income.

Mortgage securities transactions are recorded on trade date for mortgage securities purchased or sold. Purchases of new issue mortgage securities are recorded when all significant uncertainties regarding the characteristics of the mortgage securities are removed, generally on closing date. Realized gains and losses on mortgage securities transactions are determined on the specific identification method.

Equity Investments

Prior to June 2005, Hanover recorded its investment in HDMF-I LLC ("HDMF-I") based on the equity method, recording its proportionate share of the earnings or losses of HDMF-I. In June 2005, Hanover acquired a majority ownership of HDMF-I and began to consolidate the balance sheet and statement of operations of HDMF-I into the Company's consolidated balance sheets and statements of operations.

Hanover records its investments in Hanover Statutory Trust I and Hanover Statutory Trust II on the equity method. See Note 11 for further information.

Repurchase Agreements

Securities sold under repurchase agreements are accounted for as collateralized financing transactions and are recorded at their contractual amounts, plus accrued interest.

Financial Instruments

The Company enters into forward sales of mortgage securities issued by U.S. government agencies to manage its exposure to changes in market value of its Agency MBS. These instruments are considered economic hedges and are considered freestanding derivatives for accounting purposes. The Company recognizes changes in the fair value of such economic hedges and the proceeds or payments in connection with the monthly close-out of the position as a component of gain (loss) on freestanding derivatives.

The Company also enters into interest rate caps to manage its interest rate exposure on financing under certain debt instruments. Interest rate caps are considered freestanding derivatives for accounting purposes. Changes in fair value are recognized as a component of gain (loss) on freestanding derivatives.

The fair values of the forward sales and interest rate caps are included as a component of other assets and are based on estimates using third party determined market prices.

Revenue Recognition

Revenues from due diligence services provided by HCP include fees earned and reimbursed out-of-pocket expenses from providing consulting and outsourcing services for third parties in the mortgage industry, including loan file due diligence reviews, staffing solutions and mortgage assignment and collateral rectification services. Due diligence services are generally fixed-price or time-and-materials contracts and are short-term in nature (generally taking less than 30 days to complete).

Revenues from loan brokering and advisory services are recognized concurrently with the closing and funding of transactions, at which time fees are earned. At the time of closing a transaction, the number of loans, loan principal balance and purchase price in the transaction are agreed upon, documentation is signed and the sale is funded.

Revenues from technology provided by HT include fees earned from consulting services, the licensing of software and hosting of systems. The percentage-of-completion method is used to recognize revenues and profits for long-term technology consulting contracts. Progress towards completion is measured using the efforts-expended method or the contract milestones method. These methods are applied consistently to all contracts having similar characteristics in similar circumstances. Under the efforts-expended method, revenues and profits are recognized based on the extent of progress as measured by the ratio of hours performed at the measurement date to estimated total hours at completion. Estimated hours include estimated hours of employees and subcontractors engaged to perform work under the contract. Under the contract milestones method, revenues and profits are recognized based on results achieved in accordance with the contract in consideration of remaining obligations. Revenues from monthly license or hosting arrangements are recognized on a subscription basis over the period in which the client uses the product.

When contracts include the delivery of a combination of services, such contracts are divided into separate units of accounting and the total contract fee is allocated to each unit based on its relative fair value. Revenue is recognized separately, and in accordance with the revenue recognition policy, for each element.

Income Taxes

Hanover has elected to be taxed as a REIT and intends to comply with the provisions of the Internal Revenue Code of 1986, as amended (the “Code”), with respect thereto. Accordingly, Hanover will not be subject to Federal or state income tax on that portion of its income that is distributed to stockholders, as long as certain asset, income and stock ownership tests are met.

HCP-2 files a separate consolidated Federal income tax returns and is subject to Federal, state and local income taxation. HCP-2 uses the asset and liability method in accounting for income taxes. Deferred income taxes are provided for the effect of temporary differences between the tax basis and financial statement carrying amounts of assets and liabilities.

Earnings Per Share

Basic earnings per share excludes dilution and is computed by dividing income available to common stockholders by the weighted-average number of common shares outstanding during the period. Diluted earnings per share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock that then shared in earnings and losses. Shares issued during the period and shares reacquired during the period are weighted for the period they were outstanding.

Stock-Based Compensation

Hanover applies Statement of Financial Accounting Standards (“SFAS”) No. 123 (revised 2004), “Share-Based Payment”, in accounting for its stock-based compensation plans, as more thoroughly described in Note 12, for all awards granted after December 31, 2005 and all awards modified, repurchased, or cancelled after December 31, 2005. For these awards, the Company measures the cost of employee services received in exchange for the award of equity instruments based on the grant-date fair value of the award and recognizes the total cost as compensation expense on a straight-line basis over the applicable vesting period.

HANOVER CAPITAL MORTGAGE HOLDINGS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Hanover applied Accounting Principles Board "APB" Opinion No. 25, *Accounting for Stock Issued to Employees*, in accounting for its stock-based compensation plans up to December 31, 2005. No compensation cost has been recognized for its stock options in the financial statements for the years ended December 31, 2005 and 2004. Had the Company determined compensation cost based on the fair value as of the grant date for its stock options under Statement of Financial Accounting Standards No. 123, *Accounting For Stock-Based Compensation*, the Company's net income would have been reduced to the pro forma amounts for the period indicated below (dollars in thousands, except per share data):

	Years Ended December 31,	
	2005	2004
Net income:		
As reported	$ 1,366	$ 8,121
Deduct: Total stock-based employee compensation expense determined under fair value based method	(1)	(4)
Pro forma	$ 1,365	$ 8,117
Basic earnings per share:		
As reported	$ 0.16	$ 0.98
Pro forma	$ 0.16	$ 0.98
Diluted earnings per share:		
As reported	$ 0.16	$ 0.97
Pro forma	$ 0.16	$ 0.97

The per share weighted-average fair value of stock options granted for the years ended December 31, 2005 and 2004 was $0.49 and $1.06, respectively, as of the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions:

	2005	2004
Expected life (years)	10	10
Risk-free interest rate	4.12%	4.70%
Volatility	25.00%	29.51%
Expected dividend yield	10.53%	9.41%

Recent Accounting Pronouncements

In February 2006, the FASB issued Statement 155, *Accounting for Certain Hybrid Financial Instruments*, (FAS 155), to amend FAS 133 and FAS 140. This statement simplifies the accounting for certain financial instruments by allowing an entity to make an irrevocable election on a specific instrument basis for certain financial assets and liabilities that contain embedded derivatives that would otherwise require bifurcation and to recognize and remeasure at fair market value these instruments so elected. Thus, under this election, an entity would measure the entire hybrid financial instrument at fair market value with changes in fair market value recognized in earnings. FAS 155 will become effective for us as of January 1, 2007. In January 2007, the FASB released Statement 133 Implementation Issue No. B40, "Embedded Derivatives: Application of Paragraph 13(b) to Securitized Interests in Prepayable Financial Assets" (B40). B40 provides a narrow scope exception for certain securitized interests from the tests required under paragraph 13(b) FAS 133. Those tests are commonly referred to in practice as the "double-double" test. B40 represents the culmination of the FASB staff's consideration of the need for further guidance for securitized interests, following the issuance in

February 2006 of FAS 155. B40 is applicable to securitized interests issued after June 30, 2007. We are currently assessing the impact, if any, on our financial statements.

In April 2006, the FASB issued FASB Staff Position FIN 46(R)-6, “Determining the Variability to be Considered in Applying FASB Interpretation No. 46(R)” (“FSP FIN 46(R)-6”), which addresses the approach to determine the variability to consider when applying FIN 46(R). The variability that is considered in applying FIN 46(R) may affect (a) the determination as to whether the entity is a variable interest entity, (b) the determination of which interests are variable interests in the entity, (c) if necessary, the calculation of expected losses and residual returns of the entity, and (d) the determination of which party is the primary beneficiary of the variable interest entity. The Company has adopted FSP FIN 46(R)-6 as of July 1, 2006 and will apply the guidance prospectively for all entities (including newly created entities) with which the Company first becomes involved and to all entities previously required to be analyzed under FIN 46(R) when a reconsideration event has occurred. The adoption of this pronouncement did not have a material impact on the Company’s consolidated financial statements.

In June 2006, the FASB issued FASB Interpretation No. 48, “Accounting for Uncertainty in Income Taxes — an interpretation of FASB Statement No. 109” (“FIN 48”), which prescribes a recognition threshold and measurement attribute for income tax positions taken or expected to be taken in a tax return. In addition, this pronouncement provides guidance on derecognition, classification, penalties and interest, accounting in interim periods, disclosure, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company’s management is currently evaluating the potential impact of this pronouncement and does not believe that the adoption will have a significant impact on the Company’s consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, “Fair Value Measurements”, which establishes a framework for measuring fair value in GAAP, clarifies the definition of fair value within that framework, and expands disclosures about the use of fair value measurements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007 and is to be applied prospectively as of the fiscal year of adoption. The Company is currently evaluating the potential impact of this pronouncement and does not believe the adoption will have a material impact on the Company’s consolidated financial statements.

In September 2006, the Staff of the Securities and Exchange Commission issued Staff Accounting Bulletin No. 108, “Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements” (“SAB 108”). This pronouncement provides guidance on how to quantify financial statement misstatements and how to correct any resulting misstatements. The adoption of this pronouncement during the forth quarter of 2006 did not have a significant impact on the Company’s consolidated financial statements.

Change in Estimate of Fair Value

During the second quarter of 2006, the Company changed the methodology by which it determines estimated fair value for its Subordinate MBS portfolio to an enhanced proprietary valuation model developed by the Company from a model used for several years as a bench-mark for evaluating independent third-party estimates of fair value.

Through the first quarter of 2006, the Company used the lower of independent third-party valuations or the Company’s valuations as the fair value of its Subordinate MBS. Over time, as the portfolio of these securities has changed in size, complexity, and age or maturity, historical sales data suggested that the fair values developed under this methodology were, overall, too low.

As part of its normal quarterly activities related to fair value estimates, the Company’s management conducted a review of its Subordinate MBS sales for the years 2004 and 2005 and the first two quarters of 2006 and compared prices obtained in the sales to the corresponding independent third-party estimates of fair value and the estimates determined by the Company’s enhanced internal model. The review disclosed that the Company’s enhanced model was a more accurate indicator of fair value especially as the nature of the portfolio has changed through increased size and concentration into these securities and the portfolio of Subordinate MBS has aged. Although the independent third-party estimates are useful as a comparison tool, the Company's management believes they are no longer representative of fair value. Further, the Company's management does not believe independent third-parties are willing to consistently provide valuations that are more robust in nature and therefore a more representative estimate of fair value of the Company's Subordinate MBS without considerable cost to the Company.

The Company's Subordinate MBS securities are not readily marketable with quoted market prices. To obtain the best estimate of fair value requires a current knowledge of the Subordinate MBS attributes, characteristics related to the underlying mortgages collateralizing the securities and the market of these securities. The Company's management maintains extensive data related to the collateral of its Subordinate MBS and as a result is able to apply this data and all other relevant market data to its estimates of fair value. The Company's management believes the estimates used reasonably reflect the values the Company may be able to receive should the Company choose to sell them. Many factors must be considered in order to estimate market values, including, but not limited to interest rates, prepayment rates, amount and timing of credit losses, supply and demand, liquidity, and other market factors. Accordingly, the Company's estimates are inherently subjective in nature and involve uncertainty and judgment to interpret relevant market and other data. Amounts realized in actual sales may differ from the fair values presented.

The following schedule shows the impact of the change in estimate as of June 30, 2006 (dollars in thousands, except per share amounts):

	Estimated Fair Value of Subordinate MBS	Difference in Estimated Fair Value and Adjusted Cost Basis included in Accumulated Other Comprehensive Income Unrealized Gain (Loss)	Book Value per Share
Newly adopted methodology	$ 145,746	$ 340	$ 7.59
Previous methodology	138,610	(6,796)	6.73
Impact of change	$ 7,136	$ 7,136	$ 0.86

3. DISCONTINUED OPERATIONS

During the fourth quarter of 2006, the Company's Board of Directors approved the sale of HCP, the Company's due diligence business, to Terwin Acquisition I, LLC ("Buyer") (now known as Edison Mortgage Decisioning Solutions, LLC). This sale was effective January 12, 2007. The sale included certain assets and the assumption of certain liabilities of the Company's wholly-owned subsidiary HCP-2 and included all of the Company's due diligence operations.

As a result of the sale, the Company will no longer perform due diligence activities for third parties. The Company does not have any continuing involvement in HCP, nor does the Company have a direct financial ownership investment in HCP. The Company will perform certain services to assist Buyer with the transition of the business, but these services are expected to terminate by May 31, 2007.

As of December 31, 2006, in accordance with SFAS No. 144, "Accounting for Impairment or Disposal of Long-lived Assets", the related financial information for HCP are reported as discontinued operations for all periods presented. The following is a summary of the components of assets and liabilities for discontinued operations, which excludes intercompany balances, assets, and other liabilities that were not part of the sale or extinguished in connection with the divestiture of the HCP business (amounts in thousands):

	December 31, 2006	December 31, 2005
Assets		
Cash and cash equivalents	$ 1	$ 3
Accounts receivable	1,184	1,989
Accrued interest receivable	—	14
Other assets (primarily unbilled receivables)	1,364	2,002
Total Assets	2,549	4,008
Liabilities		
Accounts payable, accrued expenses and other liabilities	$ 823	$ 847
Total Liabilities	823	847
Net Assets	$ 1,726	$ 3,161

The following is a summary of the results of operations of the discontinued operations of the HCP business (amounts in thousands):

	Years Ended December 31, 2006	2005	2004
Revenues	$ 12,001	$ 15,706	$ 10,229
Operating expenses	12,918	14,319	10,121
Income (loss) from discontinued operations before income tax provision (benefit)	(917)	1,387	108
Income tax provision (benefit)	58	172	(63)
Income (loss) from discontinued operations	$ (975)	$ 1,215	$ 171

4. MORTGAGE LOANS

During June 2005, the Company exercised an available call option to retire the entire CMO borrowing named 1999-A. At December 31, 2004, the CMO had an outstanding borrowing balance and collateral carrying value of approximately $18,099,000 and $18,083,000, respectively. As a result of the call and retirement of the CMO, the Company realized a gain for the year ended December 31, 2005 of approximately $149,000.

In conjunction with the call and retirement of the 1999-A CMO, the Company acquired the mortgage loans of 1999-A. The loans were acquired at estimated fair market value.

A summary of the 1999-A mortgage loans purchase is as follows (dollars in thousands):

Mortgage loans acquired at fair market value	$ 20,139
Principal value of mortgage loans	19,529
Premium paid	$ 610

HANOVER CAPITAL MORTGAGE HOLDINGS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Mortgage Loans — Held for Sale
(dollars in thousands)

	December 31, 2006			December 31, 2005		
	Fixed Rate	Adjustable Rate	Total	Fixed Rate	Adjustable Rate	Total
Principal amount of mortgage loans	$ —	$ —	$ —	$ 6,712	$ 3,478	$ 10,190
Net premium (discount)	—	—	—	38	34	72
Mark to market adjustments	—	—	—	(133)	(68)	(201)
Carrying value of mortgage loans	$ —	$ —	$ —	$ 6,617	$ 3,444	$ 10,061

As of December 31, 2006 and 2005 the Company had approximately $0 and $3,545,000, respectively, of mortgage loans held for sale pledged as collateral for repurchase agreements.

Mortgage Loans — Collateral for CMOs
(dollars in thousands)

	December 31, 2006			December 31, 2005		
	Fixed Rate	Adjustable Rate	Total	Fixed Rate	Adjustable Rate	Total
Principal amount of mortgage loans	$ 1,932	$ 8,217	$ 10,149	$ 3,046	$ 11,491	$ 14,537
Net premium (discount) and deferred financing costs	(26)	(113)	(139)	(37)	(142)	(179)
Loan loss allowance	(52)	(222)	(274)	(60)	(224)	(284)
Carrying value of mortgage loans	$ 1,854	$ 7,882	$ 9,736	$ 2,949	$ 11,125	$ 14,074

The following table summarizes the activity in the loan loss allowance for mortgage loans securitized as collateral in outstanding CMOs (dollars in thousands):

	Years Ended December 31,		
	2006	2005	2004
Balance, beginning of period	$ 284	$ 424	$ 407
Loan loss provision	—	26	36
Sales	—	(157)	—
Charge-offs	(10)	(9)	(19)
Balance, end of period	$ 274	$ 284	$ 424

The following table presents delinquency rates for such mortgage loans:

	December 31,	
	2006	2005
30-59 days delinquent	5.46%	13.69%
60-89 days delinquent	0.70%	2.92%
90 or more days delinquent	0.20%	8.00%
Loans in foreclosure	1.58%	2.07%
Real estate owned	0.31%	0.00%

HANOVER CAPITAL MORTGAGE HOLDINGS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

The Company realized credit losses of approximately $10,000, $9,000 and $19,000 on the mortgage loan assets that have been recorded as charge-offs to the Company's loan loss allowance, for the years ended December 31, 2006, 2005 and 2004, respectively.

5. MORTGAGE AND OTHER SUBORDINATE SECURITIES

Mortgage Securities Classified as Trading
(dollars in thousands)

	December 31,					
	2006			2005		
	Pledged	Not Pledged	Total	Pledged	Not Pledged	Total
Principal balance	$ 106,479	$ —	$ 106,479	$ 83,505	$ —	$ 83,505
Net premium (discount)	(2,251)	—	(2,251)	755	—	755
Amortized cost	104,228	—	104,228	84,260	—	84,260
Gross unrealized gain	1,672	—	1,672	36	—	36
Gross unrealized loss	(796)	—	(796)	(1,809)	—	(1,809)
Carrying value	$ 105,104	$ —	$ 105,104	$ 82,487	$ —	$ 82,487

Mortgage Securities Classified as Available for Sale
(dollars in thousands)

	December 31,					
	2006			2005		
	Pledged	Not Pledged	Total	Pledged	Not Pledged	Total
Principal balance	$ 221,756	$ 8,995	$ 230,751	$ 172,836	$ 1,901	$ 174,737
Net (discount)	(74,816)	(3,713)	(78,529)	(60,985)	(843)	(61,828)
Amortized cost	146,940	5,282	152,222	111,851	1,058	112,909
Gross unrealized gain	3,710	9	3,719	263	2	265
Gross unrealized loss	(1,272)	(70)	(1,342)	(6,203)	(4)	(6,207)
Carrying value	$ 149,378	$ 5,221	$ 154,599	$ 105,911	$ 1,056	$ 106,967

HANOVER CAPITAL MORTGAGE HOLDINGS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Mortgage Securities Classified as Held to Maturity
(dollars in thousands)

	December 31, 2006 Pledged	2006 Not Pledged	2006 Total	2005 Pledged	2005 Not Pledged	2005 Total
Principal balance	$ —	$ 5,845	$ 5,845	$ —	$ 7,460	$ 7,460
Net premium	—	409	409	—	574	574
Amortized cost	—	6,254	6,254	—	8,034	8,034
Gross unrealized gain	—	—	—	—	—	—
Gross unrealized loss	—	—	—	—	—	—
Carrying value	$ —	$ 6,254	$ 6,254	$ —	$ 8,034	$ 8,034

Other Subordinate Securities Classified as Held to Maturity
(dollars in thousands)

	December 31, 2006 Pledged	2006 Not Pledged	2006 Total	2005 Pledged	2005 Not Pledged	2005 Total
Principal balance	$ —	$ 3,812	$ 3,812	$ —	$ 3,812	$ 3,812
Net (discount)	—	(1,055)	(1,055)	—	(1,109)	(1,109)
Amortized cost	—	2,757	2,757	—	2,703	2,703
Gross unrealized gain	—	—	—	—	—	—
Gross unrealized loss	—	—	—	—	—	—
Carrying value	$ —	$ 2,757	$ 2,757	$ —	$ 2,703	$ 2,703

As of December 31, 2006, the carrying value of the Company's mortgage securities classified as trading and available for sale included approximately $796,000 and $1,342,000, respectively, of gross unrealized losses that the Company did not consider to be other-than-temporary impairments. In addition, the carrying value of the Company's other subordinate securities classified as held to maturity did not include approximately $62,000 of gross unrealized losses that the Company did not consider to be other than temporary impairments. These temporary declines in market value were not deemed to be other-than-temporary impairments as they were not attributable to significant adverse changes in loss or prepayment assumptions. The Company has the ability and intent to hold these securities for a reasonable period of time sufficient for a forecasted recovery of market value. The market value and gross unrealized loss for those securities with unrealized losses by duration, as of December 31, 2006, are as follows (dollars in thousands):

	Trading Market Value	Trading Gross Unrealized Loss	Available for Sale Market Value	Available for Sale Gross Unrealized Loss
Less than 12 months	$ —	$ —	$ 11,527	$ 551
12 months or longer	15,936	796	25,563	791
Total	$ 15,936	$ 796	$ 37,090	$ 1,342

All Mortgage and Other Subordinate Securities by Collateral Type
(dollars in thousands)

	Trading December 31,		Available for Sale December 31,		Held to Maturity December 31,	
	2006	2005	2006	2005	2006	2005
Fixed-Rate Agency Mortgage-Backed Securities	$ 105,104	$ 82,487	$ —	$ —	$ 6,254	$ 8,034
Fixed-Rate Subordinate Mortgage- Backed Securities	—	—	40,515	31,417	—	—
Fixed-Rate Other Subordinate Security	—	—	—	—	2,757	2,703
Adjustable-Rate Subordinate Mortgage-Backed Securities	—	—	114,084	75,550	—	—
Carrying value of mortgage and other subordinate securities	$ 105,104	$ 82,487	$ 154,599	$ 106,967	$ 9,011	$ 10,737

The carrying value of the Company's available for sale mortgage securities by estimated average life until payment in full, as of December 31, 2006, are as follows (dollars in thousands):

Average Life	Carrying Value
Within one year	$ —
After one year through five years	38,401
After five years through ten years	111,439
After ten years	4,759
	$ 154,599

Actual maturities may differ from stated maturities because borrowers usually have the right to prepay certain obligations, often without penalties. Maturities of mortgage securities depend on the repayment characteristics and experience of the underlying mortgage loans.

The proceeds and gross realized gain (loss) from sales of available for sale mortgage securities in 2006, 2005 and 2004 were as follows (dollars in thousands):

	Proceeds	Gross Realized Gain	Gross Realized Loss
Sale of Subordinate MBS — Year ended December 31, 2006	$ 43,420	$ 1,358	$ 509
Sale of Subordinate MBS — Year ended December 31, 2005	$ 60,772	$ 4,587	$ 449
Sale of Subordinate MBS — Year ended December 31, 2004	$ 75,747	$ 10,430	$ 69

Included in gain (loss) on mark to market of mortgage assets for the years ended December 31, 2006 and 2005 are approximately $1,744,000 of net unrealized gains and approximately $2,300,000 of net unrealized losses from trading securities held as of December 31, 2006 and 2005, respectively.

6. CONCENTRATION OF CREDIT RISK

Mortgage Loans

The Company's exposure to credit risk associated with its investment activities is measured on an individual borrower basis as well as by groups of borrowers that share similar attributes. In the normal course of its business, the Company has concentrations of credit risk in mortgage loans held for sale and held as collateral for CMOs in certain geographic areas. As of December 31, 2006, the percent of the total principal amount of loans outstanding in any one state exceeding 5% of the principal amount of mortgage loans is as follows:

State	Collateral for CMOs
Texas	16%
Maryland	10%
California	9%
New Jersey	9%
Florida	8%
Connecticut	6%
Illinois	6%
Virginia	5%
Other	31%
Total	100%

Mortgage and Other Subordinate Securities

The Company's exposure to credit risk associated with its investment activities is measured on an individual security basis as well as by groups of securities that share similar attributes. In certain instances, the Company has concentrations of credit risk in its mortgage securities portfolio for the securities of certain issuers (dollars in thousands):

	December 31, 2006			
Issuer	Trading	Available for Sale	Held to Maturity	Total
Issuer 1	$ 95,674	$ —	$ —	$ 95,674
Issuer 2	—	46,992	—	46,992
Issuer 3	—	37,053	—	37,053
Issuer 4	—	15,872	—	15,872
Issuer 5	9,430	—	6,254	15,684
Issuer 6	—	14,192	—	14,192
Issuer 7	—	9,626	—	9,626
Issuer 8	—	9,459	—	9,459
Issuer 9	—	6,662	—	6,662
Issuer 10	—	4,334	—	4,334
Issuer 11	—	4,276	—	4,276
Issuer 12	—	3,211	—	3,211
Issuer 13	—	—	2,757	2,757
Issuer 14	—	2,061	—	2,061
Issuer 15	—	861	—	861
Total	$ 105,104	$ 154,599	$ 9,011	$ 268,714

In the normal course of its business, the Company has concentrations of credit risk in mortgage securities in certain geographic areas. As of December 31, 2006, approximately 55% of the principal balance of available for sale mortgage securities are secured by mortgaged properties located in California.

Cash and Cash Equivalents

The Company has cash and cash equivalents in major financial institutions which are insured by the Federal Deposit Insurance Corporation ("FDIC") up to $100,000 per institution for each legal entity. As of December 31, 2006, the Company had amounts on deposit with financial institutions in excess of FDIC limits. As of December 31, 2006, the Company had overnight investments of approximately $12,165,000 primarily in large money market mutual funds invested in government securities. The Company limits its risk by placing its cash and cash equivalents in high quality financial institutions, U.S. Treasury bills or mutual funds of government securities or A-1/P-1 commercial paper.

7. EQUITY INVESTMENTS

The table below reflects the activity recorded in Hanover's equity investments (dollars in thousands):

	Years Ended December 31,							
	2006			2005				2004
	HST-I	HST-II	Total	HST-I	HST-II	HDMF-I	Total	HDMF-I
Beginning balance	$ 661	$ 628	$ 1,289	$ —	$ —	$ 3,067	$ 3,067	$ 2,085
Investment	$ —	$ —	$ —	$ 619	$ 620	$ 986	$ 2,225	$ 537
Equity in income (loss)	53	57	110	42	8	(215)	(165)	445
Acquisition resulting in consolidation	—	—	—	—	—	(3,838)	(3,838)	—
Ending balance	$ 714	$ 685	$ 1,399	$ 661	$ 628	$ —	$ 1,289	$ 3,067

8. OTHER ASSETS

The following is a breakdown of other assets (dollars in thousands):

	December 31,	
	2006	2005
Prepaid expenses and other assets	$ 2,837	$ 2,247
Deferred financing costs	2,154	1,650
Real Estate Owned	788	3,320
Goodwill	—	2,478
Capitalized software, net	458	1,010
	$ 6,237	$ 10,705

As of December 31, 2005, the Company has recorded goodwill of approximately $2,041,000 relating to the January 19, 2001 purchase of all of the assets of Pamex Capital Partners LLC and approximately $437,000 relating to the July 1, 2002 purchase of 100% of the outstanding common stock of HCP-2. The Company evaluates goodwill for impairment on at least an annual basis. For the year ended December 31, 2006, the Company recorded impairment expense of $2,478,000 in connection with the assessment of the goodwill balance assigned to HT due to a significant reduction in projected revenue. No impairment expense was recorded for the years ended December 31, 2005 and 2004.

Real Estate Owned consists of residential properties that once secured mortgage loans that were subsequently foreclosed. Those mortgage loans were acquired as part of a distressed mortgage loan acquisition program of HDMF-I. These properties are carried at fair value less the estimated costs of disposition. Expenses associated with disposition of the properties are recognized in operating income. At December 31, 2006 and 2005, these properties were not part of any financing.

As of January 1, 2006, the Company increased the remaining estimated useful life of its capitalized software costs, as the underlying software components and modules are expected to have a useful life in excess of the original estimation. The net balance as of December 31, 2005 was originally estimated to be substantially amortized by the end of 2007 and that net balance will now be amortized over a three year period beginning on January 1, 2006. This change in estimate resulted in reducing amortization expense and increasing the Company's net income by approximately $294,000 and increasing diluted earnings (loss) per share by $0.04 for the year ended December 31, 2006.

9. REPURCHASE AGREEMENTS AND OTHER LIABILITIES

The Company enters into repurchase agreements in which mortgage securities are pledged as collateral to secure short-term financing. All securities pledged as collateral for repurchase agreements are held in safekeeping by the lender.

Information pertaining to repurchase agreement financing is summarized as follows (dollars in thousands):

	As of and for the Years Ended December 31,							
	2006				2005			
	Retained CMO Securities	Mortgage Loans	Other Mortgage Securities	Total	Retained CMO Securities	Mortgage Loans	Other Mortgage Securities	Total
Repurchase Agreements								
Balance of borrowing as of end of period	$ 698	$ —	$ 192,549	$ 193,247	$ 763	$ 3,474	$ 150,031	$ 154,268
Average borrowing balance during the period	$ 736	$ 795	$ 164,726		$ 1,037	$ 6,569	$ 129,702	
Average interest rate during the period	8.42%	6.67%	5.81%		5.00%	5.72%	3.82%	
Maximum month-end borrowing balance during the period	$ 761	$ 3,061	$ 206,197		$ 1,274	$ 13,317	$ 150,031	
Balance as of end of period of underlying collateral — carrying value	$ 1,024	$ —	$ 254,482	$ 255,506	$ 1,148	$ 3,545	$ 188,398	$ 193,091

The average interest rates for retained CMO and other mortgage securities for the year ended December 31, 2004 were 3.21% and 2.05%, respectively.

Repurchase financing pertaining to individual repurchase agreement lenders as of December 31, 2006 is summarized as follows (dollars in thousands):

Lender	Committed Borrowing Limit	December 31, 2005 Balance	Net Change	December 31, 2006 Balance	Carrying Value of Underlying Collateral	Type of Collateral
Lender A	$ 200,000	$ —	$ —	$ —	$ —	Mortgage Loans
Lender B	—	3,474	(3,474)	—	—	Mortgage Loans
Lender C	10,000	5,222	3,205	8,427	15,078	Retained CMO Securities, Mortgage Securities
Lender C	—	11,724	(4,942)	6,782	12,489	Mortgage Securities
Lender D	—	6,171	6,352	12,523	21,552	Mortgage Securities
Lender E	—	897	2,906	3,803	6,413	Mortgage Securities
Lender F	—	91,659	20,729	112,388	120,208	Mortgage Securities
Lender G	—	16,253	(289)	15,964	23,894	Mortgage Securities
Lender H	—	4,357	1,289	5,646	10,020	Mortgage Securities
Lender I	—	3,172	(3,172)	—	—	Mortgage Securities
Lender J	—	725	36	761	1,301	Mortgage Securities
Lender K	—	1,252	(584)	668	1,185	Mortgage Securities
Lender L	—	9,362	2,831	12,193	19,669	Mortgage Securities
Lender M	—	—	11,583	11,583	20,312	Mortgage Securities
Lender N	—	—	104	104	174	Mortgage Securities
Lender O	—	—	2,405	2,405	3,211	Mortgage Securities
Total		$ 154,268	$ 38,979	$ 193,247	$ 255,506	

As of December 31, 2006, the weighted-average borrowing rate on the Company's repurchase agreements was 5.90%.

On June 22, 2006, the Company entered into a master repurchase agreement with Lender A for up to $200 million (the "Agreement"). The Company will utilize the facility primarily for the purchase of prime residential whole mortgage loans. Pursuant to the terms of the Agreement, the Company will pay interest to Lender A, based on the one-month London Interbank Offered Rate Index ("LIBOR") plus an interest rate margin tied to a formula for each tranche of mortgage loans purchased, plus various facility fees. The Company is required to maintain $5.0 million of cash and cash equivalents on hand at all times and a minimum level of tangible net worth, as defined in the Agreement. In addition, the Company is required to meet certain monthly net income requirements, as defined in the Agreement. The facility established by the Agreement will expire on June 22, 2011.

The committed borrowing amount for Lender C expires on May 15, 2007.

In June 2005, Hanover obtained a committed borrowing facility from Lender B, pursuant to a Master Repurchase Agreement, for up to $100 million. The facility was primarily available for financing mortgage loans and, subject to certain conditions, allowed funding at 97% of the fair market value of the mortgage loans outstanding principal balance. This facility was terminated in May 2006.

In connection with the two committed borrowing facilities, the Company is required to maintain certain levels of cash and cash equivalents, tangible net worth, debt to tangible net worth and profitability. The Company is in compliance with these requirements as of December 31, 2006.

HANOVER CAPITAL MORTGAGE HOLDINGS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

All of the Company's other repurchase borrowings, including the uncommitted amounts with Lender C, are pursuant to uncommitted repurchase financing arrangements that are typically renewed monthly.

HCP had a revolving line of credit established with a major business finance organization for up to the lesser of $2 million or 80% of HCP's accounts receivable. The assets of HCP secured amounts outstanding under the line. This line was terminated in January 2006.

The Company, through HDMF-I, had a $25 million committed line of credit from a private mortgage banking organization. In September 2005, the Company paid off the outstanding balance and elected to terminate the line of credit.

10. CMO BORROWING

The Company has issued long-term debt in the form of collateralized mortgage obligations, or CMOs. All of the Company's CMOs are structured as financing transactions, whereby the Company has pledged mortgage loans to secure CMOs. These mortgage loans are treated as assets of the Company and the related CMOs are treated as debt of the Company.

Borrower remittances received on the CMO collateral are used to make payments on the CMOs. The obligations of the CMOs are payable solely from the underlying mortgage loans collateralizing the debt and otherwise are nonrecourse to the Company. The maturity of each class of CMO is directly affected by principal prepayments on the related CMO collateral. Each class of CMO is also subject to redemption according to specific terms of the respective indenture agreements. As a result, the actual maturity of any class of CMO is likely to occur earlier than its stated maturity.

Information pertaining to the CMOs is summarized as follows (dollars in thousands):

	As of and for the Year Ended December 31, 2006 Securitization			As of and for the Year Ended December 31, 2005 Securitization			
	2000-A	1999-B	Total	2000-A	1999-B	1999-A	Total
CMO Borrowing:							
Balance of borrowing as of end of period	$ —	$ 7,384	$ 7,384	$ —	$ 11,438	$ —	$ 11,438
Average borrowing balance during the period	—	9,515	9,515	760	13,175	7,756	21,691
Average interest rate during the period	—	6.50%	6.50%	12.81%	4.86%	4.32%	5.59%
Interest rate as of end of period	—	6.85%	6.85%	0.00%	5.88%	0.00%	6.39%
Maximum month-end borrowing balance during the period	—	11,124	11,124	1,688	14,989	17,724	34,401
Collateral For CMOs:							
Balance as of end of period — carrying value	$ —	$ 9,736	$ 9,736	$ 3,094	$ 10,980	$ —	$ 14,074

The average interest rates for the 2000-A, 1999-B and 1999-A CMOs for the year ended December 31, 2004 were 11.99%, 2.89%, and 6.47% respectively, and the total average interest rate was 5.18%.

HANOVER CAPITAL MORTGAGE HOLDINGS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Expected amortization of the underlying mortgage loan collateral for CMOs as of December 31, 2006 is as follows (dollars in thousands):

Year	Principal Balance
2007	$ 2,872
2008	2,126
2009	1,565
2010	1,145
2011	830
Thereafter	1,611
	$ 10,149

11. LIABILITY TO SUBSIDIARY TRUSTS ISSUING PREFERRED AND CAPITAL SECURITIES

In March 2005, Hanover Statutory Trust I ("HST-I") sold, in a private placement, trust preferred securities for an aggregate amount of $20 million. Hanover owns all of the common stock of HST-I. HST-I used the proceeds to purchase Hanover junior subordinated notes due March 2035, which represent all of the assets of HST-I. The terms of the junior subordinated notes are substantially the same as the terms of the trust preferred securities. The trust preferred securities have a fixed distribution rate of 8.51% per annum during the first five years, after which the distribution rate will float and reset quarterly at the three-month LIBOR rate plus 4.25% per annum.

Hanover may redeem the notes, in whole or in part, for cash, at par, after March 30, 2010. Hanover may redeem the notes prior to March 30, 2010 for a 7.5% premium. To the extent Hanover redeems the notes, HST-I is required to redeem a corresponding amount of trust preferred securities.

The ability of HST-I to pay distributions depends on the receipt of interest payments on the debentures. Hanover has the right, pursuant to certain qualifications and covenants, to defer payments of interest on the notes for up to four consecutive quarters. If payment of interest on the notes is deferred, HST-I will defer the quarterly distributions on the trust preferred securities for a corresponding period. Additional interest accrues on deferred payments at the annual rate payable on the notes, compounded quarterly.

In November 2005, Hanover Statutory Trust II ("HST-II") sold, in a private placement, capital securities of the trust for an aggregate amount of $20 million. Hanover owns all of the common stock of HST-II. HST-II used the proceeds to purchase Hanover fixed/floating rate junior subordinated debt securities due July 2035 (junior subordinated debentures), which represent all of the assets of HST-II. The terms of the junior subordinated debentures are substantially the same as the terms of the capital securities of the trust. The capital securities of the trust have a fixed distribution rate of 9.209% per annum during the first five years, after which the distribution rate will float and reset quarterly at the three-month LIBOR rate plus 4.25% per annum.

Hanover may redeem the debentures, in whole or in part, for cash, at par, after July 30, 2010. Hanover may redeem the notes prior to July 30, 2010 for a 7.5% premium. To the extent Hanover redeems the debentures; HST-II is required to redeem a corresponding amount of capital securities of the trust.

The ability of HST-II to pay distributions depends on the receipt of interest payments on the debentures. Hanover has the right, pursuant to certain qualifications and covenants, to defer payments of interest on the debentures for up to four consecutive quarters. If payment of interest on the debentures is deferred, HST-II will defer the quarterly distributions on the capital securities of the trust for a corresponding period. Additional interest accrues on deferred payments at the annual rate payable on the debentures, compounded quarterly.

Summary

	HST-I	HST-II
Trust preferred securities outstanding at December 31, 2006	$ 20 million	$ 20 million
Interest rate as of December 31, 2006	8.51%	9.209%
Redemption period, at Hanover's option	After March 30, 2010	After July 30, 2010
Maturity date	March 30, 2035	July 30, 2035

Under the provisions of the FASB issued revision to FASB Interpretation No. 46, "Consolidation of Variable Interest Entities", Hanover determined that the holders of the trust preferred and capital securities were the primary beneficiaries of the subsidiary trusts. As a result, Hanover cannot consolidate the subsidiary trusts and has reflected the obligation to the subsidiary trusts under the caption "liability to subsidiary trusts issuing preferred and capital securities" and accounts for the investment in the common stock of the subsidiary trusts on the equity method of accounting.

12. EMPLOYEE BENEFIT PLANS

401(k) Plan

The Company participates in the Hanover Capital Partners 2, Ltd. 401(k) Plan ("401(k) Plan"). The 401(k) Plan is available to all full-time employees with at least 3 months of service. The Company can, at its option, make a discretionary matching contribution to the 401(k) Plan. For the years ended December 31, 2006, 2005 and 2004, expense related to the 401(k) Plan was approximately $53,000, $68,000 and $73,000, respectively.

Hanover Stock-Based Compensation

Hanover has adopted two stock-based compensation plans: (i) the 1997 Executive and Non-Employee Director Stock Option Plan (the "1997 Stock Plan") and (ii) the 1999 Equity Incentive Plan (the "1999 Stock Plan", together with the 1997 Stock Plan, the "Stock Plans"). The purpose of the Stock Plans is to provide a means of performance-based compensation in order to attract and retain qualified personnel and to afford additional incentive to others to increase their efforts in providing significant services to the Company. The exercise price for options granted under the Stock Plans cannot be less than the fair market value of the Company's common stock on the date of grant. Options are granted, and the terms of the options are established, by the Compensation Committee of the Board of Directors.

1997 Stock Plan — The 1997 Stock Plan provides for the grant of qualified incentive stock options, stock options not so qualified, restricted stock, performance shares, stock appreciation rights and other equity-based compensation. The 1997 Stock Plan authorized the grant of options to purchase, and limited stock awards to, an aggregate of up to 325,333 shares of Hanover's common stock.

Of the stock options granted by the Compensation Committee pursuant to the 1997 Stock Plan, stock options granted to the Principals to purchase an aggregate of 162,664 shares of Hanover's common stock at Hanover's initial offering price vested ratably over a 48 month period from the date of the grant and, as of December 31, 2006, are fully vested. Stock options granted to the non-employee directors to purchase an aggregate of 18,000 shares of Hanover's common stock are exercisable when issued. The remaining stock options granted to the Principals to purchase an aggregate of 80,160 shares of Hanover's common stock vested in 1/3 increments on July 1, 2003, 2004, and 2005 in connection with the earn-out measuring dates in the Contribution Agreement. All other stock options granted pursuant to the 1997 Stock Option Plan have expired.

1999 Stock Plan — The 1999 Stock Plan authorizes the grant of options of up to 550,710 shares of Hanover's common stock.

Stock option transactions during the years ended December 31, 2006, 2005 and 2004 relating to the 1997 Stock Plan and the 1999 Stock Plan are as follows:

	# of Options for Shares		Weighted-Average Exercise Price	Weighted-Average Exercise Price
	1997 Stock Plan	1999 Stock Plan		
Outstanding as of January 1, 2004	254,824			$ 15.22
		124,480		$ 5.36
Stock Option Activity — 2004				
Granted	4,000	—	$ 12.67	
Exercised	—	(75,646)	$ 5.62	
Outstanding as of December 31, 2004	258,824			$ 15.18
		48,834		$ 4.95
Stock Option Activity — 2005				
Granted	2,000	—	$ 11.40	
Exercised	—	(18,000)	$ 4.62	
Outstanding as of December 31, 2005	260,824			$ 15.16
		30,834		$ 5.14
Stock Option Activity — 2006				
Granted	2,000	—	$ 5.61	
Expired	(2,000)	—	$ 18.13	
Outstanding as of December 31, 2006	260,824			$ 15.06
		30,834		$ 5.14

As of December 31, 2006, 2005 and 2004, 291,658, 291,658 and 280,938 options were exercisable, respectively, with weighted-average exercise prices of $14.01, $14.10 and $13.35, respectively.

As of December 31, 2006, there were 40,509 and 6,417 shares eligible to be granted under the 1997 Stock Plan and the 1999 Stock Plan, respectively.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

The following table summarizes information about stock options outstanding and exercisable:

1997 Stock Plan				1999 Stock Plan			
Exercise Prices	Number Outstanding as of December 31, 2006	Number Exercisable as of December 31, 2006	Weighted-Average Remaining Life in Years	Exercise Prices	Number Outstanding as of December 31, 2006	Number Exercisable as of December 31, 2006	Weighted-Average Remaining Life in Years
$ 5.61	2,000	2,000	9.42	$ 3.88	15,334	15,334	3.42
10.26	2,000	2,000	6.42	4.63	8,000	8,000	2.58
11.40	2,000	2,000	8.42	7.69	1,500	1,500	1.17
12.67	4,000	4,000	7.42	7.75	4,000	4,000	4.42
12.83	2,000	2,000	6.92	9.80	2,000	2,000	5.42
15.00	162,664	162,664	0.75				
15.75	86,160	86,160	5.17				
$5.61 to $15.75	260,824	260,824	2.53	$3.88 to $9.80	30,834	30,834	3.35

In May and August of 2005, the Company issued a total of 22,000 shares of common stock to certain of its employees. The shares were issued pursuant to the 1997 Stock Plan. The shares vest ratably over a five-year period. The Company has accounted for this share issuance under APB 25 and has recorded deferred compensation using the closing market price of the stock on the date of grant. The deferred compensation is being amortized to compensation expense ratably over the five-year vesting period.

In May 2005, the Company granted an option to purchase of 2,000 shares of its common stock to one of the Company's independent directors, upon his re-election to the Board of Directors, in accordance with the terms of the Company's 1997 Stock Plan. The exercise price of the option equals the closing market price on the date of grant and expires ten years from the date of the grant. In accordance with APB 25, the Company did not record deferred compensation or compensation expense, as there is no intrinsic value associated with this option.

In May 2006, the Company granted an option to purchase 2,000 shares of its common stock to one of the Company's independent directors, upon his re-election to the Board of Directors, in accordance with the terms of the Company's 1997 Stock Plan. This option is immediately exercisable and has a term of ten years. The exercise price of the option equals the closing price of the Company's stock on the date of the grant. In the period the option was granted, the Company recorded compensation cost of approximately $1,000, which represents the fair market value of the option as estimated using the Black-Scholes option pricing model.

Bonus Incentive Compensation Plan

A bonus incentive compensation plan was established in 1997, whereby an annual bonus will be accrued for eligible participants of the Company. The annual bonus generally will be paid one-half in cash and (subject to ownership limits) one-half in shares of common stock in the following year. The Company must generate annual net income before bonus accruals that allows for a return of equity to stockholders in excess of the average weekly ten-year U.S. Treasury rate plus 4.0% before any bonus accrual is recorded. There was no bonus expense recorded for the years ended December 31, 2006 and 2005. A bonus expense of $314,000 was recorded for the year ended December 31, 2004.

13. INCOME TAXES

The REIT

Taxable income (loss) for the year ended December 31, 2006 was approximately $(499,000). Taxable income (loss) differs from net income (loss) because of timing differences (refers to the period in which elements of net income can be included in taxable income) and permanent differences (refers to an element of net income that must be included or excluded from taxable income).

The following table reconciles net income (loss) to estimated taxable income (loss) for the year ended December 31, 2006 (dollars in thousands):

Net loss — year ended December 31, 2006	$ (2,926)
Add (deduct) differences:	
Mark to market of mortgage assets	(1,336)
Sale of mortgage securities	(1,072)
Mark to market of freestanding derivatives	(994)
Losses in subsidiaries not consolidated for tax purposes — net	6,209
Other	(380)
Estimated taxable income (loss) — year ended December 31, 2006	$ (499)

Taxable Subsidiaries (dollars in thousands)

	December 31,	
	2006	2005
Deferred tax assets		
Federal net operating loss carryforwards	$ 4,020	$ 4,237
State net operating loss carryforwards	488	710
Not currently deductible interest	943	571
Goodwill	545	—
	5,996	5,518
Deferred tax liabilities		
Goodwill	—	(179)
Capitalized software	(123)	(105)
	(123)	(284)
	5,873	5,234
Valuation allowance	(5,873)	(5,222)
Deferred tax asset — net	$ —	$ 12

One taxable subsidiary has a Federal tax net operating loss carryforward of approximately $10,249,000 that expires in various years between 2019 and 2025.

The items resulting in significant temporary differences for the years ended December 31, 2006 and 2005 that generate deferred tax assets relate primarily to the benefit of net operating loss carryforwards and differences in the amortization of goodwill and capitalized software and interest expense payable to Hanover that is non-deductible for income tax purposes. The Company has established a valuation allowance for substantially all of its deferred income tax benefit.

The components of the income tax provision (benefit) for the years ended December 31, 2006, 2005 and 2004 consist of the following:

	Years Ended December 31,		
	2006	2005	2004
Current — Federal, state and local	$ —	$ —	$ —
Deferred — Federal, state and local	(639)	(959)	(542)
	(639)	(959)	(542)
Valuation allowance	651	961	516
Total	$ 12	$ 2	$ (26)

The income tax provision (benefit) relating to the taxable subsidiaries differs from amounts computed at statutory rates due primarily to state and local income taxes and non-deductible intercompany interest expense.

14. DERIVATIVE INSTRUMENTS

Components of Income From Freestanding Derivatives
(Dollars in thousands)

	Years Ended December 31,		
	2006	2005	2004
Mark-to-market and settlements on forward contracts	$ (2,214)	$ 234	$ (4,047)
Mark-to-market on interest rate caps	(130)	(54)	(342)
Net (loss) gain on freestanding derivatives	$ (2,344)	$ 180	$ (4,389)

15. STOCKHOLDERS' EQUITY AND EARNINGS PER SHARE

Common Stock Repurchase Program

The Company's Board of Directors has periodically approved programs to repurchase shares of the Company's common stock. A summary of the total authorizations and remaining authority is as follows:

	Share Repurchase Program Authorized in Years Ended December 31,			
	2006	2002	2001	2000
Total number of common shares authorized to be repurchased	2,000,000	18,166	60,000	1,000,000
Remaining number of common shares authorized to be repurchased	1,736,900	2,500	1,000	501,025
Total amount authorized for repurchase of common shares	n/a	n/a	n/a	$ 3,000,000
Remaining amount authorized for repurchase of common shares	n/a	n/a	n/a	$ 137,000

During the year ended December 31, 2006, the Company repurchased 263,100 shares of the Company's common stock at a total purchase price of approximately $1,479,000, or $5.62 per share, under the 2006 program. There were no other stock repurchases for the years ended December 31, 2006, 2005, and 2004. Under Maryland law, Hanover's state of incorporation, treasury shares are not allowed. As a result, repurchased shares are retired when acquired.

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Stockholder Protection Rights Agreement

In 2000, the Board of Directors approved and adopted the Stockholder Protection Rights Agreement and approved amendments to such agreement in September 2001 and June 2002 (combined, the “Rights Agreement, as amended”). The Rights Agreement, as amended, provides for the distribution of preferred purchase rights (“Rights”) to common stockholders. One Right is attached to each outstanding share of common stock and will attach to all subsequently issued shares. Each Right entitles the holder to purchase one one-hundredth of a share (a “Unit”) of Participating Preferred Stock at an exercise price of $17.00 per Unit, subject to adjustment. The Rights separate from the common stock ten days (or a later date approved by the Board of Directors) following the earlier of (a) a public announcement by a person or group of affiliated or associated persons (“Acquiring Person”) that such person has acquired beneficial ownership of 10% or more of Hanover’s outstanding common shares (more than 20% of the outstanding common stock in the case of John A. Burchett or more than 17% in the case of Wallace Weitz) or (b) the commencement of a tender or exchange offer, the consummation of which would result in an Acquiring Person becoming the beneficial owner of 10% or more of Hanover’s outstanding common shares (more than 20% of the outstanding common stock in the case of John A. Burchett or more than 17% in the case of Wallace Weitz).

If any Acquiring Person holds 10% or more of Hanover’s outstanding shares (more than 20% of the outstanding common stock in the case of John A. Burchett or more than 17% in the case of Wallace Weitz) or Hanover is party to a business combination or other specifically defined transaction, each Right (other than those held by the Acquiring Person) will entitle the holder to receive, upon exercise, shares of common stock of the surviving company with a market value equal to two times the exercise price of the Right. The Rights expire in 2010, and are redeemable at the option of a majority of Hanover’s Directors at $0.01 per Right at any time until the tenth day following an announcement of the acquisition of 10% or more of Hanover’s common stock.

Earnings Per Share

(dollars in thousands, except per share data):

	Years Ended December 31, 2006	2005	2004
BASIC EARNINGS PER SHARE:			
Income (loss) from continuing operations (numerator)	$ (1,951)	$ 151	$ 7,950
Weighted-average common shares outstanding (denominator)	8,358,433	8,443,744	8,288,405
Basic earnings per share	$ (0.23)	$ 0.02	$ 0.96
DILUTED EARNINGS PER SHARE:			
Income (loss) from continuing operations (numerator)	$ (1,951)	$ 151	$ 7,950
Weighted-average common shares outstanding	8,358,433	8,443,744	8,288,405
Add: Incremental shares from assumed conversion of stock options	—	17,159	56,336
Diluted weighted-average shares outstanding (denominator)	8,358,433	8,460,903	8,344,741
Diluted earnings per share	$ (0.23)	$ 0.02	$ 0.95

For the years ended December 31, 2006, 2005 and 2004 the number of potential common shares that were anti-dilutive was 291,658, 262,824 and 256,824, respectively.

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16. SUPPLEMENTAL DISCLOSURE FOR STATEMENTS OF CASHFLOWS

(dollars in thousands):

	Years Ended December 31, 2006	2005	2004
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION			
Cash paid during the period for:			
Income taxes	$ 29	$ 177	$ 300
Interest	$ 13,792	$ 8,177	$ 4,158
SUPPLEMENTAL SCHEDULE OF NONCASH ACTIVITIES			
Dividends declared in December but not paid until the following year	$ 1,236	$ 2,124	$ 2,514
Payable to broker for repurchase of common stock	$ 24	$ —	$ —
35,419 shares of common stock issued in 2004 for acquisition	$ —	$ —	$ 494
Common stock issued to Principals	$ —	$ 762	$ 849
Forgiveness of notes receivable from Principals	$ —	$ 583	$ 584
2,357 and 5,393 shares of common stock issued to Principal pursuant to Bonus Incentive Compensation Plan in 2005 and 2004, respectively	$ —	$ 25	$ 81
Transfer of mortgage loans to real estate owned, net	$ —	$ 3,820	$ —
Securitization of mortgage loans held for sale into FNMA issues held to maturity	$ —	$ 8,025	$ —

17. SEGMENT REPORTING

The Company’s principal business segments are each conducted through its primary operating companies, Hanover and HCP-2. Segment information is prepared on the accrual basis of accounting in accordance with accounting principles generally accepted in the United States. HT relies on Hanover for financing portions of its operations. Intercompany transactions are recorded on an arms-length basis. All significant intercompany accounts and transactions are eliminated in consolidation. However, interest on any intercompany notes from HT to Hanover is determined on an incremental cost basis that may be less than HT would pay to independent third parties.

The principal business of Hanover as a REIT is earning interest and income on leveraged investments in prime subordinate mortgage-backed securities and mortgage loans. The principal business of HT is generating income from technology solutions and valuation services. Prior to May 31, 2006, HT also generated income through loan sale advisory services, traditional loan brokerage services and brokering loan pools, mortgage-servicing rights, and other mortgage related assets through an Internet-based exchange. The Company’s businesses are all conducted within the United States.

As more fully described in Note 3, HCP was sold effective as of January 12, 2007 and the assets and liabilities and results of operations of HCP have been classified as discontinued operations. As a result of this reclassification, the assets and results of operations of the HCP segment that are not eliminated as a result of the sale have been reclassified to the Hanover segment for all periods presented. In addition, the results of operations of the HCP segment that are eliminated as a result of the sale, have been classified as income (loss) from discontinued operations in the Hanover segment for all periods presented.

HANOVER CAPITAL MORTGAGE HOLDINGS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

In connection with the merger of Hanover Capital Partners Ltd. and Hanover Capital Partners 2, Inc. into HanoverTrade, Inc. (subsequently renamed Hanover Capital Partners 2, Ltd.), the Company transferred the results of operations for Hanover Capital Securities, Inc. to HT. The results of operations for the years ended December 31, 2005 and 2004 in the accompanying segment data have been reclassified for this realignment.

	Year Ended December 31, 2006 (dollars in thousands)			
	Hanover	HT	Eliminations	Consolidated
REVENUES				
Interest income	$ 25,094	$ 1	$ (817)	$ 24,278
Interest expense	13,942	817	(817)	13,942
Net interest income before loan loss provision	11,152	(816)	—	10,336
Loan loss provision	—	—	—	—
Net interest income	11,152	(816)	—	10,336
Gain on sale of mortgage assets	834	—	—	834
Gain (loss) on mark to market of mortgage assets	148	—	—	148
(Loss) gain on freestanding derivatives	(2,344)	—	—	(2,344)
Technology	—	2,938	(81)	2,857
Loan brokering and advisory services	—	130	(25)	105
Other income (loss)	(57)	(20)	—	(77)
Total revenues	9,733	2,232	(106)	11,859
Total expenses	8,251	5,768	(106)	13,913
Operating income (loss)	1,482	(3,536)	—	(2,054)
Equity in income (loss) of unconsolidated affiliates	110	—	—	110
Minority interest in loss of consolidated affiliate	(5)	—	—	(5)
Income (loss) from continuing operations before income tax provision (benefit)	1,597	(3,536)	—	(1,939)
Income tax provision (benefit)	—	12	—	12
Income (loss) from continuing operations	1,597	(3,548)	—	(1,951)
Income (loss) from discontinued operations	(952)	(23)	—	(975)
NET INCOME (LOSS)	$ 645	$ (3,571)	$ —	$ (2,926)
Total assets	$ 317,127	$ 815	$ (13,673)	$ 304,269
Capital expenditures and investments	$ 236	$ —	$ —	$ 236
Depreciation and amortization	$ 393	$ 315	$ —	$ 708

HANOVER CAPITAL MORTGAGE HOLDINGS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

	Year Ended December 31, 2005 (dollars in thousands)			
	Hanover	HT	Eliminations	Consolidated
REVENUES				
Interest income	$ 16,917	$ 1	$ (622)	$ 16,296
Interest expense	8,284	622	(622)	8,284
Net interest income before loan loss provision	8,633	(621)	—	8,012
Loan loss provision	26	—	—	26
Net interest income	8,607	(621)	—	7,986
Gain on sale of mortgage assets	4,515	—	—	4,515
Gain (loss) on mark to market of mortgage assets	(2,715)	—	—	(2,715)
(Loss) gain on freestanding derivatives	180	—	—	180
Technology	—	3,054	—	3,054
Loan brokering and advisory services	—	1,709	(62)	1,647
Other income (loss)	144	461	(3)	602
Total revenues	10,731	4,603	(65)	15,269
Total expenses	8,287	6,786	(65)	15,008
Operating income (loss)	2,444	(2,183)	—	261
Equity in income (loss) of unconsolidated affiliates	(165)	—	—	(165)
Minority interest in loss of consolidated affiliate	(57)	—	—	(57)
Income (loss) from continuing operations before income tax provision (benefit)	2,336	(2,183)	—	153
Income tax provision (benefit)	8	(6)	—	2
Income (loss) from continuing operations	2,328	(2,177)	—	151
Income (loss) from discontinued operations	1,382	(167)	—	1,215
NET INCOME (LOSS)	$ 3,710	$ (2,344)	$ —	$ 1,366
Total assets	$ 273,929	$ 4,171	$ (9,921)	$ 268,179
Capital expenditures and investments	$ 2,285	$ 251	$ —	$ 2,536
Depreciation and amortization	$ 186	$ 1,034	$ —	$ 1,220

HANOVER CAPITAL MORTGAGE HOLDINGS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

	Year Ended December 31, 2004 (dollars in thousands)			
	Hanover	HT	Eliminations	Consolidated
REVENUES				
Interest income	$ 14,590	$ —	$ (348)	$ 14,242
Interest expense	4,271	348	(348)	4,271
Net interest income before loan loss provision	10,319	(348)	—	9,971
Loan loss provision	36	—	—	36
Net interest income	10,283	(348)	—	9,935
Gain on sale of mortgage assets	10,400	—	—	10,400
Gain (loss) on mark to market of mortgage assets	237	—	—	237
(Loss) gain on freestanding derivatives	(4,389)	—	—	(4,389)
Technology	—	2,794	—	2,794
Loan brokering and advisory services	—	2,707	(7)	2,700
Other income (loss)	62	293	(50)	305
Total revenues	16,593	5,446	(57)	21,982
Total expenses	7,848	6,712	(57)	14,503
Operating income (loss)	8,745	(1,266)	—	7,479
Equity in income (loss) of unconsolidated affiliates	445	—	—	445
Income (loss) from continuing operations before income tax provision (benefit)	9,190	(1,266)	—	7,924
Income tax provision (benefit)	20	(46)	—	(26)
Income (loss) from continuing operations	9,170	(1,220)	—	7,950
Income (loss) from discontinued operations	386	(215)	—	171
Net income (loss)	$ 9,556	$ (1,435)	$ —	$ 8,121
Total assets	$ 242,160	$ 6,776	$ (9,104)	$ 239,832
Capital expenditures and investments	$ 549	$ 1,192	$ —	$ 1,741
Depreciation and amortization	$ 14	$ 898	$ —	$ 912

18. COMMITMENTS AND CONTINGENCIES

Employment Agreements

Hanover previously entered into employment agreements with four of its executive officers, the Principals. Such agreements (i) have five year terms, (ii) provide for aggregate annual base salaries of approximately $1,078,000 (subject to annual cost of living increases) and (iii) automatically renew for successive one year terms thereafter until Hanover or the officer terminates the agreement.

In December 2006, two of these Principals agreed to a separation from the Company under terms consistent with their existing employment agreements. As a result of these separations, the Company recorded approximately $615,000 of severance expense, which is included in income (loss) from discontinued operations for the year ended December 31, 2006.

Credit Risk

In October 1998, the Company sold 15 adjustable-rate FNMA certificates and 19 fixed-rate FNMA certificates that the Company received in a swap for certain adjustable-rate and fixed-rate mortgage loans. These securities were sold with recourse. Accordingly, the Company retains credit risk with respect to the principal amount of these mortgage securities. As of December 31, 2006, the unpaid principal balance of these mortgage securities was approximately $3,428,000.

Forward Commitments

As of December 31, 2006, the Company had forward commitments to sell approximately $106.4 million (par value) of Agency MBS that had not yet settled. These forward commitments were entered into to economically hedge approximately $106.5 million principal balance of Agency MBS classified as trading. As of December 31, 2006, the fair value of the Company's forward sales of Agency MBS was approximately $649,000.

Warehouse Agreement

On August 28, 2006, we entered into a warehouse agreement for up to a $125 million warehousing facility, which is established and financed by a third party. The warehousing facility will enable us to acquire a diversified portfolio of mezzanine grade asset-backed securities, and certain other investments and assets in anticipation of the possible formation and issuance of a collateralized debt obligation. As of December 31, 2006, we have sold 3 securities into the warehousing facility with total sales proceeds of $4.1 million. If we do not form and issue a collateralized debt obligation within a contractual timeframe, the warehouse agreement will expire and we will be liable for any losses incurred by the counterparty in connection with closing the warehousing facility and selling these securities. The term of the warehouse agreement as of December 31, 2006, is day-to-day or closing and issuance of the collateralized debt obligation.

Lease Agreements

The Company has noncancelable operating lease agreements for office space and office equipment. Future minimum rental payments for such leases, as of December 31, 2006, are as follows (dollars in thousands):

Year	Amount
2007	$ 301
2008	298
2009	296
2010	249
Thereafter	8
	$ 1,152

Rent expense for the years ended December 31, 2006, 2005 and 2004 amounted to approximately $282,000, $301,000 and $266,000, respectively.

Legal Proceedings

On or about January 11, 2006, the Company received a Complaint filed on behalf of its former CFO, J. Holly Loux, claiming the Company and its current CEO, John A. Burchett, wrongfully terminated her employment. The action is titled Loux v Hanover Capital Mortgage Holdings, Inc. Civil Action No. 06-0122 (KSM), and is currently pending in the United States District Court for the District of New Jersey. By her Complaint, Ms. Loux seeks reinstatement, attorney's fees and costs, and an undetermined amount of damages. The Company and Mr. Burchett deny her allegations and they are vigorously defending the claims made by

Ms. Loux. The matter is still in the discovery stage. A settlement conference was held on March 9, 2007. The parties were unable to resolve the case at the settlement conference.

From time to time, we are involved in litigation incidental to the conduct of our business. Except for the Loux matter noted above, we are not currently a party to any lawsuit or proceeding which, in the opinion of management, is likely to have a material adverse effect on our business, financial condition, or results of operation.

19. FINANCIAL INSTRUMENTS

The estimated fair value of the Company's assets and liabilities classified as financial instruments and off-balance sheet financial instruments are as follows (dollars in thousands):

	December 31, 2006		December 31, 2005	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Assets:				
Cash and cash equivalents	$ 13,982	$ 13,982	$ 30,492	$ 30,492
Accrued interest receivable	1,652	1,652	1,367	1,367
Mortgage loans:				
Held for sale	—	—	10,061	10,061
Collateral for CMOs	9,736	10,025	14,074	14,345
Mortgage securities				
Trading	105,104	105,104	82,487	82,487
Available for sale	154,599	154,599	106,967	106,967
Held to maturity	6,254	6,226	8,034	8,034
Other subordinate security, held to maturity	2,757	2,695	2,703	2,703
Interest rate caps	26	26	47	47
Forward commitments to sell mortgage securities	649	649	—	—
Liabilities:				
Repurchase agreements	$ 193,247	$ 193,247	$ 154,268	$ 154,268
CMO borrowing	7,384	7,388	11,438	11,442
Forward commitments to sell mortgage securities	—	—	465	465
Accounts payable, accrued expenses and other liabilities	2,757	2,757	2,651	2,651

The following methods and assumptions were used to estimate the fair value of the Company's financial instruments:

Mortgage loans — The fair value of these financial instruments is based upon projected prices which could be obtained through investors considering interest rates, loan type and credit quality.

Mortgage securities — The fair value of these financial instruments is based upon some or all of the following: actual prices received upon recent sales of securities to investors, projected prices which could be obtained through investors, estimates considering interest rates, underlying loan type, quality and discounted cash flow analysis based on prepayment and interest rate assumptions used in the market place for similar securities with similar credit ratings.

Cash and cash equivalents, accrued interest receivable, Repurchase Agreements and accounts payable, accrued expenses and other liabilities — The fair value of these financial instruments is determined to be their carrying value due to their high liquidity or short-term nature.

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Interest rate caps — The fair value of these financial instruments is estimated based on dealer quotes and is the estimated amount the Company would pay to execute new agreements with similar terms.

Forward commitments to sell mortgage securities — The Company has outstanding forward commitments to sell mortgage securities into mandatory delivery contracts with investment bankers. The fair value of these financial instruments is determined as the difference between the contractual forward sale amount and the market value as provided by independent third parties.

CMO borrowing — The fair value of these financial instruments is based upon estimates considering interest rates, underlying loan type, quality and discounted cash flow analysis based on prepayment and interest rate assumptions used in the market place for similar securities with similar credit ratings.

20. SUBSEQUENT EVENTS

On January 12, 2007, a $0.15 cash dividend, previously declared by the Board of Directors, was paid to stockholders of record as of December 26, 2006.

Effective January 12, 2007, the Company sold its due diligence business to the Buyer. See Note 3 for further information.

21. UNAUDITED QUARTERLY FINANCIAL DATA

(dollars in thousands, except per share data):

	Three Months Ended			
	December 31, 2006	September 30, 2006	June 30, 2006	March 31, 2006
Net interest income	$ 2,708	$ 2,650	$ 2,483	$ 2,495
Total revenues	$ 2,544	$ 2,793	$ 3,714	$ 2,808
Total expenses	$ 5,037	$ 2,684	$ 2,877	$ 3,315
Income from continuing operations	$ (2,489)	$ 136	$ 865	$ (463)
Income from discontinuing operations	$ (676)	$ (53)	$ (12)	$ (234)
Net income (loss)	$ (3,165)	$ 83	$ 853	$ (697)
Basic earnings per share	$ (0.38)	$ 0.01	$ 0.10	$ (0.08)
Diluted earnings per share	$ (0.38)	$ 0.01	$ 0.10	$ (0.08)
Dividends declared (1)	$ 0.15	$ 0.15	$ 0.20	$ 0.20

HANOVER CAPITAL MORTGAGE HOLDINGS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

	Three Months Ended			
	December 31, 2005	September 30, 2005	June 30, 2005	March, 31, 2005
Net interest income	$ 2,023	$ 1,855	$ 1,846	$ 2,262
Total revenues	$ 3,239	$ 2,896	$ 4,382	$ 4,752
Total expenses	$ 3,510	$ 3,238	$ 4,606	$ 3,654
Income from continuing operations	$ (257)	$ (296)	$ (306)	$ 1,010
Income from discontinuing operations	$ 287	$ 432	$ 143	$ 353
Net income (loss)	$ 30	$ 136	$ (163)	$ 1,363
Basic earnings per share	$ 0.00	$ 0.02	$ (0.02)	$ 0.16
Diluted earnings per share	$ 0.00	$ 0.02	$ (0.02)	$ 0.16
Dividends declared (1)	$ 0.25	$ 0.25	$ 0.30	$ 0.30

(1) Quarterly dividends are presented in respect of earnings rather than declaration date.

CONFIDENTIAL
SEPARATION AGREEMENT AND GENERAL RELEASE

This is a Confidential Separation Agreement and General Release (the "Agreement") between Hanover Capital Mortgage Holdings, Inc. (the "Company") and Joyce Mizerak (the "Employee" and together with the Company, the "Parties", each a "Party") that nullifies and supersedes that certain Amended and Restated Employment Agreement dated July 1, 2002, as same has been amended from time to time, together with all agreements referenced and/or incorporated therein (the "Employment Agreement"), including, but not limited to, those related to the Employee's employment, compensation, benefits and directorship. EMPLOYEE IS ADVISED TO CONSULT WITH AN ATTORNEY BEFORE SIGNING THIS AGREEMENT. In consideration of the mutual promises and commitments made in this Agreement, and intending to be legally bound, the Company on the one hand, and Employee on the other hand, agree to the terms set forth in this Agreement.

1. SEPARATION

Employee's employment with the Company was separated by mutual agreement effective January 31, 2007 (the "Separation Date"). Employee agrees and acknowledges that Employee's employment relationship with the Company and any of its Related Organizations (i.e., the Company's parent, subsidiary and related corporations, and their predecessors and successors) has ended, and that neither the Company nor any of its Related Organizations has any obligation to hire, rehire or employ Employee. Furthermore, Employee represents and acknowledges that Employee voluntarily and willfully resigned as a member of the Company's Board of Directors and as a member of the Board of Directors of any Related Organizations as of the Separation Date.

2. CONSIDERATION

(a) In exchange for Employee's execution of this Agreement, and the relinquishment and nullification of the Employment Agreement, and Employee's resignation from the Company's Board of Directors and as a member of the Board of Directors of any Related Organizations and provided that Employee does not revoke this Agreement within the seven day revocation period described in Paragraph 17 hereof, the Company will pay Employee the equivalent of sixteen (16) month's separation pay, based on Employee's annual base salary rate in effect on the Separation Date (the "Severance Payment") by check payable to Employee's order in the gross amount of $374,900.80. From the gross amount of the Severance Payment, the Company will determine and withhold payroll deductions for taxes (federal, FICA, Medicare, state, local and unemployment compensation).

(b) The obligation of the Company to make the Severance Payment shall be fulfilled by the direct deposit of such check into the bank account into which Employee's payroll checks were deposited at the time of her separation not less than eight days (8) and not more than fifteen (15) days after Employee executes this Agreement and the seven day revocation period described in Paragraph 17 hereof has expired without the Employee having revoked this Agreement.

(c) If Employee is a participant in the Company's group health care plans (medical, dental and vision), Employee's eligibility for benefits under those plans will terminate as of January 31, 2007, unless Employee elects to continue coverage in accordance with the Consolidated Omnibus Budget Reconciliation Act of 1985 ("COBRA"). In order to elect such coverage, Employee must complete all necessary forms in a timely manner.

(d) If Employee elects COBRA continuation coverage, the Company will waive payment of the COBRA premiums for eighteen (18) complete calendar months following the month in which employment terminated. If Employee is eligible for, and elects to, continue such benefit coverage beyond the waiver period provided in the preceding sentence, during the time period that the Company is required to provide such coverage under COBRA, Employee will be required to pay the COBRA premiums for such coverage. The Company has no obligation under this Agreement with regard to any group health care plan benefit coverage beyond the waiver of premiums for the period set forth in this subparagraph. Moreover, the Company's obligation under this subparagraph to waive the premiums for such coverage will cease immediately if Employee ceases to be eligible for COBRA coverage or obtains comparable benefit coverage from any future employer.

(e) Upon the earlier of the expiration of (i) eighteen (18) complete calendar months from the Separation Date or (ii) the date Employee ceases to be eligible for COBRA coverage or obtains comparable benefit coverage from any future employer, the Company shall pay Employee the lump sum payment of $6,000, less applicable withholding taxes (federal, FICA, Medicare, state, local and unemployment compensation).

(f) The Company confirms that it has paid the premium for Employee's supplemental life insurance policy, administered by First Colony Life Insurance Company (#534470) ("the Policy"), through August 6, 2007. The Company shall, thereafter, transfer any ownership interest that it has in the Policy and all payment obligations thereunder to Employee.

(g) The Parties will use reasonable best efforts to agree upon the language for any public communication related to Employee's separation from employment.

(h) The Company shall reimburse Employee in the amount of, $2,500 for attorneys' fees, incurred by Employee in the negotiation of this Agreement.

(i) Employee acknowledges and agrees that the Company's obligations under subparagraphs 2(a), 2(d), 2(e), 2(f), 2(g) and 2(h) arise under this Agreement, are in consideration for Employee's signing this Agreement, and constitute consideration to which Employee is not otherwise entitled. Employee also acknowledges and agrees that the Company shall be entitled to discontinue providing payments and benefits under this Agreement if Employee breaches any of Employee's obligations hereunder including, without limitation, Employee's obligations under Paragraph 5 of this Agreement, and that such discontinuance will not relieve Employee of her obligations hereunder, nor shall it affect the validity of the release of claims provided in Paragraph 3 of this Agreement.

3. GENERAL RELEASE OF CLAIMS

It is understood and agreed by and between the Parties to this Agreement that in return for the consideration set forth in Paragraph 2 and the other promises contained herein, Employee does, knowingly and voluntarily, completely and forever release and discharge the Company, including all present and former parent corporations, affiliates, subsidiaries, predecessors, successors, agents, assigns, insurers, and all of their present and former employees, officers, directors, and representatives (collectively the "Released Parties"), from any and all causes of action, claims, judgments, obligations, damages of any kind (e.g., compensatory and punitive), claims for attorneys' fees, and rights to pre- or post-judgment interest or liabilities of whatever kind and character, that Employee (on behalf of either Employee or any other person or entity) ever had, now has, or may have against, or pertaining to, any or all of the Released Parties, based on, relating to, involving, or arising from any cause, decision, event, matter, omission, statement or any other thing, existing or occurring at any time up to and including the time when Employee signs this Agreement. This release includes any claims that Employee or anyone on Employee's behalf may have arising under the New Jersey Conscientious Employee Protection Act, N.J.S.A. 34:19-1 et seq., the New Jersey Law Against Discrimination ("NJLAD"), N.J.S.A. 10:5-1 et seq., New Jersey Family Leave Act, N.J.S.A. 34:11B-1 et seq., the Civil Rights Act of 1964 as amended, the Civil Rights Act of 1991 as amended, the Americans with Disabilities Act ("ADA"), 42 U.S.C. Section 12101 et seq., the Employee Retirement Income Security Act ("ERISA"), 29 U.S.C. Section 1001 et seq., the Consolidated Omnibus Budget Reconciliation Act "COBRA"), the Age Discrimination in Employment Act ("ADEA"), 29 U.S.C. Section 621 et seq., 42 U.S.C. Sections 1981-1988, the Worker Adjustment and Retraining Notification Act ("WARN"), 29 U.S.C. Section 2101 et seq., or any other federal, state or local human rights, civil rights, wage and hour, notice, pension, employment or labor law, rule and/or regulation, public policy, contract or tort law, any claim of retaliation under such laws, any claim arising under the common law, including but not limited to causes of action for wrongful discharge, breach of contract, fraud, defamation, interference with contract or prospective economic advantage, violation of public policy, infliction of emotional distress, violation of any other national, state or local statute, law or ordinance, claims for loss of income, compensatory damages, emotional distress, liquidated damages, punitive damages, attorneys' fees and costs, and any other action whether cognizable in law or in equity based on any conduct up to and including the date on which Employee executes this Agreement. The release of claims in this Agreement shall extend to claims of any nature whatsoever including claims that are known or unknown. Employee further represents that, before executing this Agreement, Employee has not asserted a claim against or involving the Company before any court, agency or tribunal. Moreover Employee further represents that Employee is presently unaware of any basis on which she would be entitled to file a claim for benefits under the New Jersey Workers' Compensation Act.

4. CONFIDENTIAL INFORMATION

(a) As used in this Agreement, the term "Confidential Information" means any and all information and any idea in whatever form, tangible or intangible, pertaining in any manner to the business of the Company, or to any employees, contractors, consultants, clients or business associates of the Company or any Related Organizations, that is not generally known outside of the Company, or that is known outside of the Company through improper means. Without limiting the foregoing definition, Confidential Information includes, but is not limited to: (i) technical information, formulas, teaching and development techniques, methodologies, processes, trade secrets, computer programs, electronic codes, designs, product development information, inventions, improvements, and research projects; (ii) information about finances, costs, profits, markets, proposals, sales and lists or names of customers, clients and employees; (iii) consumer information (including, without limitation, any information collected as part of any process to evaluate or review any person's application for any mortgage, loan or credit); (iv) business, marketing and strategic plans; and (v) employee personnel files and compensation information.

(b) Employee represents and warrants that Employee has not improperly disclosed any Confidential Information and agrees, for the maximum period permitted by law, to continue to hold all Confidential Information in trust and confidence for the Company and any Related Organizations, and except as Employee may be authorized by the Company in writing, Employee agrees not to publish or disclose to any person or entity, or use in any manner, such Confidential Information. Employee's obligations under this paragraph are in addition to, and do not limit in any way, Employee's obligations regarding Confidential Information under common law or statute.

5. NON-DISCLOSURE

(a) Employee covenants and agrees that Employee will keep confidential and will not at any time disclose, directly or indirectly, or make available to any person or entity, or in any manner use for Employee's own benefit, any information concerning the due diligence business of Hanover Capital Partners 2, Ltd. ("HCP") which is of a type that in accordance with HCP's past practices has been treated as confidential or proprietary, including, without limitation, business strategies, operating plans, acquisition strategies (including the identities of [and any other information concerning] possible acquisition candidates), pro forma financial information, market analysis, acquisition terms and conditions, personnel information, product information (whether existing, former, or proposed), trade secrets, sources of leads and methods of obtaining new business, know-how, customer lists and relationships, supplier lists and relationships, or other non-public confidential and proprietary information relating to the Company and any of its Related Organizations, except to the extent that such information (i) is obtained from a third party whom Employee has no reason to believe is bound by a duty of confidentiality, (ii) relates to information that is or becomes generally known to the public other than as a result of a breach of this Agreement, or (iii) is required to be disclosed by law or judicial administrative process (in which case prior to such disclosure Employee shall promptly provide prior written notice of such required disclosure to the Company in order to afford the Company the opportunity to seek an appropriate protective order preventing such disclosure).

(b) Employee understands that Employee's obligations in Paragraph 5 are essential elements of this Agreement, are designed, among other reasons, to prevent the inevitable disclosure of confidential and proprietary information and trade secrets and to protect the business of the Company and the Related Organizations. If Employee breaches any of Employee's obligations in Paragraph 5 of this Agreement, Employee agrees that the time periods of the obligations that Employee has breached shall be extended by the period of time of such breach. Employee also agrees that Employee's violation or threatened violation of any of the provisions of Paragraph 5 of this Agreement shall cause the Company or the affected Related Organization immediate and irreparable harm and that, in such event, an injunction restraining Employee from such violation or threatened violation may be entered in addition to any other relief available against Employee. Employee waives any right Employee may have to assert in any such proceeding that the Company or Related Organization had an adequate remedy at law.

(c) If any covenant in Paragraph 5 is held to be unreasonable, arbitrary, or against public policy, such covenant will be considered to be divisible with respect to scope, time, and geographic area, and such lesser scope, time, or geographic area, or all of them, as a court of competent jurisdiction or arbitrator may determine to be reasonable will be binding and enforceable against Employee.

(d) Employee understands and agrees that the Related Organizations are third-party beneficiaries of Paragraph 5 of the Agreement and, in addition to the Company, are entitled to enforce Paragraph 5 of the Agreement directly.

6. NON-DISPARAGEMENT

Nothing in this Agreement shall restrict Employee's ability to provide truthful testimony in response to any lawful subpoena or compulsory process or restrict Employee's ability to file an administrative charge, testify, assist or otherwise participate in any manner in any investigation, proceeding or hearing before any federal, state or local governmental agency. Except as provided in the foregoing sentence, Employee covenants and agrees that Employee will not make any statement, written or oral, in disparagement of the Company or any of its officers, shareholders, directors, employees, agents, or associates (including, but not limited to, negative references to each or any of the Company's products, services, or corporate policies) to the general public and/or the Company's employees, potential employees, customers, potential customers, suppliers, potential suppliers, business partners, and/or potential business partners. The Company agrees that it will instruct its Board Members and Officers that they should not make any statement, written or oral, in disparagement of the Employee. The Company's obligation under the immediately preceding sentence shall be limited to delivering the specified instruction, and the Company shall not be responsible or liable for any statement by any Board Member or Officer that may disparage the Employee, nor shall any such statement constitute a breach of this Agreement.

7. OBLIGATION TO RETURN COMPANY PROPERTY

(a) As used in this Agreement, the term "Company Property" includes, without limitation: (i) all materials containing any Confidential Information (including all copies thereof) including, without limitation, drawings, blueprints, tapes, disks, codes, descriptions or other papers, documents or materials that contain any such Confidential Information; (ii) all computer hardware (including, but not limited to, personal digital assistants), computer software, cell phones, pagers, business equipment, drawings, designs, specifications, tapes, drives, disks, codes, notes, memoranda or data created by Employee, or made available or furnished to Employee by the Company or any of its Related Organization (including all copies thereof), whether or not they contain Confidential Information; (iii) all other materials containing any information pertaining to the business of the Company, or any its Related Organization, or any of their employees, contractors, consultants, clients or business associates, that were acquired by Employee in the course of employment with the Company or any Related Organization.

(b) Employee represents and warrants that, before signing this Agreement, Employee has returned to the Company all Company Property. Employee understands and agrees that, unless and until Employee has complied with Company policies and/or procedures regarding the return of Company Property, Employee will not be entitled to any of the severance benefits referred to in Paragraph 2 above.

8. COOPERATION

Employee agrees reasonably to cooperate with the Company in connection with any dispute, claim, litigation or investigation by any person or entity against or involving the Company or any of its officers, employees, agents or representatives. As part of this agreement reasonably to cooperate, Employee agrees to speak and/or meet with the Company and/or its representatives or counsel at and for reasonable times upon reasonable notice, without the need for any legal proceeding or compulsory process. Employee also agrees to make Employee available at and for reasonable times upon reasonable notice for such things as interviews, depositions and trials. The Company agrees to reimburse Employee for reasonable expenses incurred with respect to such cooperation.

9. UNDISPUTED AMOUNTS

(a) Employee acknowledges and agrees that, except as set forth in Paragraphs 2 and 9(b) of this Agreement, Employee has received all compensation and other payments to which Employee is or may be entitled by reason of Employee's employment or termination of employment with the Company.

(b) Notwithstanding anything in this Agreement to the contrary, the Parties are not waiving or changing any rights, claims, conditions, requirements, or defenses in connection with the following matters: (1) Employee's 401(k) account and the related matching contribution made by the Company for the calendar year 2006, if any; (2) the reimbursement to Employee of reasonable and necessary business expenses incurred by Employee on or before December 29, 2006 on behalf of the Company, and reported and properly documented on expense reports, in accordance with and subject to the requirements of the Company's expense reimbursement practices; (3) Employee's options granted under the 1997 Executive and Non-Employee Director Stock Option Plan; or (4) any right that Employee may have to benefits under the New Jersey Workers' Compensation Act.

10. DENIAL OF LIABILITY

Employee acknowledges and agrees that neither the offer of this Agreement, nor the acceptance of this Agreement, nor the Agreement itself is an admission, or shall be construed to be an admission, of any wrongdoing or liability by the Company or any of the Released Parties; moreover, any such liability or wrongdoing is denied by the Company. Neither the offer of this Agreement, nor the Agreement, nor any of its terms, shall be admissible as evidence of any liability or wrongdoing by the Company or any of the Released Parties in any judicial, administrative or other proceeding now pending or hereafter instituted by any person or entity. 11. ARBITRATION

(a) Should either party to this Agreement have any dispute as to any aspect of this Agreement, or arising out of, or related to or connected with Employee's employment, compensation or benefits, or the termination thereof, the parties will submit any such dispute to final and binding arbitration pursuant to the Employment Arbitration Rules of the American Arbitration Association before a neutral arbitrator selected from the list of Arbitrators. Unless another limitations period is expressly mandated by statute, to be timely, any dispute must be referred to arbitration within twelve (12) months of the date on which the Party making such referral became aware, or with reasonable diligence should have become aware, of the incident or complaint giving rise to the dispute. Disputes not timely referred to arbitration shall be deemed waived, and the arbitrator shall deny any untimely claims. THE PARTIES EXPRESSLY AGREE THAT SUCH ARBITRATION SHALL BE THE EXCLUSIVE REMEDY FOR ANY DISPUTE INVOLVING THIS AGREEMENT, THE EMPLOYEE'S EMPLOYMENT, TERMINATION, COMPENSATION, BENEFITS OR THE VIOLATION OF EMPLOYEE'S CIVIL RIGHTS, AND HEREBY EXPRESSLY WAIVE ANY RIGHT THEY HAVE, OR MAY HAVE, TO A COURT TRIAL OR A JURY TRIAL OF ANY SUCH DISPUTE. In making an award, the arbitrator shall have no power to add to, delete from or modify this Agreement, or to enforce purported unwritten or prior agreements, or to construe implied terms or covenants into the Agreement. In reaching a decision, the arbitrator shall adhere to the relevant law and applicable precedent, and shall have no power to vary therefrom. In construing this Agreement, its language shall be given a fair and reasonable construction in accordance with the intention of the parties and without regard to which party drafted it. At the time of issuing a decision, the arbitrator shall (in the decision or separately) make specific findings of fact, and shall set forth such facts as support the decision, as well as conclusions of law, and the reasons and bases for the opinion. In the event the arbitrator exceeds the powers or jurisdiction here conferred, or fails to issue a decision in conformance herewith, it is specifically agreed that the aggrieved party may petition a court of competent jurisdiction to correct or vacate such award, and that the arbitrator's act of exceeding his or her powers shall be grounds for granting such relief. It is further agreed by the parties that venue for any arbitration or other legal proceedings shall be Edison, New Jersey. This arbitration clause is entered pursuant to, and shall be governed by, the Federal Arbitration Act, but in all other respects this Agreement shall be governed by the provisions of New Jersey law without application of its laws with respect to conflict of laws. If the Federal Arbitration Act is not applicable then the New Jersey General Arbitration Act shall govern (N.J.S.A. 2A:24-1 et. seq.). If any one or more provisions of this arbitration clause shall for any reason be held invalid or unenforceable, it is the specific intent of the parties that such provisions shall be modified to the minimum extent necessary to make it or its application valid and enforceable.

12. JURISDICTION, VENUE AND INJUNCTIVE RELIEF

(a) To the extent that either party is permitted to file any action in court that involves any aspect of this Agreement, or arises out of, or is related to or connected with Executive's employment, compensation or benefits, or the termination thereof, the parties agree that such action must be brought in either federal court in the State of New Jersey, or in the Superior Court of New Jersey, Middlesex County, and the parties irrevocably consent to jurisdiction and venue in such courts.

(b) Although all claims arising between the parties are subject to arbitration, unless otherwise prohibited by applicable law, each party retains the right to file, in the aforementioned federal or state courts of the State of New Jersey, an application for provisional injunctive and/or equitable relief in connection with a claim relating to this Agreement, including any claims relevant to the application for provisional relief, and shall not be obligated to post a bond or other security in seeking such relief unless specifically required by law. Although a court may grant provisional injunctive and/or equitable relief, the arbitrator shall at all times retain the power to grant permanent injunctive relief, or any other final remedy. Employee acknowledges that the injury that would be suffered by the Company as a result of a breach of Paragraph 4, Paragraph 5 or Paragraph 6 of this Agreement would be irreparable and that an award of monetary damages to the Company for such a breach would be an inadequate remedy. Consequently, the Company will have the right in addition to any other rights it may have, to obtain injunctive relief to restrain any breach or threatened breach or otherwise to specifically enforce Paragraph 4, Paragraph 5 and/or Paragraph 6 of this Agreement

13. SEVERABILITY AND REFORMATION

All provisions and portions of this Agreement are severable. If any provision or portion of this Agreement or the application of any provision or portion of this Agreement to any person, to any circumstance, or to any claims, shall be determined to be invalid, void, voidable or unenforceable to any extent for any reason, (1) the application of such provision or portion of this Agreement to any other person, to any other circumstance, or to any other claims shall be unaffected thereby, and the remaining provisions and portions of this Agreement also shall be unaffected thereby; (2) all other provisions and portions of this Agreement shall remain in full force and shall continue to be enforceable to the fullest and greatest extent permitted by law; and (3) any provision or part of the Agreement found by any Court with jurisdiction to be invalid, void, voidable or unenforceable, may be construed or changed by the Court to the extent reasonably necessary to make the provision or part (as construed or changed), valid, enforceable and binding.

14. APPLICABLE LAW

This Agreement is made and entered into by the Company in the State of New Jersey. The Agreement shall in all respects be governed by and interpreted under and in accordance with the laws of the State of New Jersey. The breach of any promise in this Agreement by any party shall not invalidate the Agreement or the release and shall not be a defense to the enforcement of the Agreement against any party.

15. INTEGRATION

Employee warrants and agrees that no promise, other than the promises in this Agreement, has been made to Employee. Employee warrants and agrees that in signing this Agreement Employee is not relying upon any statement or representation made by or on behalf of the Company concerning the merits or value of any Claims or concerning any other thing or matter. Employee warrants and agrees that Employee is relying solely upon Employee's own judgment and that before signing this Agreement Employee has read it.

16. CONSTRUCTION

The Parties have had an ample opportunity to review and have in fact reviewed this Agreement. Accordingly, the normal rule of construction, to the effect that any ambiguities be resolved against the drafting party, shall not be employed in the interpretation of this Agreement. The captions and headings at the beginning of each paragraph are for convenience and reference only and shall not limit, define, or affect the construction and interpretation of this Agreement.

17. REVIEW AND REVOCATION

Employee acknowledges that Employee was given twenty-one (21) days to review this Agreement from the time it was presented to Employee, and Employee has reviewed it with an attorney to the extent Employee chose to do so. If Employee does not return this Agreement executed by the end of the twenty-one (21) day review period, this Agreement shall be null and void for all purposes. Employee also acknowledges that Employee was advised that Employee has seven (7) days after signing and delivering this Agreement to the Company in which to revoke it by notifying Caryl O'Dowd, Vice President, Human Resources, in writing at Hanover Capital Mortgage Holdings, Inc., 200 Metroplex Drive -- Suite 100, Edison, New Jersey, 08817. This Agreement is not effective or enforceable until the seven (7) day revocation period has expired.

18. MISCELLANEOUS

a. Employee acknowledges that Employee is signing this Agreement voluntarily, with full knowledge of the nature and consequences of its terms. All executed copies of this Agreement and photocopies thereof shall have the same force and effect and shall be as legally binding and enforceable as the original.

b. This Agreement shall inure to the benefit of the Company and its predecessors, successors and assigns, and to the benefit of Employee and Employee's heirs, administrators and executors.

c. This Agreement is being signed by Employee and for the Company with the intent to be legally bound.

BY SIGNING THIS AGREEMENT, EMPLOYEE ACKNOWLEDGES AS FOLLOWS:

- EMPLOYEE HAS READ THIS AGREEMENT COMPLETELY.
- EMPLOYEE HAS HAD THE OPPORTUNITY TO CONSIDER THE TERMS OF THIS AGREEMENT.
- EMPLOYEE HAS BEEN ADVISED TO CONSULT WITH AN ATTORNEY PRIOR TO EXECUTING THIS AGREEMENT.
- EMPLOYEE UNDERSTANDS AND MEANS EVERYTHING THAT EMPLOYEE SAID IN THIS AGREEMENT AND EMPLOYEE AGREES TO ALL ITS TERMS.
- EMPLOYEE IS NOT RELYING ON THE COMPANY OR ANY REPRESENTATIVE OF THE COMPANY TO EXPLAIN THIS AGREEMENT TO EMPLOYEE.
- EMPLOYEE HAS HAD AN OPPORTUNITY TO CONSULT AN ATTORNEY TO EXPLAIN THIS AGREEMENT AND ITS CONSEQUENCES TO EMPLOYEE BEFORE EMPLOYEE SIGNED IT, AND EMPLOYEE HAS DONE SO TO WHATEVER EXTENT EMPLOYEE DESIRED.

EMPLOYEE HAS SIGNED THIS AGREEMENT CONSISTING OF 7 PAGES VOLUNTARILY AND ENTIRELY OF EMPLOYEE'S OWN FREE WILL, WITHOUT ANY PRESSURE FROM THE COMPANY OR ANY REPRESENTATIVE OF THE COMPANY.

DATED: 2/2/07

/s/ JOYCE MIZERAK

JOYCE MIZERAK

DATED: 2/2/07

HANOVER CAPITAL MORTGAGE HOLDINGS, INC.

BY: /s/ JOHN A. BURCHETT

JOHN A. BURCHETT

CHIEF EXECUTIVE OFFICER

CONFIDENTIAL
SEPARATION AGREEMENT AND GENERAL RELEASE

This is a Confidential Separation Agreement and General Release (the "Agreement") between Hanover Capital Mortgage Holdings, Inc. (the "Company") and George J. Ostendorf (the "Employee" and together with the Company, the "Parties", each a "Party") that nullifies and supersedes that certain Amended and Restated Employment Agreement dated July 1, 2002, as same has been amended from time to time, together with all agreements referenced and/or incorporated therein (the "Employment Agreement"), including, but not limited to, those related to the Employee's employment, compensation, benefits and directorship. EMPLOYEE IS ADVISED TO CONSULT WITH AN ATTORNEY BEFORE SIGNING THIS AGREEMENT. In consideration of the mutual promises and commitments made in this Agreement, and intending to be legally bound, the Company on the one hand, and Employee on the other hand, agree to the terms set forth in this Agreement.

1. SEPARATION

Employee's employment with the Company was separated by mutual agreement effective December 29, 2006 (the "Separation Date"). Employee agrees and acknowledges that Employee's employment relationship with the Company and any of its Related Organizations (i.e., the Company's parent, subsidiary and related corporations, and their predecessors and successors) has ended, and that neither the Company nor any of its Related Organizations has any obligation to hire, rehire or employ Employee. Furthermore, Employee represents and acknowledges that Employee voluntarily and willfully resigned as a member of the Company's Board of Directors and as a member of the Board of Directors of any Related Organizations as of the Separation Date.

2. CONSIDERATION

(a) In exchange for Employee's execution of this Agreement, and the relinquishment and nullification of the Employment Agreement, and Employee's resignation from the Company's Board of Directors and as a member of the Board of Directors of any Related Organizations and provided that Employee does not revoke this Agreement within the seven day revocation period described in Paragraph 14 hereof, the Company will pay Employee the equivalent of one year's separation pay, based on Employee's base salary rate in effect on the Separation Date (the "Severance Payment") by check payable to Employee's order in the gross amount of $281,175.60. From the gross amount of the Severance Payment, the Company will determine and withhold payroll deductions for taxes (federal, FICA, Medicare, state, local and unemployment compensation).

(b) The obligation of the Company to make the Severance Payment shall be fulfilled by the mailing of such check by Federal Express, next-day-air, to Employee at Employee's home address listed as: 506 East Marshall Street, Arlington Heights, IL 60004 not less than eight days and not more than thirty days after Employee executes this Agreement and the seven day revocation period described in Paragraph 14 hereof has expired without the Employee having revoked this Agreement.

(c) If Employee is a participant in the Company's group health care plans (medical, dental and vision), Employee's eligibility for benefits under those plans will terminate as of December 31, 2006, unless Employee elects to continue coverage in accordance with the Consolidated Omnibus Budget Reconciliation Act of 1985 ("COBRA"). In order to elect such coverage, Employee must complete all necessary forms in a timely manner.

(d) If Employee elects COBRA continuation coverage, the Company will waive payment of the COBRA premiums for the first twelve (12) complete calendar months following the month in which employment terminated. If Employee is eligible for, and elects to, continue such benefit coverage beyond the waiver period provided in the preceding sentence, during the time period that the Company is required to provide such coverage under COBRA, Employee will be required to pay the COBRA premiums for such coverage. The Company has no obligation under this Agreement with regard to any group health care plan benefit coverage beyond the waiver of premiums for the period set forth in this subparagraph. Moreover, the Company's obligation under this subparagraph to waive the premiums for such coverage will cease immediately if Employee ceases to be eligible for COBRA coverage or obtains comparable benefit coverage from any future employer.

(e) The Company confirms that it has paid the premium for Employee's supplemental life insurance policy, administered by ReliaStar Life Insurance Company (Policy #SC2515046D) ("the Policy"), through August 6,

2007. The Company shall, thereafter, transfer any ownership interest that it has in the Policy and all payment obligations thereunder to Employee.

(f) The Company agrees to pay the rent for the premises at: 208 South LaSalle Street, Suite 1331, Chicago, IL (the "Chicago Office") for the lesser of six (6) months through June 30, 2007 or the date Employee vacates the Chicago Office and to permit Employee to utilize the Chicago Office and all furniture and equipment located therein through that date. Employee agrees not to abuse or remove the furniture in the Chicago Office, and to vacate those premises no later than June 30, 2007, leaving all furniture and equipment presently located therein. Employee represents that, with the exception of the furniture and equipment located in the Chicago Office, Employee returned to the Company all Company records and Company property, on or before the Separation Date and before executing this Agreement. The Company has no obligation under this Agreement with regard to the Chicago Office beyond paying the rent therefore and permitting Employee to use the furniture and equipment located therein.

(g) The Company shall reimburse Employee for reasonable attorneys' fees, up to a maximum of $2,500, incurred by Employee in the negotiation of the non-competition agreement Employee is being asked to sign with Terwin Acquisition I, LLC in connection with the Asset Purchase Agreement by and among Company, Hanover Capital Partners 2 Ltd. ("HCP") and Terwin Acquisition I, LLC ("Terwin") (the "Asset Purchase Agreement").

(h) The Parties will use reasonable best efforts to agree upon the language for any public communication related to Employee's separation from employment.

(i) Employee acknowledges and agrees that the Company's obligations under subparagraphs 2(a), 2(d), 2(e), 2(f), 2(g) and 2(h) arise under this Agreement, are in consideration for Employee's signing this Agreement, and constitute consideration to which Employee is not otherwise entitled. Employee also acknowledges and agrees that the Company shall be entitled to discontinue providing payments and benefits under this Agreement if Employee breaches any of Employee's obligations hereunder including, without limitation, Employee's obligations under paragraph 4 of this Agreement, and that such discontinuance will not relieve Employee of his obligations hereunder, nor shall it affect the validity of the release of claims provided in Paragraph 3 of this Agreement.

3. GENERAL RELEASE OF CLAIMS

It is understood and agreed by and between the Parties to this Agreement that in return for the consideration set forth in Paragraph 2 and the other promises contained herein, Employee does, knowingly and voluntarily, completely and forever release and discharge the Company, including all present and former parent corporations, affiliates, subsidiaries, predecessors, successors, agents, assigns, insurers, and all of their present and former employees, officers, directors, and representatives (collectively the "Released Parties"), from any and all causes of action, claims, judgments, obligations, damages of any kind (e.g., compensatory and punitive), claims for attorneys' fees, and rights to pre- or post-judgment interest or liabilities of whatever kind and character, that Employee (on behalf of either Employee or any other person or entity) ever had, now has, or may have against, or pertaining to, any or all of the Released Parties, based on, relating to, involving, or arising from any cause, decision, event, matter, omission, statement or any other thing, existing or occurring at any time up to and including the time when Employee signs this Agreement. This release includes any claims that Employee or anyone on Employee's behalf may have arising under the New Jersey Conscientious Employee Protection Act, N.J.S.A. 34:19-1 et seq., the New Jersey Law Against Discrimination ("NJLAD"), N.J.S.A. 10:5-1 et seq., New Jersey Family Leave Act, N.J.S.A. 34:11B-1 et seq., the Civil Rights Act of 1964 as amended, the Civil Rights Act of 1991 as amended, the Americans with Disabilities Act ("ADA"), 42 U.S.C. Section 12101 et seq., the Employee Retirement Income Security Act ("ERISA"), 29 U.S.C. Section 1001 et seq., the Consolidated Omnibus Budget Reconciliation Act "COBRA"), the Age Discrimination in Employment Act ("ADEA"), 29 U.S.C. Section 621 et seq., 42 U.S.C. Sections 1981-1988, the Worker Adjustment and Retraining Notification Act ("WARN"), 29 U.S.C. Section 2101 et seq., or any other federal, state or local human rights, civil rights, wage and hour, notice, pension, employment or labor law, rule and/or regulation, public policy, contract or tort law, any claim of retaliation under such laws, any claim arising under the common law, including but not limited to causes of action for wrongful discharge, breach of contract, fraud, defamation, interference with contract or prospective economic advantage, violation of public policy, infliction of emotional distress, violation of any other national, state or local statute, law or ordinance, claims for loss of income, compensatory damages, emotional distress, liquidated damages, punitive damages, attorneys' fees and costs, and any other action whether cognizable in law or in equity based on any conduct up to and including the date on which Employee executes this Agreement. The release of claims in this Agreement shall extend to claims of any nature whatsoever including claims that are known or unknown. Employee further represents that, before executing this Agreement, Employee has not asserted a claim against or involving the Company before any court, agency or tribunal.

4. NON-COMPETE, NON-SOLICITATION AND NON-DISCLOSURE

(a) Non-Compete. For a period of six (6) months following the Separation Date, Employee shall not, within or with respect to the geographical area of the United States and Canada, directly or indirectly own, operate, lease, manage, control, participate in, consult with, advise, permit his name to be used by, provide services for, or in any manner engage in any business (including by himself or in association with any person, firm, corporate or other business organization or through any other entity) that distributes any product or provides any service that is distributed or provided by, or otherwise competes with any product or service of, the business carried out with respect to the Assets (as defined the Asset Purchase Agreement) (i.e., the business of providing due diligence services to mortgage bankers, banks, thrifts, pension funds and government agencies, such due diligence line of business being referred to as the "Business" in the Asset Purchase Agreement ; provided, however, that nothing in this subparagraph 4(a) shall prohibit Employee from (x) engaging in the business consistent with that currently conducted by Company unrelated to the Assets or to the Business, or (y) being a passive owner of not more than 2% of the outstanding stock of any other corporation which is publicly traded, so long as Employee has no active participation in the business of such corporation.

(b) Non-Solicitation. For a period of six (6) months following the Separation Date (the "Non-Solicit Period"), Employee shall not directly or indirectly (i) induce or attempt to induce any employee, consultant or contractor of the Company or any of its affiliates (i.e., collectively the "Company Group") to leave the employ of the Company or such affiliate, or in any way interfere with the relationship between the employee, consultant or contractor and the Company or such affiliate, including inducing or attempting to induce any union, employee or group of employees to interfere with the business or operations of the Company or any such affiliate, (ii) hire any person who was an employee, consultant or contractor of the Company or any such affiliate at any time during the Non-Solicit Period, or (iii) induce or attempt to induce any customer, supplier, distributor, franchisee, licensee or other business relation of the Company or any such affiliate not to do, or to cease doing, business with the Company or such affiliate, or in any way interfere with the relationship between any such customer, supplier, distributor, franchisee, licensee or business relation and the Company or such affiliate.

(c) Non-Disclosure. Employee covenants and agrees that Employee will keep confidential and will not at any time disclose, directly or indirectly, or make available to any person or entity, or in any manner use for Employee's own benefit, any information concerning the Business, the Assets or the Assumed Liabilities (each as defined in the Asset Purchase Agreement) which is of a type that in accordance with Company's and HCP's past practices has been treated as confidential or proprietary, including, without limitation, business strategies, operating plans, acquisition strategies (including the identities of [and any other information concerning] possible acquisition candidates), pro forma financial information, market analysis, acquisition terms and conditions, personnel information, product information (whether existing, former, or proposed), trade secrets, sources of leads and methods of obtaining new business, know-how, customer lists and relationships, supplier lists and relationships, or other non-public confidential and proprietary information relating to the Company Group, except to the extent that such information (i) is obtained from a third party whom Employee has no reason to believe is bound by a duty of confidentiality, (ii) relates to information that is or becomes generally known to the public other than as a result of a breach of this Agreement, or (iii) is required to be disclosed by law or judicial administrative process (in which case prior to such disclosure Employee shall promptly provide prior written notice of such required disclosure to the Company in order to afford the Company the opportunity to seek an appropriate protective order preventing such disclosure).

5. NON-DISPARAGEMENT

Nothing in this Agreement shall restrict Employee's ability to provide truthful testimony in response to any lawful subpoena or compulsory process or restrict Employee's ability to file an administrative charge, testify, assist or otherwise participate in any manner in any investigation, proceeding or hearing before any federal, state or local governmental agency. Except as provided in the foregoing sentence, Employee covenants and agrees that Employee will not make any statement, written or oral, in disparagement of the Company or any of its officers, shareholders, directors, employees, agents, or associates (including, but not limited to, negative references to each or any of the Company's products, services, or corporate policies) to the general public and/or the Company's employees, potential employees, customers, potential customers, suppliers, potential suppliers, business partners, and/or potential business partners.

6. COOPERATION

Employee agrees reasonably to cooperate with the Company in connection with any dispute, claim, litigation or investigation by any person or entity against or involving the Company or any of its officers, employees, agents or representatives. As part of this agreement reasonably to cooperate, Employee agrees to speak and/or meet with the Company and/or its representatives or counsel at and for reasonable times upon reasonable notice, without the need for any legal proceeding or compulsory process. Employee also agrees to make Employee available at and for reasonable times upon reasonable notice for such things as interviews, depositions and trials. The Company agrees to reimburse Employee for reasonable expenses incurred with respect to such cooperation.

7. UNDISPUTED AMOUNTS

(a) Employee acknowledges and agrees that, except as set forth in Paragraphs 2 and 7(b) of this Agreement, Employee has received all compensation and other payments to which Employee is or may be entitled by reason of Employee's employment or termination of employment with the Company.

(b) Notwithstanding anything in this Agreement to the contrary, the Parties are not waiving or changing any rights, claims, conditions, requirements, or defenses in connection with the following matters: (1) Employee's 401(k) account and the related matching contribution made by the Company for the calendar year 2006, if any, and: (2) the reimbursement to Employee of reasonable and necessary business expenses incurred by Employee on or before December 29, 2006 on behalf of the Company, and reported and properly documented on expense reports, in accordance with and subject to the requirements of the Company's expense reimbursement practices.

8. DENIAL OF LIABILITY

Employee acknowledges and agrees that neither the offer of this Agreement, nor the acceptance of this Agreement, nor the Agreement itself is an admission, or shall be construed to be an admission, of any wrongdoing or liability by the Company or any of the Released Parties; moreover, any such liability or wrongdoing is denied by the Company. Neither the offer of this Agreement, nor the Agreement, nor any of its terms, shall be admissible as evidence of any liability or wrongdoing by the Company or any of the Released Parties in any judicial, administrative or other proceeding now pending or hereafter instituted by any person or entity.

9. ARBITRATION

(a) Should either party to this Agreement have any dispute as to any aspect of this Agreement, or arising out of, or related to or connected with Employee's employment, compensation or benefits, or the termination thereof, the parties will submit any such dispute to final and binding arbitration pursuant to the Employment Arbitration Rules of the American Arbitration Association before a neutral arbitrator selected from the list of Arbitrators. Unless another limitations period is expressly mandated by statute, to be timely, any dispute must be referred to arbitration within twelve (12) months of the date on which the Party making such referral became aware, or with reasonable diligence should have become aware, of the incident or complaint giving rise to the dispute. Disputes not timely referred to arbitration shall be deemed waived, and the arbitrator shall deny any untimely claims. THE PARTIES EXPRESSLY AGREE THAT SUCH ARBITRATION SHALL BE THE EXCLUSIVE REMEDY FOR ANY DISPUTE INVOLVING THIS AGREEMENT, THE EMPLOYEE'S EMPLOYMENT, TERMINATION, COMPENSATION, BENEFITS OR THE VIOLATION OF EMPLOYEE'S CIVIL RIGHTS, AND HEREBY EXPRESSLY WAIVE ANY RIGHT THEY HAVE, OR MAY HAVE, TO A COURT TRIAL OR A JURY TRIAL OF ANY SUCH DISPUTE. In making an award, the arbitrator shall have no power to add to, delete from or modify this Agreement, or to enforce purported unwritten or prior agreements, or to construe implied terms or covenants into the Agreement. In reaching a decision, the arbitrator shall adhere to the relevant law and applicable precedent, and shall have no power to vary therefrom. In construing this Agreement, its language shall be given a fair and reasonable construction in accordance with the intention of the parties and without regard to which party drafted it. At the time of issuing a decision, the arbitrator shall (in the decision or separately) make specific findings of fact, and shall set forth such facts as support the decision, as well as conclusions of law, and the reasons and bases for the opinion. In the event the arbitrator exceeds the powers or jurisdiction here conferred, or fails to issue a decision in conformance herewith, it is specifically agreed that the aggrieved party may petition a court of competent jurisdiction to correct or vacate such award, and that the arbitrator's act of exceeding his or her powers shall be grounds for granting such relief. It is further agreed by the parties that venue for any arbitration or other legal proceedings shall be Edison, New Jersey. This arbitration clause is entered pursuant to, and shall be governed by, the Federal Arbitration Act, but in all other respects this Agreement shall be governed by the provisions of New Jersey law without application of its laws with respect to conflict of laws. If the Federal Arbitration Act is not applicable then the New Jersey General Arbitration Act shall govern (N.J.S.A. 2A:24-1 et. seq.). If any one or more provisions of this arbitration clause shall for any reason be held invalid or unenforceable, it is the specific intent of the parties that such provisions shall be modified to the minimum extent necessary to make it or its application valid and enforceable.

10. SEVERABILITY

All provisions and portions of this Agreement are severable. If any provision or portion of this Agreement or the application of any provision or portion of this Agreement to any person, to any circumstance, or to any claims, shall be determined to be invalid, void, voidable or unenforceable to any extent for any reason, (1) the application of such provision or portion of this Agreement to any other person, to any other circumstance, or to any other claims shall be unaffected thereby, and the remaining provisions and portions of this Agreement also shall be unaffected thereby; (2) all other provisions and portions of this Agreement shall remain in full force and shall continue to be enforceable to the fullest and greatest extent permitted by law; and (3) any provision or part of the Agreement found by any Court with jurisdiction to be invalid, void, voidable or unenforceable, may be construed or changed by the Court to the extent reasonably necessary to make the provision or part (as construed or changed), valid, enforceable and binding.

11. APPLICABLE LAW

This Agreement is made and entered into by the Company in the State of New Jersey. The Agreement shall in all respects be governed by and interpreted under and in accordance with the laws of the State of New Jersey. The breach of any promise in this Agreement by any party shall not invalidate the Agreement or the release and shall not be a defense to the enforcement of the Agreement against any party.

12. INTEGRATION

Employee warrants and agrees that no promise, other than the promises in this Agreement, has been made to Employee. Employee warrants and agrees that in signing this Agreement Employee is not relying upon any statement or representation made by or on behalf of the Company concerning the merits or value of any Claims or concerning any other thing or matter. Employee warrants and agrees that Employee is relying solely upon Employee's own judgment and that before signing this Agreement Employee has read it.

13. CONSTRUCTION

The Parties have had an ample opportunity to review and have in fact reviewed this Agreement. Accordingly, the normal rule of construction, to the effect that any ambiguities be resolved against the drafting party, shall not be employed in the interpretation of this Agreement. The captions and headings at the beginning of each paragraph are for convenience and reference only and shall not limit, define, or affect the construction and interpretation of this Agreement.

14. REVIEW AND REVOCATION

Employee acknowledges that Employee was given twenty-one (21) days to review this Agreement from the time it was presented to Employee on December 22, 2006 and Employee has reviewed it with an attorney to the extent Employee chose to do so. If Employee does not return this Agreement executed by the end of the twenty-one (21) day review period, this Agreement shall be null and void for all purposes. Employee also acknowledges that Employee was advised that Employee has seven (7) days after signing and delivering this Agreement to the Company in which to revoke it by notifying Caryl O'Dowd, Vice President, Human Resources, in writing at Hanover Capital Mortgage Holdings, Inc., 200 Metroplex Drive -- Suite 100, Edison, New Jersey, 08817. This Agreement is not effective or enforceable until the seven (7) day revocation period has expired.

15. MISCELLANEOUS

(a) Employee acknowledges that Employee is signing this Agreement voluntarily, with full knowledge of the nature and consequences of its terms.

(b) All executed copies of this Agreement and photocopies thereof shall have the same force and effect and shall be as legally binding and enforceable as the original.

(c) This Agreement shall inure to the benefit of the Company and its predecessors, successors and assigns, and to the benefit of Employee and Employee's heirs, administrators and executors.

(d) This Agreement is being signed by Employee and for the Company with the intent to be legally bound.

BY SIGNING THIS AGREEMENT, EMPLOYEE ACKNOWLEDGES AS FOLLOWS:

- EMPLOYEE HAS READ THIS AGREEMENT COMPLETELY.
- EMPLOYEE HAS HAD THE OPPORTUNITY TO CONSIDER THE TERMS OF THIS AGREEMENT.
- EMPLOYEE HAS BEEN ADVISED TO CONSULT WITH AN ATTORNEY PRIOR TO EXECUTING THIS AGREEMENT.
- EMPLOYEE UNDERSTANDS AND MEANS EVERYTHING THAT EMPLOYEE SAID IN THIS AGREEMENT AND EMPLOYEE AGREES TO ALL ITS TERMS.
- EMPLOYEE IS NOT RELYING ON THE COMPANY OR ANY REPRESENTATIVE OF THE COMPANY TO EXPLAIN THIS AGREEMENT TO EMPLOYEE.
- EMPLOYEE HAS HAD AN OPPORTUNITY TO CONSULT AN ATTORNEY TO EXPLAIN THIS AGREEMENT AND ITS CONSEQUENCES TO EMPLOYEE BEFORE EMPLOYEE SIGNED IT, AND EMPLOYEE HAS DONE SO TO WHATEVER EXTENT EMPLOYEE DESIRED.

EMPLOYEE HAS SIGNED THIS AGREEMENT CONSISTING OF 6 PAGES VOLUNTARILY AND ENTIRELY OF EMPLOYEE'S OWN FREE WILL, WITHOUT ANY PRESSURE FROM THE COMPANY OR ANY REPRESENTATIVE OF THE COMPANY.

DATED: 12/27/06

/s/ GEORGE OSTENDORF

GEORGE J. OSTENDORF

DATED: 12/21/06

HANOVER CAPITAL MORTGAGE HOLDINGS, INC.

BY: /s/ JOHN A. BURCHETT

JOHN A. BURCHETT
CHIEF EXECUTIVE OFFICER

EXHIBIT 10.38.7

EXECUTION COPY

ASSET PURCHASE AGREEMENT

BY AND AMONG

HANOVER CAPITAL MORTGAGE HOLDINGS, INC.

AND

HANOVER CAPITAL PARTNERS 2, LTD.

AND

TERWIN ACQUISITION I, LLC

DATED AS OF JANUARY 12, 2007

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ASSET PURCHASE AGREEMENT

THIS ASSET PURCHASE AGREEMENT (this "AGREEMENT") is entered into as of January 12, 2007 by and among Hanover Capital Partners 2, Ltd., a Delaware corporation ("SELLER"), Hanover Capital Mortgage Holdings, Inc., a Maryland corporation (the "COMPANY"), and Terwin Acquisition I, LLC, a Delaware limited liability company ("BUYER"). Buyer, Seller and the Company are sometimes referred to herein as the "PARTIES."

WHEREAS, the Company owns 100% of the issued and outstanding capital stock of Seller;

WHEREAS, Seller is engaged in several lines of business, including the business of providing due diligence services to mortgage bankers, banks, thrifts, pension funds and government agencies (such due diligence line of business being referred to as the "BUSINESS") and owns or has the right to use all of the Assets (as defined herein);

WHEREAS, Seller desires to sell, and Buyer desires to purchase, the Assets, upon the terms set forth below.

NOW, THEREFORE, for good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, the Parties agree as follows:

ARTICLE I
DEFINITIONS

1.1 DEFINED TERMS. In this Agreement, the following terms shall have the following respective meanings:

"ADJUSTED INCOME" shall mean, for the Relevant Period, the sum of (a) Revenues less (b) Direct Expenses less (c) Indirect Expenses plus (d) Senior Executive Compensation.

"ADDITIONAL PURCHASE PRICE" has the meaning set forth in Section 2.3.

"AFFILIATE" means, with respect to any Person, any other Person that, directly or indirectly, controls, is controlled by or is under common control with such first Person.

"AGREEMENT" has the meaning set forth in the preamble to this Agreement.

"ASSETS" means all of the assets of Seller being transferred by Seller to Buyer pursuant to the terms of this Agreement and as set forth on Schedule 2.1(a) hereto.

"ASSIGNMENT AND ASSUMPTION AGREEMENT" has the meaning set forth in Section 7.1.

"ASSUMED CONTRACTS" has the meaning set forth in Section 2.1(c).

"ASSUMED LIABILITIES" means the Liabilities and obligations of Seller set forth on Schedule 2.1(b) hereto. In the event of any claim against Buyer with respect to any of the Assumed Liabilities hereunder, Buyer shall have, and Seller hereby assigns to Buyer, any defense, counterclaim, or right of setoff which would have been available to Seller if such claim had been asserted against Seller.

"BASKET" has the meaning set forth in Section 10.2(a).

"BENEFIT PLAN" means any "employee benefit plan" (as such term is defined in ERISA Section 3(3)) and any other employee benefit plan, program or arrangement of any kind.

"BILL OF SALE" has the meaning set forth in Section 7.1.

"BUSINESS" has the meaning set forth in the recitals.

"BUSINESS DAY" means a day, other than a Saturday or Sunday, on which commercial banks in New York, New York are open for the general transaction of business.

"CAP" has the meaning set forth in Section 10.2(a).

"CLOSING" has the meaning set forth in Section 3.1.

"CLOSING DATE" has the meaning set forth in Section 3.1.

"CLOSING DATE SCHEDULE" has the meaning set forth in Section 2.4(b).

"CODE" means the United States Internal Revenue Code of 1986, as amended.

"COBRA" has the meaning set forth in Section 4.14.

"COMPANY" has the meaning set forth in the preamble to this Agreement.

"CONFIDENTIAL INFORMATION" has the meaning set forth in Section 9.4(a).

"CONSENT" means any consent, order, approval, authorization or other action of, or any filing with or notice to or other action with respect to, any Governmental Entity or any other Person which is (a) required or necessary for any of (i) the execution, delivery or performance of this Agreement or any other Transaction Document, (ii) the consummation of any Closing Transaction or other transaction contemplated hereby or thereby or (iii) the conduct of the Business by Buyer after Closing in substantially the same manner as presently conducted or proposed to be conduced by Seller or the holding or utilization of any Asset thereafter, whether such requirement or necessity arises pursuant to any Legal Requirement, Contract, Lease or License (including any of the foregoing which is required in order to prevent a breach of or a default under or a termination or modification of any Contract) or (b) requested by Buyer and set forth on the attached Schedule 6.1 and Schedule 7.1.

"CONTRACT" means any oral or written agreement, instrument, document, lease, employee benefit or welfare plan or other business or commercial arrangement (in each case, including any extension, renewal, amendment or other modification thereof) to which Seller is a party or by which it is bound or to which it or any Asset is subject or which pertains to the Business.

"CONTRACTORS" has the meaning set forth in Section 4.13.

"DIRECT EXPENSES" shall mean the total direct expenses as contained in Seller's internal monthly management financial results binder titled "HCP-2-DUE DILIGENCE TOTAL", which results binder shall have been prepared in accordance with past practices of Seller, for the due diligence division of Hanover Capital Partners 2, Ltd. for the Relevant Period, including, without limitation, the expense items listed under "Direct Expenses" on Exhibit A attached hereto.

"ENVIRONMENTAL LAWS" has the meaning set forth in Section 4.17(a).

"ERISA" means the Employment Retirement Income Security Act of 1974, as amended.

"ESCROW AGENT" means Klehr, Harrison, Harvey, Branzburg & Ellers LLP.

"ESCROW AGREEMENT" has the meaning set forth in Section 7.1.

"ESCROW AMOUNT" has the meaning set forth in Section 2.2.

"ESTIMATED CLOSING DATE SCHEDULE" has the meaning set forth in Section 2.4(a).

"ESTIMATED NET EQUITY AMOUNT" has the meaning set forth in Section 2.4(a).

"EXCLUDED LIABILITIES" means all Liabilities and obligations of Seller other than the Assumed Liabilities.

"FCPA" has the meaning set forth in Section 4.25.

"FIRST ADDITIONAL PURCHASE PRICE PAYMENT" has the meaning set forth in Section 2.2.

"FINAL NET EQUITY AMOUNT" has the meaning set forth in Section 2.4(c).

"FINANCIAL STATEMENTS" has the meaning set forth in Section 4.5.

"FRINGE EXPENSE RATE" shall mean 18%.

"GAAP" means United States generally accepted accounting principles, as in effect from time to time.

"GOVERNMENTAL ENTITY" means any government, agency, governmental department, commission, board, bureau, court, arbitration panel or instrumentality of the United States of America or any state or other political subdivision thereof (whether now or hereafter constituted and/or existing) and any entity exercising executive, legislative, judicial, regulatory or administrative functions of or pertaining to government.

"HANOVER NONCOMPETITION AGREEMENT" has the meaning set forth in Section 7.1.

"INDEMNIFIED PARTY" has the meaning set forth in Section 10.3.

"INDEMNIFYING PARTY" has the meaning set forth in Section 10.3.

"INDEPENDENT ACCOUNTING FIRM" has the meaning set forth in Section 2.4(d).

"INDIRECT EXPENSES" shall mean the total indirect expenses as contained in Seller's internal monthly management financial results binder titled "HCP-2-DUE DILIGENCE TOTAL", which results binder shall have been prepared in accordance with past practices of Seller, for the due diligence division of Hanover Capital Partners 2, Ltd. for the Relevant Period, including, without limitation, the expense items listed under "Indirect Expenses" on Exhibit A attached hereto.

"INSIDER" means any stockholder, partner, member, officer or director (or similar official) of Seller, any Affiliate or member of the immediate family of any of the foregoing Persons, or any Person in which any of the foregoing Persons directly or indirectly owns any material beneficial interest. The "immediate family" of any individual means such individual's (and such individual's present or former spouse's) grandparents, parents, spouse, siblings, children and grandchildren.

"IRS" has the meaning set forth in Section 4.14.

"LEASED REAL PROPERTY" means all leasehold or subleasehold estates and other rights to use or occupy any land, building, structures, improvements, fixtures or other interest in real property held by Seller.

"LEASES" means all leases, subleases, licenses, concessions and other agreements (written or oral), including all amendments, extensions, renewals, guaranties and other agreements with respect thereto, pursuant to which Seller holds any Leased Real Property, including the right to all security deposits and other amounts and instruments deposited by or on behalf of Seller thereunder.

"LEGAL REQUIREMENT" means all federal, state and local laws, statutes, codes, rules, regulations, ordinances, judgments, orders, decrees and the like of any Governmental Entity, including common law.

"LIABILITY" means any liability (whether known or unknown, whether asserted or unasserted, whether absolute or contingent, whether accrued or unaccrued, whether liquidated or unliquidated, and whether due or to become due), including any liability for Taxes.

"LICENSE AGREEMENT" has the meaning set forth in Section 7.1.

"LICENSES" means all licenses, permits, franchises, certificates, and other authorizations issued by any Governmental Entity to Seller or held by Seller with respect to the Business or any of the Assets, including all applications therefor and all renewals, extensions, or modifications thereof and additions thereto.

"LIEN" means any mortgage, pledge, hypothecation, lien (statutory or otherwise), preference, priority, security agreement or other encumbrance of any kind or nature whatsoever (including any conditional sale or other title retention agreement and any lease having substantially the same effect as any of the foregoing and any assignment or deposit arrangement in the nature of a security device).

"LOSS" has the meaning set forth in Section 10.2(a).

"MANDATORY CONSENTS" has the meaning set forth in Section 7.1.

"MATERIAL ADVERSE EFFECT" means a material adverse effect on the Business, the Assets, the Assumed Liabilities or the business, operations, financial condition, or results of operations of the Business or on the ability of Seller to perform its obligations under this Agreement or any other Transaction Document.

"NET EQUITY AMOUNT" has the meaning set forth in Section 2.4(a).

"NOTICE OF NET EQUITY DISAGREEMENT" has the meaning set forth in Section 2.4(c).

"ORDINARY COURSE" means, with respect to any Person, in the ordinary course of that Person's business consistent with past practice, including as to the quantity, quality and frequency.

"OTHER CONSENTS" has the meaning set forth in Section 6.1.

"PARTIES" has the meaning set forth in the preamble to this Agreement.

"PERMITTED LIENS" means:

(a) Liens on Assets arising by operation of law and securing the payment of Taxes which are not yet due and payable;

(b) easements, rights-of-way, reservations of rights, conditions or covenants, zoning, building or similar restrictions or other restrictions or encumbrances that do not, individually or in the aggregate materially interfere with the use of the affected property in the operation of the Business as conducted or as proposed to be conducted by Seller;

(c) restrictions on transfer imposed under state or federal securities laws;

(d) the lessors' and sublessors' rights under the Leases and leases of personal property by Seller as lessee which are part of the Assets;

(e) mechanics', carriers', workers', repairers', and similar non-consensual Liens arising by operation of law and relating to obligations which are incurred in the ordinary course of business and which secure only Assumed Liabilities which are not yet due and payable on the Closing Date; and

(f) Liens arising out of any failure to comply with the provisions of any bulk transfer law which may be applicable to the purchase and sale of the Assets pursuant to this Agreement.

"PERSON" means an individual, a partnership, a limited liability company, a corporation, an association, a joint stock company, a trust, a joint venture, an unincorporated organization, any Governmental Entity or any similar entity.

"PLAN" has the meaning set forth in Section 4.14.

"PRE-CLOSING PERIOD" means any taxable period or portion thereof ending on or before the Closing Date or, as the context may require, all such periods and portions. If a taxable period begins on or before the Closing Date and ends after the Closing Date, then the portion of the taxable period through the end of the Closing Date shall constitute a Pre-Closing Period.

"POST-CLOSING PERIOD" means any taxable period or portion thereof beginning after the Closing Date or, as the context may require, all such periods and portions. If a taxable period begins on or before the Closing Date and ends after the Closing Date, then the portion of the taxable period that begins on the day following the Closing Date shall constitute a Post-Closing Period.

"PROPRIETARY RIGHTS" means all of the following items owned by, issued to or licensed to, Seller that relate solely to the Assets or the Assumed Liabilities, along with all income, royalties, damages and payments due or payable at the Closing or thereafter, including damages and payments for past, present or future infringements or misappropriations thereof, the right to sue and recover for past infringements or misappropriations thereof and any and all corresponding rights that, now or hereafter, may be secured throughout the world: patents, patent applications, patent disclosures and inventions (whether or not patentable and whether or not reduced to practice) and any reissue, continuation, continuation-in-part, division, revision, extension or reexamination thereof; copyrights registered or unregistered and copyrightable works; mask works; and all registrations, applications and renewals for any of the foregoing; trade secrets and confidential information (including ideas, formulae, compositions, know-how, manufacturing and production processes and techniques, research and development information, drawings, specifications, designs, plans, proposals, technical data, financial, business and marketing plans, and customer and supplier lists and related information);

computer software and software systems (including data, databases and related documentation); other proprietary rights; licenses or other agreements to or from third parties regarding the foregoing; and all copies and tangible embodiments of the foregoing (in whatever form or medium), in each case including the items set forth on Schedule 4.9(a).

"PURCHASE PRICE" has the meaning set forth in Section 2.2.

"PURCHASE PRICE ALLOCATIONS" has the meaning set forth in Section 2.5.

"REAL PROPERTY" means all real property and all improvements thereon used, or held for use, in the Business.

"RELEVANT GROUP" means any affiliated, combined, consolidated, unitary or other group for Tax purposes of which Seller is or was a member.

"RELEVANT PERIOD" shall mean the three month period beginning on October 1, 2006 through and including December 31, 2006.

"REVENUES" shall mean the total revenues as contained in Seller's internal monthly management financial results binder titled "HCP-2-DUE DILIGENCE TOTAL", which results binder shall have been prepared in accordance with past practices of Seller, for the due diligence division of Hanover Capital Partners 2, Ltd. for the Relevant Period, including, without limitation, the revenue items listed under "Revenue" on Exhibit A attached hereto.

"SELLER" has the meaning set forth in the preamble to this Agreement.

"SENIOR EXECUTIVE COMPENSATION" shall mean the sum of (a) the salary paid/accrued to George Ostendorf by Seller during the Relevant Period, (b) the auto allowance expenses paid to George Ostendorf by Seller during the Relevant Period, (c) the product of (i) the Fringe Expense Rate and (ii) the salary paid to George Ostendorf by Seller during the Relevant Period, (d) the salary paid/accrued to Joyce Mizerak by Seller during the Relevant Period; (e) the auto allowance expenses paid to Joyce Mizerak by Seller during the Relevant Period, and (f) the product of (i) the Fringe Expense Rate and (ii) the salary paid to Joyce Mizerak by Seller during the Relevant Period, all of which amounts shall have been paid in accordance with past practices of Seller.

"SEPARATION AGREEMENTS" has the meaning set forth in Section 9.7.

"SHARES" has the meaning set forth in Section 4.24.

"SIGNIFICANT CUSTOMER" has the meaning set forth in Section 4.23.

"SOFTWARE PREMIUM" has the meaning set forth in Section 2.2.

"TAX" (and, with correlative meaning, "TAXES," "TAXABLE" and "TAXING") means (i) any federal, state, local or foreign income, gross receipts, franchise, estimated, alternative minimum, add-on minimum, sales (including bulk sales), use, transfer, registration, value added, excise, natural resources, severance, stamp, occupation, premium, windfall profits, environmental (including under Section 59A of the Code), customs, duty, real property, real property gains, personal property, capital stock, social security, unemployment, disability, payroll, license, employee or other withholding or other tax assessment, fees, levy or other governmental charge of any kind whatever, whether disputed or not, including any interest, penalties or additions to tax or additional amounts in respect of the foregoing; (ii) any liability for or in respect of the payment of any amount of a type described in clause (i) of this definition arising as a result of being or having been a member of any Relevant Group and (iii) any liability for or in respect of the payment of any amount of a type described in clauses (i) or (ii) of this definition as a transferee or successor, by contract or otherwise.

"TAX RETURN" means any return, declaration, report, claim for refund, information return or other document (including any related or supporting schedules, statements or information) filed or required to be filed in connection with the determination, assessment or collection of Taxes or the administration of any Legal Requirement relating to any Taxes.

"TAXING AUTHORITY" means any governmental agency, board, bureau, body, department or authority of any United States federal, state or local jurisdiction or any non-United States jurisdiction, having or purporting to exercise jurisdiction with respect to any Tax.

"TRANSACTION DOCUMENTS" means this Agreement, the License Agreement, the Assignment and Assumption Agreement, the Escrow Agreement, the Bill of Sale, the Hanover Noncompetition Agreement and the Transitional Services Agreement.

"TRANSFER TAXES" means sales, bulk sales, use, transfer, real property transfer, filing, recording, stock transfer, stamp, stamp duty reserve, value added, documentary and other similar Taxes.

"TRANSFERRED EMPLOYEE" has the meaning set forth in Section 9.1.

"TRANSITIONAL SERVICES AGREEMENT" has the meaning set forth in Section 7.1.

"TREASURY REGULATIONS" means the regulations promulgated or proposed by the United States Treasury Department under the Code.

"TURNOVER PERIOD" has the meaning set forth in Section 6.2.

"WIP" has the meaning set forth in Section 4.20.

"WIP CONTRACT" has the meaning set forth in Section 6.2.

"WIP CUSTOMER" has the meaning set forth in Section 6.2.

1.2 INTERPRETATION. The terms "hereof," "herein" and "hereunder" and terms of similar import will refer to this Agreement as a whole and not to any particular provision of this Agreement. Section, clause, Exhibit and Schedule references contained in this Agreement are references to Sections, clauses, Exhibits and Schedules in or attached to this Agreement, unless otherwise specified. Each defined term used in this Agreement has a comparable meaning when used in its plural or singular form. Each gender-specific term used in this Agreement has a comparable meaning whether used in a masculine, feminine or gender-neutral form. As used in this Agreement, the terms "knowledge" or "aware" will include the actual knowledge and awareness of the Person in question, and the knowledge and awareness that such Person would have obtained after making reasonable inquiry and exercising reasonable diligence with respect to the matter in question. Each reference in this Agreement to any Legal Requirement will be deemed to include such Legal Requirement as it hereafter may be amended, supplemented or modified from time to time and any successor thereto, unless such treatment would be contrary to the express terms of this Agreement.

ARTICLE II
SALE OF ASSETS

2.1 SALE OF ASSETS AND ASSUMPTION OF LIABILITIES.

(a) Sale of Assets. On the Closing Date, and on the terms and subject to the conditions in this Agreement, Seller shall sell, assign, transfer, deliver, and convey to Buyer and/or its nominees, and Buyer and/or its nominees shall purchase and accept from Seller, all of Seller's right, title, and interest in and to the Assets, in each case free and clear of any Lien (other than Permitted Liens) and restrictions on transfer.

(b) Assumption of Liabilities. On the Closing Date, and on the terms and subject to the conditions in this Agreement, Buyer and/or its nominees shall assume and agree to pay, perform, fulfill, and discharge, as or when due from and after the Closing Date, the Assumed Liabilities. The Buyer will not assume or have any responsibility with respect to any Liability not expressly included in the definition of Assumed Liabilities.

(c) Assumption of Assumed Contracts. On the Closing Date, and on the terms and subject to the conditions in this Agreement and the Assignment and Assumption Agreement, Buyer and/or its nominees shall assume and agree to perform all of the duties, obligations, terms, provisions and covenants, and to pay and discharge all of the liabilities of Seller to be observed, performed, paid or discharged from and after the Closing, in connection with the Contracts set forth on Schedule 2.1(c) (the "ASSUMED CONTRACTS"). Notwithstanding the immediately preceding sentence or any other provision of this Agreement, this Section 2.1(c) shall not constitute an assignment to Buyer of any Contract set forth on Schedule 2.1(c), and the defined term "ASSUMED CONTRACTS" shall not include any Contract set forth on Schedule 2.1(c) for purposes of this Agreement, if an assignment of a Contract set forth on Schedule 2.1(c) requires the Consent of the other party thereto and such Consent has not been obtained as of the Closing Date or an attempted assignment of the same without the Consent of the other party thereto would constitute a breach thereof or in any way impair the rights of Seller thereunder; provided, that if any such Consent is obtained after the date hereof with respect to any such Contract, this instrument shall constitute an assignment of the same to Buyer as of the date of such consent without further action by Seller or Buyer.

2.2 CONSIDERATION. The consideration for the Assets and the Assumed Liabilites (the "PURCHASE PRICE") shall consist of (a) the Estimated Net Equity Amount (as defined in Section 2.4(a)), which shall be subject to adjustment as set forth in Section 2.4, (b) $750,000 (the "SOFTWARE PREMIUM"), which amount represents a premium for certain software being purchased by Buyer pursuant to this Agreement, and (c) the Additional Purchase Price. At the Closing, Buyer shall deliver to (a) Seller the Estimated Net Equity Amount, the Software Premium and the sum of $725,000 (the "FIRST ADDITIONAL PURCHASE PRICE PAYMENT") by wire transfer to an account designated by Seller and (b) the Escrow Agent the sum of $125,000 (the "ESCROW AMOUNT"). The Escrow Amount shall be paid in accordance with Section 2.3.

2.3 ADDITIONAL PURCHASE PRICE. On or before March 31, 2007, Seller shall prepare or cause to be prepared, and shall submit to Buyer, a calculation of the Adjusted Income. If the Adjusted Income of Seller is at least equal to or greater than $202,962, the "ADDITIONAL PURCHASE PRICE" shall equal $850,000. If the Adjusted Income of Seller is less than $202,962, the "ADDITIONAL PURCHASE PRICE" shall equal (a) $850,000, less (b) the product obtained by multiplying (i) two, by (ii) the amount by which $202,962 exceeds the Adjusted Income of Seller. Within 10 days of such calculation becoming final and binding on the parties hereto pursuant to Section 2.6, (a) if the Additional Purchase Price is greater than the First Additional Purchase Price Payment, Buyer and Seller shall direct the Escrow Agent to pay to Seller the difference between the Additional Purchase Price and the First Additional Purchase Price Payment and any remainder in the Escrow Account shall be paid to Buyer or (b) if the Additional Purchase Price is less than the First Additional Purchase Price Payment, Buyer and Seller shall direct the Escrow Agent to pay to Buyer the Escrow Amount and Seller shall pay to Buyer the difference between the First Additional Purchase Price Payment and the Additional Purchase Price.

2.4 ADJUSTMENT TO PURCHASE PRICE.

(a) The Purchase Price shall be adjusted based on the Seller's Net Equity Amount in accordance with this Section 2.4. For purposes of this Article II, the "NET EQUITY AMOUNT" shall be equal to the Assets minus Assumed Liabilities due and payable to unaffiliated third parties as of the Closing Date, each determined utilizing principles that are consistent with past practices of Seller. Three days prior to the expected Closing Date, Seller shall provide Buyer with a good faith estimate of the Closing Date Schedule, included as Schedule 2.4(a) (the "ESTIMATED CLOSING DATE SCHEDULE"), and the estimated calculation of the Net Equity Amount (the "ESTIMATED NET EQUITY AMOUNT").

(b) As promptly as practicable, but no later than sixty (60) days after the Closing Date, Seller shall prepare and deliver to Buyer a schedule of the Assets and the Assumed Liabilities of Seller as of the close of business on the Closing Date (the

"CLOSING DATE SCHEDULE") prepared utilizing principles that are consistent with past practices by Seller and a calculation of the Net Equity Amount as of the Closing Date. During the thirty (30) days immediately following receipt of the Closing Date Schedule by Buyer, and upon reasonable prior written notice and during normal business hours, Buyer and its representatives will be permitted to review at the location of the Business all books and records of Seller relating to Seller's preparation of the Closing Date Schedule.

(c) Buyer shall notify Seller in writing (the "NOTICE OF NET EQUITY DISAGREEMENT") within thirty (30) days after receiving the Closing Date Schedule and calculation of the Net Equity Amount if it disagrees with the Net Equity Amount. Such Notice of Net Equity Disagreement shall set forth in reasonable detail the basis for such dispute and the amounts involved and Buyer's good faith calculation of what the Net Equity Amount should be. If Buyer accepts the Net Equity Amount within such thirty (30) day period, or if Buyer does not deliver a Notice of Net Equity Disagreement to Seller within such thirty (30) day period, then the Net Equity Amount set forth in the Closing Date Schedule shall be deemed to have been accepted, shall become final and binding upon the Parties, and shall be the "FINAL NET EQUITY AMOUNT."

(d) During the thirty (30) days immediately following the delivery of a Notice of Net Equity Disagreement, Seller and Buyer shall seek in good faith to resolve any differences that they may have specified in the Notice of Net Equity Disagreement. If at the end of such thirty (30) day period Seller and Buyer have been unable to agree upon a Final Net Equity Amount, then Seller and Buyer shall submit to an independent accounting firm of national recognition mutually acceptable to Seller and Buyer (the "INDEPENDENT ACCOUNTING FIRM") for review and resolution of any and all matters that remain in dispute with respect to the Notice of Net Equity Disagreement. Buyer and Seller shall cause the Independent Accounting Firm to use commercially practicable efforts to make, within sixty (60) days from such submission, a final determination (which determination shall be binding on the Parties absent manifest error) as to what the Net Equity Amount should be, and such final determination shall be the Final Net Equity Amount. The cost of the Independent Accounting Firm's review and determination shall be paid one-half by Seller and one-half by Buyer. During the sixty (60) day review by the Independent Accounting Firm, Buyer and Seller will each make available to the Independent Accounting Firm interviews with such individuals and such information, books and records as may be reasonably required by the Independent Accounting Firm to make its final determination.

(e) In the event that the Final Net Equity Amount is less than the Estimated Net Equity Amount, then Seller shall, within three (3) Business Days of the determination of the Final Net Equity Amount, pay to Buyer the amount of the difference between the Estimated Net Equity Amount and the Final Net Equity Amount in accordance with written instructions received from Buyer. In the event that the Final Net Equity Amount is greater than the Estimated Net Equity Amount, then Buyer shall, within three (3) Business Days of the determination of the Final Net Equity Amount, pay to Seller the amount of the difference between the Final Net Equity Amount and the

Estimated Net Equity Amount in accordance with written instructions received from Seller.

(f) All amounts payable pursuant to this Section 2.4 by Seller to Buyer shall be treated as an adjustment to the Purchase Price.

2.5 ALLOCATION OF PURCHASE PRICE. The portion of the Purchase Price paid in exchange for the Assets pursuant to Section 2.2, together with the allocable portion of the Assumed Liabilities and any other relevant items, shall be allocated among the Assets, the License Agreement or the Noncompetition Agreements, as the case may be (such allocations, the "PURCHASE PRICE ALLOCATIONS"). As promptly as practicable after the Closing Date, Buyer shall prepare or cause to be prepared, and shall submit to Seller, a draft version of the Purchase Price Allocations, which shall be reasonable and determined in accordance with Section 1060 of the Code and the applicable Treasury regulations thereunder. Buyer and Seller shall report the Tax consequences of the transactions contemplated by this Agreement in a manner consistent with the Purchase Price Allocations and shall not take any action or position that is inconsistent therewith. Buyer and Seller shall mutually agree upon and shall mutually prepare and file in accordance with applicable Treasury regulations and in accordance with the Purchase Price Allocations Internal Revenue Service Form 8594 with respect to the acquisition by Buyer of the Assets.

2.6 CERTAIN DISPUTES. If Buyer or Seller disputes any item in the calculation of Adjusted Income, the Additional Purchase Price or the Purchase Price Allocations, the Party disputing such item shall notify the other Party, in writing, of each disputed item and specify the amount thereof in dispute within five Business Days after delivery to the disputing Party of the applicable determination by the other Party. In the absence of fraud, the determination of each of the Adjusted Income, Additional Purchase Price and the Purchase Price Allocations shall become final and binding upon the Parties if no dispute relating thereto shall have been asserted within such five Business Day period. If Buyer and Seller cannot resolve any such dispute within five Business Days after delivery of such notice of dispute, then upon demand of either party, such dispute will be resolved by the Independent Accounting Firm mutually acceptable to Buyer and Seller as determined pursuant to Section 2.4(d).

ARTICLE III
CLOSING

3.1 CLOSING. The closing of the purchase and sale of the Assets and the assumption of the Assumed Liabilities pursuant to this Agreement (the "CLOSING") will occur at the offices of Klehr, Harrison, Harvey, Branzburg & Ellers LLP, 260 South Broad Street, Philadelphia, PA 19102 at 10:00 a.m. on January 12, 2007 (the "CLOSING DATE")

3.2 CLOSING TRANSACTIONS. At the Closing:

(a) Buyer will deliver to Seller the Estimated Net Equity Amount, the Software Premium and the First Additional Purchase Price Payment by wire transfer to an account designated by Seller;

(b) Buyer will deliver the Escrow Amount to the Escrow Agent;

(c) Seller shall deliver or cause to be delivered to Buyer (except to the extent waived by Buyer in writing) the items set forth in Section 7.1; and

(d) Buyer shall deliver or cause to be delivered to Seller and the Company (except to the extent waived by Seller in writing) the items set forth in Section 7.2.

ARTICLE IV
REPRESENTATIONS AND WARRANTIES OF SELLER AND THE COMPANY

As a material inducement to Buyer to enter into this Agreement, Seller and the Company jointly and severally represent and warrant to Buyer as set forth below:

4.1 ORGANIZATION AND POWER. Except as set forth on the attached Schedule 4.1, each of Seller and the Company is a corporation, validly existing and in good standing (or having comparable active status) under the laws of its jurisdiction of incorporation and is qualified to do business in every jurisdiction in which the nature of its business or its ownership of property requires it to be qualified, except where the failure to be so qualified would not have a Material Adverse Effect. Each of Seller and the Company has the full power necessary to own and operate its properties and carry on the Business as now conducted.

4.2 AUTHORIZATION OF TRANSACTIONS. Each of Seller and the Company has full power and authority to execute and deliver this Agreement and all other Transaction Documents to which it is a party and to perform its obligations hereunder and thereunder. Each of Seller and the Company has duly approved this Agreement and all other Transaction Documents to which it is a party and has duly authorized its execution and delivery of this Agreement and such Transaction Documents and the performance of its obligations hereunder and thereunder. No other proceeding or action on the part of Seller or the Company or any of their shareholders is necessary to approve and authorize Seller's or the Company's execution and delivery of this Agreement or any other Transaction Document to which Seller or the Company is a party or the performance of their obligations hereunder or thereunder. This Agreement constitutes, and each of the other Transaction Documents to which Seller and the Company is a party will when executed constitute, a valid and binding obligation of Seller and the Company, enforceable in accordance with its terms, except as enforceability hereof may be limited by bankruptcy, insolvency or other laws affecting creditor's rights generally and limitations on the availability of equitable remedies.

4.3 SUBSIDIARIES; INVESTMENTS. The Assets do not include any shares of capital stock or any other security, interest or investment in, or loan to (other than extensions of trade credit in the Ordinary Course), any other Person or any right which is exercisable or exchangeable for or convertible into any capital stock or other security, interest or investment in any other Person.

4.4 ABSENCE OF CONFLICTS. Except as set forth on the attached Schedule 4.4, neither the execution, delivery and performance of this Agreement or any other Transaction Document by Seller or the Company nor the consummation by Seller or the Company of the transactions contemplated hereby or thereby:

(a) does or will (i) conflict with or result in any breach of any of the provisions of, (ii) constitute a default under, (iii) result in a violation of, (iv) give any third party the right to terminate or to accelerate any obligation under or (v) result in the creation of any Lien upon any Assets, in each case under the provisions of the articles or certificate of incorporation, bylaws or similar organizational document of Seller or the Company or any indenture, mortgage, lease, loan agreement or other agreement, instrument or Contract or any Legal Requirement by which Seller or the Company or any Asset is affected, or to which Seller or the Company or any Assets is subject, except where the violation, breach, default, termination, acceleration or lien would not have a Material Adverse Effect, or

(b) without limiting clause (a) above, requires any Consent of any Governmental Entity or any other Person, except where the failure to obtain Consent would not have a Material Adverse Effect.

4.5 FINANCIAL STATEMENTS. Seller has delivered to Buyer (i) audited consolidated financial statements (balance sheet, statement of operations and statement of cash flows) for the Company for the period from incorporation through December 31, 2005 and (ii) Seller's unaudited financial schedules from Seller's monthly financial book (balance sheet and statement of operations) for the eleven (1) month period from January 1, 2006 through November 30, 2006 (collectively, the "FINANCIAL STATEMENTS"). The Financial Statements are complete and correct in all material respects. The Company's Financial Statements only have been prepared in accordance with GAAP applied on a consistent basis throughout the periods indicated with each other. The Financial Statements of Seller fairly present the assets and liabilities of Seller as of the date thereof and fairly and accurately present the financial condition and operating results of Seller as of the dates, and for the periods, indicated therein. All of Seller's transactions are fairly and accurately presented in the Financial Statements.

4.6 CERTAIN DEVELOPMENTS. Except as set forth on Schedule 4.6, during the period beginning on January 1, 2006 and ending on the Closing Date, Seller has not:

(a) suffered any theft, damage, destruction or casualty loss to any Asset or any portion of the Assets, or any substantial destruction of its books and records (in each case whether or not covered by insurance);

(b) sold, leased, assigned or transferred any Asset or any portion of the Assets (other than dispositions of obsolete or worn-out Assets disposed of in the Ordinary Course, dispositions of Assets which have been replaced with Assets of equal or greater value and utility and dispositions of non-material amounts of Assets in the Ordinary Course);

(c) waived any right of material value under the Assumed Contracts or relating to the Business, the Assets or the Assumed Liabilities;

(d) accelerated, terminated, modified, or cancelled any Assumed Contract or other agreement, contract, lease, or license (or series of related agreements, contracts, leases, and licenses) relating to the Business, the Assets or the Assumed Liabilities involving more than $10,000 (individually or in the aggregate);

(e) imposed any Lien upon any of the Assets, tangible or intangible (other than a Permitted Lien or any Lien for which Seller has delivered to Buyer an executed authorization for Buyer (or its lenders) to file all appropriate UCC termination statements);

(f) made any capital expenditure (or series of related capital expenditures) relating to the Business, the Assets or the Assumed Liabilities either involving more than $25,000 or outside the Ordinary Course;

(g) made any capital investment in, any loan to, or any acquisition of the securities or assets of, any other Person (or series of related capital investments, loans, and acquisitions) relating to the Business, the Assets or the Assumed Liabilities, other than transactions with any Affiliate;

(h) issued any note, bond, or other debt security or created, incurred, assumed, or guaranteed any indebtedness for borrowed money or capitalized lease obligation relating to the Business, the Assets or the Assumed Liabilities;

(i) delayed or postponed the payment of accounts payable or other Liabilities relating to the Business, the Assets or the Assumed Liabilities outside the Ordinary Course;

(j) entered into any employment contract or collective bargaining agreement relating to the Business or the Assets, written or oral, or modified the terms of any existing such contract or agreement;

(k) adopted, amended, modified, or terminated any bonus, profit sharing, incentive, severance, or other plan, contract, or commitment for the benefit of any of its directors, officers, employees or consultants engaged in any respect in the Business (or taken any such action with respect to any other Benefit Plan);

(l) made any Tax election, adopted or changed any accounting method for Tax purposes, filed any amended Tax Return, consented to or entered into any closing agreement or similar agreement with any Taxing Authority, consented to or settled or compromised any Tax claim or assessment or taken any position inconsistent with any past practice on any Tax Return;

(m) entered into any other transaction relating to the Business, the Assets or the Assumed Liabilities other than in the Ordinary Course, or materially changed any material business practice relating to the Business;

(n) made or granted any bonus or any wage, salary or compensation increase in excess of $5,000 per year to any employee or independent contractor engaged in any respect in the Business, except as described on the attached Schedule 4.8(a); or

(o) agreed or committed to do any of the foregoing.

4.7 TAX MATTERS. Except as set forth on Schedule 4.7:

(a) Seller has duly and timely filed all Tax Returns that it was required to file. All such Tax Returns are true, complete and correct. All Taxes owed by Seller (whether or not shown on any Tax Return) have been paid. Seller is not the beneficiary of any extension of time within which to file any Tax Return. No claim has ever been made by a Taxing Authority in a jurisdiction where Seller does not file Tax Returns that it is or may be subject to taxation by that jurisdiction. There are no Liens on any of the assets of Seller that arose in connection with any failure (or alleged failure) to pay any Tax. No power of attorney with respect to any Taxes has been executed or filed with any Taxing Authority with respect to Seller.

(b) Seller has withheld and paid all Taxes required to have been withheld and paid in connection with amounts paid or owing to any employee, former employee, partner, independent contractor, creditor, stockholder, affiliate, customer, supplier or other third party.

(c) There is no dispute or claim concerning any Tax Liability of Seller (i) claimed or raised by any Taxing Authority in writing or (ii) otherwise to Seller's knowledge (including, for this purpose, to the knowledge of any employee responsible for Tax matters). Schedule 4.7 lists all United States federal, state, local and non-United States income Tax Returns filed by or with respect to Seller for any taxable period ended on or after January 1, 2000, indicates those Tax Returns that have been audited and indicates those Tax Returns that currently are the subject of audit. Seller has delivered or made available to Buyer correct and complete copies of all material Tax Returns filed by, and all examination reports and statements of deficiencies assessed against or agreed to by, Seller since January 1, 2000.

(d) There are no outstanding requests, agreements, consents or waivers to extend the statutory period of limitation applicable to the assessment of any Taxes against Seller.

4.8 CONTRACTS AND COMMITMENTS.

(a) Generally. Except for the Transaction Documents or Contracts described on Schedule 4.8(a), Seller is not a party to or bound by, and neither Seller nor any Asset is subject to, any Contract relating to the Business, the Assets or the Assumed Liabilities including any:

(i) collective bargaining agreement or contract with any labor union or any bonus, pension, profit sharing, retirement or any other form of deferred compensation plan or any hospitalization insurance or similar plan or practice;

(ii) (A) contract for the employment or engagement of any individual employee or other Person (including as an independent contractor, part-time laborer or on a consulting basis) other than at the will of the employing Person, (B) any agreement to provide severance or similar benefits upon any termination of employment or other engagement, or (C) any contract with any labor agency for the employment of seasonal or part-time labor;

(iii) agreement, indenture or other Contract placing a Lien (other than a Permitted Lien or any Lien for which Seller has delivered to Buyer an executed authorization for Buyer (or its lenders) to file appropriate UCC termination statements) on any Asset;

(iv) agreement with respect to the lending or investing of funds by Seller;

(v) guaranty of any obligation of any other Person, other than endorsements made for collection made in the Ordinary Course;

(vi) sales representation agreement;

(vii) agreement (or group of related agreements) for the purchase or sale of raw materials, commodities, supplies, products, or other personal property, or for the furnishing or receipt of services, the performance of which will (A) extend over a period of more than one year, (B) result in a material loss to Seller, or (C) involve consideration in excess of $5,000;

(viii) agreement concerning confidentiality or noncompetition, outside the Ordinary Course;

(ix) agreement involving any of the stockholders of Seller or any Affiliate of Seller;

(x) profit sharing, stock option, stock purchase, stock appreciation, deferred compensation, severance, or other plan or arrangement for the benefit of its current or former directors, officers, and employees;

(xi) currently outstanding agreement under which it has advanced or loaned any amount to any of its directors, officers, and employees outside the Ordinary Course;

(xii) lease or agreement under which Seller is lessee of, or holds or operates, any personal property owned by any other party calling for payments in excess of $10,000 annually or entered into outside of the Ordinary Course, or under which Seller holds or occupies any real property or interest therein;

(xiii) lease or agreement under which Seller is lessor of or permits any third party to hold or operate any property, real or personal, owned or controlled by it;

(xiv) agreement, contract or understanding pursuant to which Seller subcontracts work to a third party, other than agreements with independent contractors pursuant to which such contractors perform services related to the Business; or

(xv) any other agreement material to the Business.

(b) Absence of Breach, etc. Each of the items which is described or required to be described on Schedule 4.8(a) and which is to be assigned to or assumed by Buyer under this Agreement is in full force and effect in all material respects and will be in full force and effect in all material respects immediately following the Closing Date; no item which is described or required to be described on Schedule 4.8(a) and which is to be assigned to or assumed by Buyer under this Agreement has been breached in any material respect, canceled or repudiated by Seller or (to Seller's knowledge) by any other party thereto; no such other party has indicated in writing or orally to Seller that it will stop or decrease the rate of business done with Seller, or that it desires to renegotiate its arrangements with Seller; Seller has performed in all material respects all obligations required to be performed by it in connection with the items which are described or required to be described on Schedule 4.8(a) and which are to be assigned to or assumed by Buyer under this Agreement and is not in receipt of any claim of default under any such item; and Seller has no present expectation or intention of not fully performing any obligation pursuant to any item which is described or required to be described on Schedule 4.8(a) and which is to be assigned to or assumed by Buyer under this Agreement.

(c) Copies. Seller has furnished to Buyer a true and correct copy or representative form of all written contracts and other items which are described or required to be described on Schedule 4.8(a) which are to be assigned to or assumed by Buyer under this Agreement, in each case together with all material written amendments, waivers or other changes thereto.

4.9 PROPRIETARY RIGHTS.

(a) Generally. Schedule 4.9(a) sets forth a complete and correct list of: (i) all registered Proprietary Rights and all pending applications for registration of Proprietary Rights owned, filed or used by Seller that relate to the Assets or the Assumed Liabilities, and (ii) all other licenses or similar agreements or arrangements to which Seller is a party either as licensee or licensor for the Proprietary Rights that relate to the Assets or the Assumed Liabilities.

(b) Ownership; Infringement. Except as set forth on Schedule 4.9(b), (i) taken together, Seller owns and possesses all right, title and interest in and to, or has a valid and enforceable right to use its registered Proprietary Rights described or required to be described on Schedule 4.9(a), free and clear of all Liens (other than Permitted Liens), and no claim by any third party contesting the validity, enforceability, use or ownership of any of the foregoing has been made, is currently outstanding or, to Seller's knowledge, is threatened, (ii) no loss or expiration of any material Proprietary Right of any such type or material group of such Proprietary Rights is pending or, to Seller's knowledge, threatened, (iii) Seller has not received any notice of, nor is Seller aware of any fact which indicate a likelihood of any infringement or misappropriation by, or any conflict with, any third party with respect to any such Proprietary Right, including any demand or request that Seller license rights from a third party, and (iv) Seller has not infringed, misappropriated or otherwise conflicted with any rights of any third party and Seller is not aware of any infringement, misappropriation or conflict which will occur as a result of the continued operation of the Business as currently conducted or as proposed to be conducted by Seller.

(c) Protective Measures. The Seller has no actual knowledge that the owners of the Proprietary Rights licensed to Seller have not taken all reasonably necessary and desirable actions to maintain and protect such Proprietary Rights.

4.10 LITIGATION; PROCEEDINGS. There are no actions, suits, proceedings, orders, judgments, decrees or investigations pending (or, to Seller's knowledge, threatened) against or affecting the Business, the Assets, the Assumed Liabilities or the transactions contemplated by this Agreement, at law or in equity, or before or by any Governmental Entity, except where such action, suit, proceeding, order, judgment, decree or investigation would not have a Material Adverse Effect. Seller reasonably believes there is no basis for any of the foregoing actions, suits, proceedings, orders, judgments, decrees or investigations.

4.11 BROKERAGE. Except as set forth on the attached Schedule 4.11, there are no claims for brokerage commissions, finders' fees or similar compensation in connection with the transactions contemplated by this Agreement and the Transaction Documents based on any arrangement or agreement made by or on behalf of Seller. Seller and the Company hereby acknowledge and agree that Buyer shall have no obligation with respect to the brokerage commissions set forth on the attached Schedule 4.11.

4.12 GOVERNMENTAL LICENSES AND PERMITS. The attached Schedule 4.12 sets forth a complete listing and summary description of all Licenses owned, possessed or used by Seller relating to the Business, the Assets or the Assumed Liabilities. Taken together, Seller owns or possesses all right, title and interest in and to all of the Licenses which are necessary or material to conduct the Business as currently conducted by Seller. Except with respect to a loss or expiration that would not have a Material Adverse Effect, no loss or expiration of any License is pending, reasonably foreseeable or, to Seller's knowledge, threatened (including as a result of the transactions contemplated by this Agreement and the Transaction Documents) other than by reason of expiration in accordance with the terms thereof.

4.13 EMPLOYEES; INDEPENDENT CONTRACTORS. To Seller's knowledge as of the date of this Agreement, no executive employee and no group of employees or independent contractors of Seller engaged in any respect in the conduct of the Business has any plans to terminate his, her or its employment or relationship as an independent contractor with Seller. Seller has materially complied with all applicable Legal Requirements relating to the employment of personnel and labor, including provisions thereof relating to wages, hours, equal opportunity, collective bargaining and the payment of social security and other Taxes, including withholding requirements. Seller has not experienced any strike, grievance, unfair labor practice claim or other material employee or labor dispute, and Seller has not engaged in any unfair labor practice. To Seller's knowledge, there is no organizational effort presently being made or threatened by or on behalf of any labor union with respect to employees of Seller. Seller has in all material respects satisfied any notice or bargaining obligation it may have under any law or collective bargaining agreement to any employee representative. The attached Schedule 4.13(a) sets forth the name, start date, title or position, and the annual or, as the case may be, hourly rate of compensation (including salary, bonuses and commissions), as of the date of this Agreement for each individual engaged by Seller as an employee or independent contractor engaged in any respect in the conduct of the Business whose annual income (of all types) from Seller, has exceeded or is expected to exceed $50,000. The attached Schedule 4.13(b) sets forth the name for each person that is a contractor of Seller (the "CONTRACTORS"). All of the Contractors are retained pursuant to agreements that specify that their employment is limited to the duration of a project or undertaking as described in 20 CFR Section 639.5(c). Except as set forth on Schedule 4.13(c), to Seller's and the Company's knowledge as of the date of this Agreement, no employee, former employee, independent contractor, director or officer of Seller or the Company has any plans to, directly or indirectly (a) start, own, operate, lease, manage, control, participate in, consult with, advise, provide services to or in any manner engage in any business (including by itself or in association with any person, firm, corporate or other business organization or through any other entity) that distributes any product or provides any service that is distributed or provided by, or otherwise competes with any product or service of, the business carried out with respect to the Assets and (b) (i) induce or attempt to induce any employee, consultant or contractor of Buyer to leave the employ of Buyer, or in any way interfere with the relationship between Buyer and any employee thereof, (ii) hire any person who was an employee, consultant or contractor of Seller during the six (6) months prior to the date hereof or (iii) induce or attempt to induce any customer, supplier, distributor, franchisee, licensee or other business relation of Buyer not to do, or to cease doing, business with Buyer, or in any way interfere with the relationship between any such customer, supplier, distributor, franchisee, licensee or business relation and Buyer.

4.14 ERISA.

(a) Schedule 4.14 sets forth an accurate and complete list of each Benefit Plan at any time maintained, sponsored, or contributed to by Seller or with respect to which Seller has any Liability (each a "PLAN" and collectively the "PLANS").

(b) No asset of Seller is subject to any lien under ERISA or the Code. There are no pending or threatened actions, suits, investigations or claims with respect to any Plan (other than routine claims for benefits).

(c) Each Plan that is intended to be qualified under Code Section 401(a) has received a determination from the Internal Revenue Service ("IRS") that such Plan is so qualified, and nothing has occurred since the date of such determination that could adversely affect the qualified status of such Plan.

(d) Each of the Plans and all related trusts, insurance contracts and funds have been maintained, funded and administered in compliance with their terms and in compliance with the applicable provisions of ERISA, the Code, and any other applicable laws. With respect to each Plan, all required payments, premiums, contributions, distributions, or reimbursements for all periods ending prior to or as of the Closing Date have been made or properly accrued.

(e) Neither Seller nor any other "disqualified person" (within the meaning of Code Section 4975) or any "party in interest" (within the meaning of ERISA Section 3(14)) has engaged in any "prohibited transaction" (within the meaning of Code Section 4975 or ERISA Section 406) with respect to any of the Plans which could subject any of the Plans, Buyer, or any officer, director or employee of any of the foregoing to a penalty or tax under ERISA Section 502(i) or Code Section 4975.

(f) Each Plan which is subject to the health care continuation requirements of Part 6 of Subtitle B of Title I of ERISA or Code Section 4980B ("COBRA") has been administered in material compliance with such requirements. No Plan provides medical or life or other welfare benefits to any current or future retired or terminated employee (or any dependent thereof) of Seller other than as required pursuant to COBRA.

(g) With respect to each Plan, Seller has provided Buyer with true, complete and correct copies of (to the extent applicable) the summary plan descriptions.

4.15 AFFILIATE TRANSACTIONS. Other than as described on the attached Schedule 4.15, no Insider (i) is a party to any agreement, contract, commitment or transaction relating to the Business, the Assets or the Assumed Liabilities (other than in such Insider's capacity as an employee of Seller, the compensation or consideration for which is reflected on Schedule 4.15), or (ii) has any interest in any Asset, other than indirectly, as a stockholder of Seller.

4.16 COMPLIANCE WITH LAWS. Except as set forth on Schedule 4.16, Seller and each of its independent contractors, agents and employees has materially complied with and is in material compliance with all applicable Legal Requirements which affect the Business or any Assets and to which the Business or any Asset is subject, and no claim has been filed against Seller alleging a violation of any such Legal Requirement. Except as set forth on Schedule 4.16, Seller is not now subject (nor has Seller been subject) to any investigation, penalty assessment, or audit by any Governmental Entity or to any other allegation that Seller (including any agent, representative or broker acting on behalf of Seller) has violated the regulations of any such Governmental Entity or made a material false statement or omission to any Governmental Entity.

4.17 ENVIRONMENTAL MATTERS.

(a) Seller has obtained, and is in compliance with, all Consents, if any, required by any Legal Requirement relating to the protection of human health and the environment ("ENVIRONMENTAL LAWS"). All such Consents are valid and in full force and effect and none of such Consents will be terminated or impaired or become terminable as a result of the transactions contemplated by this Agreement or the Transaction Documents. Seller has been, and is currently, in compliance with all Environmental Laws. Seller has not received notice alleging that Seller is not in such compliance with Environmental Laws.

(b) There are no past, pending or, to Seller's knowledge, threatened actions against or affecting Seller under any Environmental Law, and Seller has no knowledge of any facts or circumstances which could reasonably be expected to form the basis for any such action against Seller.

(c) Seller has not entered into or agreed to any order, and Seller is not subject to any order, relating to compliance with any Environmental Law or to investigation or cleanup of a hazardous substance under any Environmental Law.

4.18 ASSETS.

(a) Seller owns or leases all of the Assets and has good and marketable title to all such Assets free and clear of any Liens (other than Permitted Liens) or restriction on transfer. The Company has no security interest in the Assets.

(b) The Assets comprise all of the properties and assets necessary for the conduct of the Business as presently conducted by Seller. Each such Asset is in good operating condition and repair (reasonable wear and tear excepted) and is suitable for the purposes for which it is presently used and presently proposed to be used, except as otherwise set forth on Schedule 4.18.

4.19 LIABILITIES. Upon consummation of the transactions contemplated by this Agreement, Buyer will not acquire, assume, succeed to or incur any Liability relating to the Business, Seller or the Assets except for the Assumed Liabilities and Assumed Contracts.

4.20 WORK IN PROCESS. All work in process of Seller (the "WIP") with respect to the WIP Customers and the dollar amount billable by Seller with respect thereto is reflected properly on its books and records and is set forth on Schedule 4.20. The WIP represents work that has been started, and not completed or billed by Seller. As of the Closing Date, the WIP is valid and billable and is not subject to setoffs or counterclaims against Seller, and, assuming the project related thereto is properly completed by Buyer pursuant to the terms and conditions of the contracts related thereto, would, when properly billed by Buyer, constitute valid receivables of Buyer.

4.21 INSURANCE. Schedule 4.21 sets forth the following information with respect to each insurance policy (including policies providing property, casualty, liability, and workers' compensation coverage and bond and surety arrangements) to which Seller is a party, a named insured, or otherwise the beneficiary of coverage, relating to the Business, the Assets or the Assumed Liabilities:

(a) the name, address, and telephone number of the agent;

(b) the name of the insurer, the name of the policyholder, and the name of each covered insured;

(c) the policy number and the period of coverage;

(d) the scope (including an indication of whether the coverage was on a claims made, occurrence, or other basis) and amount (including a description of how deductibles and ceilings are calculated and operate) of coverage; and

(e) a description of any retroactive premium adjustments or other loss-sharing arrangements.

With respect to each such insurance policy: (A) the policy is legal, valid, binding, enforceable, will be in full force and effect until the date of Closing, at which time Seller may cancel each such insurance policy unless Buyer elects to continue such coverage; (B) neither Seller nor any other party to the policy is in material breach or default (including with respect to the payment of premiums or the giving of notices), and no event has occurred which, with notice or the lapse of time, would constitute such a breach or default, or permit termination, modification, or acceleration, under the policy; and (C) no party to the policy has repudiated any provision thereof. Except for professional liability insurance, which Seller has not maintained for the entire five (5) years, Seller (or its predecessor) has been covered during the past five years by insurance in scope and amount customary and reasonable for the Business during the aforementioned period. Schedule 4.21 describes any self-insurance arrangements affecting Seller.

4.22 REAL PROPERTY.

(a) Owned Properties. Seller does not own any Real Property.

(b) Leased Properties. Schedule 4.22(b) contains a true and complete list of all of the Real Property used or useful in the Business and describes all of the Leases relating thereto (including the date and name of the parties to such Lease document and the address of such Leased Real Property). Seller has delivered to Buyer a true and complete copy of each such Lease document. Except as set forth on Schedule 4.22(b), and except for matters that would not have a Material Adverse Effect, with respect to each of the Leases:

(i) such Lease is legal, valid, binding, enforceable and in full force and effect;

(ii) the transactions contemplated by this Agreement and the Transaction Documents do not require the consent of any other party to such Lease, will not result in a breach of or default under such Lease, and will not otherwise cause such Lease to cease to be legal, valid, binding, enforceable and in full force and effect on identical terms following the Closing;

(iii) Seller's possession and quiet enjoyment of the Leased Real Property under such Lease has not been disturbed and there are no disputes with respect to such Lease;

(iv) neither Seller nor any other party to any Lease is in material breach or default under such Lease, and no event has occurred or circumstance exists which, with the delivery of notice, the passage of time or both, would constitute such a breach or default, or permit the termination, modification or acceleration of rent under such Lease;

(v) no security deposit or portion thereof deposited with respect to such Lease has been applied in respect of a breach or default under such Lease which has not been redeposited in full;

(vi) the other party to such Lease is not an Affiliate of, and otherwise does not have any economic interest in, Seller;

(vii) Seller has not subleased, licensed or otherwise granted any Person the right to use or occupy such Leased Real Property or any portion thereof;

(viii) Seller has not collaterally assigned or granted any other security interest in such Lease or any interest therein;

(ix) there are no liens or encumbrances on the estate or interest created by such Lease; and

(x) Seller has not agreed or committed to do any of the foregoing, as applicable.

(c) No Proceedings. There is no condemnation, expropriation or other proceeding in eminent domain or any similar proceeding pending, or (to Seller's knowledge) threatened, affecting Seller's interest in any Real Property. There exists no writ, injunction, decree, order or judgment outstanding, nor any litigation, pending, or (to Seller's knowledge) threatened, relating to the ownership, lease, use, occupancy or operation by Seller of any Real Property.

(d) Current Use. Except as set forth on Schedule 4.22(d): (i) the current use by Seller of the Real Property does not violate in any material respect any Legal Requirement, instrument of record or agreement affecting any Real Property, and (ii) there is no violation in any material respect of any applicable covenant, condition, restriction, easement or agreement.

4.23 CUSTOMERS. Schedule 4.23 lists the customers who, in the 11 months ended November 30, 2006, were the fifteen (15) largest customers, as measured by gross revenue, of Seller (each, a "SIGNIFICANT CUSTOMER"). Except as set forth on Schedule 4.23, with respect to any Significant Customer, Seller does not intend to (i) terminate its relationship or any Contract between such Significant Customer and Seller, (ii) stop, or materially decrease the rate of providing services (in each case, as measured against Seller's historical rate of providing services since January 1, 2005, or such shorter period of time Seller has been providing services to such Significant Customer) to such Significant Customer, or (iii) seek the exercise of any remedy against any such Significant Customer. Except as set forth on Schedule 4.23, Seller has no knowledge of any intent on the part of a Significant Customer to (i) terminate its relationship or any Contract between such Significant Customer and Seller, (ii) stop, or materially decrease the rate of purchasing services (in each case, as measured against such Significant Customer's historical rate of purchasing services since January 1, 2005, or such shorter period of time such Significant Customer has been purchasing services from Seller) from Seller, (iii) refuse to pay any amount due from such Significant Customer to Seller (other than non-material, bona fide disputes), or (iv) seek the exercise of any remedy against Seller. Seller has not, since January 1, 2006, been engaged in any material dispute with any Significant Customer.

4.24 CAPITALIZATION OF SELLER. The Company is the record and beneficial owners of all of the issued and outstanding shares of common and preferred stock of Seller (the "SHARES"), free and clear of any Liens. There are no restrictions upon the voting of any of the Shares pursuant to any agreement or other instrument to which the Company or Seller is a party or by which the Company or Seller is bound.

4.25 FOREIGN CORRUPT PRACTICES ACT. Neither Seller nor, to Seller's knowledge, any of its officers, directors, agents, employees or any other Person acting on behalf of Seller has, directly or indirectly, taken any action which would cause it to be in violation of the Foreign Corrupt Practices Act of 1977, as amended, or any rules or regulations thereunder or any similar anti-corruption or Legal Requirement with respect to anti-bribery in any jurisdiction other than the United States (collectively, the "FCPA"), used any corporate funds for unlawful contributions, gifts, entertainment or other unlawful expenses relating to political activity, made, offered or authorized any unlawful payment to foreign or domestic government officials or employees, whether directly or indirectly, or made, offered or authorized any bribe, rebate, payoff, influence payment, kickback or other similar unlawful payment, whether directly or indirectly. Seller has established sufficient internal controls and procedures to ensure compliance with the FCPA.

4.26 DISCLOSURE. With respect to Seller, the Business and the Assets, neither this Agreement and the other Transaction Documents to which Seller is a party, nor any of the schedules or Exhibits hereto or thereto or any other documents provided by Seller to Buyer relating to the Business, when considered as a whole, contains any untrue statement of a material fact or, omits a material fact necessary to make the statements contained herein or therein, in light of the circumstances in which they were made, not misleading.

ARTICLE V
REPRESENTATIONS AND WARRANTIES OF BUYER

As a material inducement to Seller and the Company to enter into this Agreement, Buyer represents and warrants to Seller and the Company as set forth below:

5.1 ORGANIZATION AND POWER. Buyer is a limited liability company which is validly existing and in good standing (or has comparable active status) under the laws of the State of Delaware and is qualified to do business in every jurisdiction in which the execution, delivery and performance of its obligations under this Agreement requires it to be so qualified. Buyer has full limited liability company power and authority to execute, deliver and perform its obligations under this Agreement and the other Transaction Documents to which Buyer is a party.

5.2 AUTHORIZATION OF TRANSACTION. No proceedings or actions on the part of Buyer except for those that have been taken are necessary to approve and authorize Buyer's execution and delivery of this Agreement or any other Transaction Documents to which Buyer is a party or the performance of Buyer's obligations hereunder or thereunder. This Agreement constitutes, and each of the other Transaction Documents to which Buyer is a party will when executed constitute, a valid and binding obligation of Buyer, enforceable in accordance with their terms, except as enforceability hereof may be limited by bankruptcy, insolvency or other laws affecting creditor's rights generally and limitations on the availability of equitable remedies.

5.3 ABSENCE OF CONFLICTS. Assuming the accuracy of the representations and warranties set forth in Section 4.4, neither the execution, delivery and performance of this Agreement or any other Transaction Document by Buyer to which it is a party nor the consummation by Buyer of the transactions contemplated hereby or thereby does or will (i) conflict with or result in a breach of any of the provisions of, (ii) constitute a default under, (iii) result in the violation of, (iv) give any third party the right to terminate or to accelerate any obligation under, or (v) require any consent, order, approval, authorization or other action of, or any filing with or notice to, any Governmental Entity or other Person, in each case under Buyer's operating agreement or under the provisions of any indenture, mortgage, lease, loan agreement or other agreement or instrument to which Buyer is bound or by which it or any of its assets are affected, or any Legal Requirement to which Buyer or any of its assets are subject.

5.4 BROKERAGE. There are no claims for brokerage commissions, finders' fees or similar compensation in connection with the transactions contemplated by this Agreement based on any arrangement or agreement made by or on behalf of Buyer or any Affiliate of Buyer.

5.5 LITIGATION; PROCEEDINGS. There are no actions, suits, proceedings, orders or investigations pending (or, to Buyer's knowledge, threatened) against or affecting Buyer at law or in equity, or before or by any Governmental Entity, which could reasonably be expected to adversely affect Buyer's performance under this Agreement or the Transaction Documents to which Buyer is a party or the consummation of the transactions contemplated hereby or thereby.

5.6 AVAILABILITY OF FUNDS. Buyer has cash available or has existing borrowing facilities which together are sufficient to enable it to consummate the transactions contemplated by this Agreement.

ARTICLE VI
COVENANTS

6.1 CONSENTS. Prior to the Closing Date, Seller and the Company have used commercially reasonable efforts to (a) obtain or cause to be obtained those Consents set forth on Schedule 6.1 (the "OTHER CONSENTS"), and (b) cause each of the Other Consents to be effective as of the Closing Date. With respect to the Other Consents that have not been obtained by the Closing Date, Seller and the Company will, for the sixty (60) day period following the Closing Date, use commercially reasonable efforts to either (i) obtain such Other Consents or (ii) assist the Buyer in entering into new Contracts with the party to which such Other Consent relates.

6.2 WORK IN PROCESS. Seller and the Company will, for a period of sixty (60) days following the Closing Date (the "TURNOVER PERIOD"), maintain, service and keep in full force and effect any Contracts or outstanding work orders with the customers listed on Schedule 6.2 (collectively, the "WIP CUSTOMERS" and each, a "WIP CUSTOMER"), or any Affiliates of the WIP Customers, in effect as of the Closing Date (collectively, the "WIP CONTRACTS" and each, a "WIP CONTRACT"). Seller and the Company will use commercially reasonable efforts to obtain the consent of the WIP Customers to assign the WIP Contracts to Buyer If Seller and Company are not able to obtain the consent to assignment of a WIP Customer or any customer for which an Other Consent is not obtained on or prior to the Closing Date, Seller hereby appoints Buyer as its agent with respect to each such contract to complete the work outstanding thereunder, and Buyer will complete any outstanding work with respect thereto as Seller's agent. To the extent any contract has been assigned, Seller and the Company shall direct each customer thereunder to make payments for any work completed by Buyer directly to the Buyer at the address set forth in Section 11.2. If a customer makes any payment directly to Seller or the Company for any work performed by Buyer, Seller and the Company will immediately remit such payment to Buyer.

6.3 RELATIONSHIP OF THE PARTIES. It is mutually agreed and understood that Buyer shall act as Seller's agent and representative for the limited purpose of performing the work and services contemplated under the contracts listed on Schedule 6.1 and the WIP Contracts that are not assigned. Buyer agrees to act in accordance with the limited authority granted to it under this Section 6.3 and solely within the terms of each such contract, as applicable.

ARTICLE VII
CLOSING DELIVERABLES

7.1 CLOSING DELIVERABLES OF SELLER AND THE COMPANY. At the Closing, Seller and the Company shall deliver or cause to be delivered to Buyer (except to the extent waived by Buyer in writing):

(a) A bill of sale executed by Seller in the form attached hereto as Exhibit "B" (the "BILL OF SALE");

(b) Copies of all those Consents set forth on Schedule 7.1(b) (the "MANDATORY CONSENTS")

(c) To the extent obtained, copies of all Other Consents set forth on Schedule 6.1;

(d) A release and termination of each Lien on any Asset which is not a Permitted Lien;

(e) A certificate, dated not earlier than forty five (45) days prior to the Closing Date, of the Secretary of State of the States of Delaware, New Jersey, New York, Georgia and Florida stating that Seller is in good standing or has comparable active status in such state;

(f) Personnel files of all employees of Seller being hired by Buyer as of the Closing Date;

(g) An Escrow Agreement executed by Seller and the Company in the form attached hereto as Exhibit "C" (the "ESCROW AGREEMENT");

(h) A Perpetual Software License Agreement executed by Seller and the Company, in the form attached hereto as Exhibit "D" (the "LICENSE AGREEMENT");

(i) A Noncompetition agreement executed by Seller and the Company, in the form attached hereto as Exhibit "E" (the "HANOVER NONCOMPETITION AGREEMENT");

(j) An assignment and assumption agreement executed by Seller in the form attached hereto as Exhibit "F" (the "ASSIGNMENT AND ASSUMPTION AGREEMENT");

(k) A Transitional Services Agreement executed by Seller and Buyer in the form attached hereto as Exhibit "G" (the "TRANSITIONAL SERVICES AGREEMENT");

(l) An estoppel certificate executed by the landlord under the Lease of the leased Real Property listed on Schedule 4.22(b) which is being assumed by Buyer, in the form attached hereto as Exhibit "H", dated no earlier than fifteen (15) days prior to Closing;

(m) An opinion of counsel to Seller and the Company, in the form attached hereto as Exhibit "I"; and

(n) Such other documents or instruments as Buyer reasonably requests and are reasonably necessary to effect the transactions contemplated by this Agreement; and

7.2 CLOSING DELIVERABLES OF BUYER. At the Closing, Buyer shall deliver or cause to be delivered to Seller and the Company (except to the extent waived by Seller and the Company in writing):

(a) the Escrow Agreement executed by Buyer;

(b) the License Agreement executed by Buyer;

(c) the Assignment and Assumption Agreement executed by Buyer;

(d) the Hanover Noncompetition Agreement executed by Buyer;

(e) the Transitional Services Agreement executed by Buyer; and

(f) such other documents or instruments as Seller reasonably requests and are reasonably necessary to effect the transactions contemplated by this Agreement.

ARTICLE VIII
INTENTIONALLY OMITTED

ARTICLE IX
OTHER COVENANTS

9.1 RETENTION OF RETAINED RECORDS; CONTINUING ASSISTANCE.

(a) General Access. Subject to Section 9.1(b) and its obligations under Section 9.4, after the Closing, Seller shall provide Buyer and Buyer's counsel, accountants and other representatives, with reasonable access during normal business hours to the books, records, property, personnel, contracts, commitments and documents relating to the Business in their possession pertaining to transactions occurring prior to the Closing Date when requested. At the request and expense of Buyer, Seller will deliver copies of any such books and records to Buyer. Without limiting the foregoing, Seller will give Buyer and Buyer's counsel, accountants and other representatives such access to such books and records as may reasonably be required in order to permit Buyer to perform any audit or other review which they may deem appropriate in connection with any offering of securities by Buyer or any Affiliate thereof, and Seller (to the extent such consent is necessary) hereby consents to the use of information contained in such books and records for any such purpose. For a period of three (3) years following the Closing, Seller will not destroy or otherwise dispose of any such books and records unless Seller gives Buyer not less than ten (10) Business Days' prior written notice of such intended destruction or disposal specifying in reasonable detail the books and records proposed to be destroyed or disposed of; provided, that prior to such destruction or disposal, Buyer may request that the books and records proposed to be destroyed or disposed of instead be delivered to Buyer, at Buyer's expense, in any manner which Buyer may reasonably indicate by notice within such ten (10) Business Day period to Seller, in which case Seller will instead so deliver such books and records.

(b) Cooperation on Tax Matters. Seller shall, and shall cause its Affiliates to, provide to Buyer such cooperation and information as Buyer reasonably may request in filing any Tax Return, amended Tax Return or claim for refund, determining a liability for Taxes or a right to refund of Taxes or in conducting any audit or other proceeding in respect of Taxes. Such cooperation and information shall include providing copies of all relevant portions of relevant Tax Returns, together with relevant accompanying schedules and relevant work papers, relevant documents relating to rulings or other determinations by Taxing Authorities and relevant records concerning the ownership and Tax basis of property, which any such Party may possess. Seller will retain all Tax Returns, schedules and work papers, and all material records and other documents relating to Tax matters of Seller for its Tax period first ending after the Closing Date and for all prior Tax periods until the later of (i) the expiration of the statute of limitations for the Tax periods to which the Tax Returns and other documents relate and (ii) eight years following the due date (without extension) for such Tax Returns. Thereafter, Seller may dispose of such Tax Returns; provided that Seller shall give to Buyer notice and an opportunity to take custody thereof prior to doing so. Seller shall make its employees reasonably available on a mutually convenient basis at its cost to provide explanation of any documents or information so provided.

(c) Wage and Tax Reporting. Seller and Buyer agree that, in accordance with the "Alternative Procedure" provided in Section 5 of Revenue Procedure 96-60, 1996-2 Cumulative Bulletin 399, with respect to filing and furnishing Internal Revenue Service Forms W-2, W-3 and 941, after the Closing Date, (i) Seller and Buyer shall, if applicable, report on a "predecessor-successor" basis with respect to any employee that is transferred from one person to another person pursuant to this Agreement (a "TRANSFERRED EMPLOYEE"), (ii) Seller shall not be required to furnish Forms W-2 or 1099 to such Transferred Employees to whom it otherwise would have been obligated to furnish such forms for the period after the Closing Date and (iii) Buyer shall assume the obligations to furnish such forms to the Transferred Employees for the period after the Closing Date.

9.2 PRESS RELEASES AND ANNOUNCEMENTS.

(a) Except for the release in substantially the form attached hereto as Exhibit "J" and any public disclosure which either Party in good faith believes is required by any Legal Requirement (in which case, if practicable, the disclosing Party will give the other Parties an opportunity to review and comment upon such disclosure before it is made), after the Closing through January 31, 2007, Seller and the Company will not make any press release or other public announcement of or with respect to the Business, this Agreement or any Closing Transaction without Buyer's consent (which consent will not be unreasonably withheld or delayed); provided, however, Buyer shall be deemed to have consented to any such press release or other public announcement in the event it does not respond (in the form of comments or otherwise) to Seller or the Company within two (2) Business Days of receiving such press release or public announcement.

(b) Seller is a wholly-owned subsidiary of the Company, which is a publicly-held company trading on the American Stock Exchange and as such, the Company is obligated to make all filings as are required by the rules and regulations of the Securities and Exchange Commission, the American Stock Exchange, and the like, all of which constitute a Legal Requirement.

9.3 FURTHER ASSURANCES. Each Party will execute and deliver such further instruments of conveyance and transfer and take such additional actions as any other Party may reasonably request to effect, consummate, confirm or evidence the transfer to Buyer of the Assets, the assumption by Buyer of the Assumed Liabilities and the other transactions contemplated hereby.

9.4 CONFIDENTIALITY.

(a) Confidentiality by Seller and the Company. Seller and the Company will treat and hold as confidential all information concerning the Business (including, without limitation, information relating to customers of Seller), the Assets and the Assumed Liabilities which is of a type that in accordance with Seller's past practices has been treated as confidential or proprietary ("CONFIDENTIAL INFORMATION"), refrain from using any Confidential Information except in connection with this Agreement, and deliver promptly to Buyer or destroy, at the request and option of Buyer, all tangible embodiments (and all copies) of Confidential Information which are in their possession or under their control. If Seller or the Company is requested or required (by oral question or request for information or documents in any legal proceeding, interrogatory, subpoena, civil investigative demand, or similar process) to disclose any Confidential Information, then it will notify Buyer promptly of the request or requirement so that Buyer may seek, at its sole cost and expense, an appropriate protective order or waive compliance with the provisions of this Section 9.4(a). If, in the absence of a protective order or the receipt of a waiver hereunder, Seller or the Company is, on the advice of counsel, compelled to disclose any Confidential Information in connection with any legal proceeding, interrogatory, subpoena, civil investigative demand, or similar process, then it may disclose such Confidential Information in connection therewith; provided, that it will use its best efforts to obtain, at the request and expense of Buyer, an order or other assurance that confidential treatment will be accorded to such portion of such Confidential Information as Buyer may designate. Until Buyer's and Seller's networks are completely separate and independent, which is estimated to be completed within three weeks following the Closing, only Chris Alfano, network manager, will have administrative rights of the networks and respective back-up tapes. In the event Chris Alfano is no longer an employee of Seller after the Closing Date and prior to the Buyer's and Seller's networks being completely separate and independent, Buyer and Seller shall appoint a mutually agreeable person to have sole administrative rights with respect to the networks and respective back-up tapes.

(b) Confidentiality by Buyer. Buyer will treat and hold as confidential (i) any and all confidential information as provided in those certain customer contracts being assumed or for which Buyer shall act as Company's agent, following the Closing Date ("CUSTOMER CONFIDENTIAL INFORMATION") and (ii) any Confidential Information of the Company and Seller to which Buyer may have access to on and after the Closing Date. Buyer hereby agrees to abide by the confidential terms in each customer contract being assumed by Buyer or for which Buyer is acting as Company's agent. Buyer shall refrain from using any Confidential Information relating to Seller or the Company except in connection with this Agreement, and shall, to the extent permitted by law, deliver promptly to Seller or the Company or destroy, at the request and option of Seller or the Company, all tangible embodiments and all copies of Confidential Information relating to Seller or the Company which are in their possession or under their control. If Buyer is requested or required (by oral question or request for information or documents in any legal proceeding, interrogatory, subpoena, civil investigative demand, or similar process) to disclose any Confidential Information relating to Seller or the Company or Customer Confidential Information, then it will notify Seller and the Company promptly of the request or requirement so that Seller and the Company may seek, at their sole cost and expense, an appropriate protective order or waive compliance with the provisions of this Section 9.4(b). If, in the absence of a protective order or the receipt of a waiver hereunder, Buyer is, on the advice of counsel, compelled to disclose any Confidential Information relating to Seller or the Company or Customer Confidential Information in connection with any legal proceeding, interrogatory, subpoena, civil investigative demand, or similar process, then it may disclose such Confidential Information relating to Seller or the Company or Customer Confidential Information in connection therewith; provided, that it will use its commercially reasonable efforts to obtain, at the request and expense of Seller and the Company, an order or other assurance that confidential treatment will be accorded to such portion of such Confidential Information relating to Seller and the Company or such Customer Confidential Information as Seller and the Company may designate.

(c) Remedy for Breach. Buyer, Seller and the Company acknowledge and agree that in the event of a breach by any party of any of the provisions of this Section 9.4, monetary damages may be inadequate and Buyer, Seller and the Company may have no adequate remedy at law. Accordingly, in the event of any such breach, Buyer, Seller and/or the Company and their respective successors or assigns may, in addition to any other rights and remedies existing in their favor, enforce their rights and Buyer's, Seller's and the Company's obligations hereunder by an action or actions for specific performance, injunctive and/or other relief, without any requirement of posting a bond or proving actual damages or posting any bond or other security.

9.5 EMPLOYMENT MATTERS.

(a) Except for any Assumed Liabilities and as set forth in the Employment Agreement between Buyer and Catherine Fetner, Buyer is not obligated to hire any employee, consultant or contractor engaged in the Business but may interview all such Persons. Buyer's expressed intention to extend certain offers of employment shall not constitute any commitment, contract or understanding (expressed or implied) of any obligation on the part of Buyer to a post-Closing employment relationship of any fixed term or duration or upon any terms or conditions other than those that Buyer may establish pursuant to individual offers of employment. Any employment offered by Buyer is "at will" and may be terminated by Buyer or by an employee at any time for any reason (subject to any written commitments to the contrary made by Buyer or an employee and Legal Requirements). Nothing in this Agreement shall be deemed to prevent or restrict in any way the right of Buyer to terminate, reassign, promote or demote any employee, consultant or contractor after the Closing or to change adversely or favorably the title, powers, duties, responsibilities, functions, locations, salaries, other compensation or terms or conditions of employment of such Persons.

(b) Buyer shall not have any responsibility, liability or obligation, whether to active or former employees, consultants or contractors of Seller, their beneficiaries or to any other Person, with respect to any employee benefit plans, practices, programs or arrangements (including the establishment, operation or termination thereof and the notification and provision of COBRA coverage extension) maintained by Seller.

9.6 RECEIVABLES. With respect to all accounts receivables retained by Seller, Seller and the Company shall use commercially reasonable efforts to collect such receivables; provided that, Seller and the Company shall utilize every effort to minimize any disruption to Buyer's relationship with any client or customer for which Seller has retained accounts receivables.

9.7 SEPARATION AGREEMENTS. Seller and/or the Company have previously entered into a separate agreement with each of George Ostendorf and Herb Lethert (the "SEPARATION AGREEMENTS"), which agreements are set forth on Schedule 9.7 and include certain restrictive covenants in favor of Seller and the Company including, without limitation, non-solicitation provisions, non-competition provisions, confidentiality provisions and non-disparagement provisions. Seller and the Company hereby agree to enforce the Separation Agreements against the respective parties thereto and to exercise any remedies under the Separation Agreements to the extent necessary to enforce the provisions thereunder.

9.8 NON-DISPARAGEMENT. Seller and the Company agree not to make any statement, written or oral, in disparagement of Buyer or any of its officers, shareholders, directors, employees, agents or representatives (including, but not limited to, negative references to each or any of Buyer's products or services) to the general public or Buyer's employees, potential employees, customers, potential customers, suppliers, potential suppliers, business partners or potential business partners. If Seller or Company are contacted by a person or entity regarding the provision of services relating to the Business or the Assets, Seller and the Company agree to state that the Assets have been sold to Buyer and to provide such person or entity with the contact information for Buyer.

9.9 POST-CLOSING DOCUMENTS.

(a) Seller and the Company agree to use commercially reasonable efforts following the Closing to cause the board of directors of the Company to adopt resolutions providing that, during their term as directors, the directors of the Company shall be subject to the non-competition and non-solicitation restrictions set forth in the Hanover NonCompetition Agreement.

(b) With fifteen (15) days of the Closing Date, Seller agrees to enter into an Escrow Agreement with Buyer and Iron Mountain Intellectual Property

Management, Inc. ("IRON MOUNTAIN") in substantially the form attached hereto as Exhibit "K", which agreement shall provide for Seller's deposit of certain source code with Iron Mountain for the benefit of Buyer.

9.10 WEBSITE. For a period of six (6) months following the Closing Date, Seller and the Company agree to link the domain name "www.havovercapital.com" to the website established by Buyer that includes the Website Assets. "Website Assets" shall mean the content of Seller's website with the domain name "www.hanovercapital.com" as more fully described on Schedule 2.1(a) attached hereto.

ARTICLE X
INDEMNIFICATION AND RELATED MATTERS

10.1 SURVIVAL; ABSENCE OF OTHER REPRESENTATIONS. The representations and warranties of Buyer, Seller and the Company contained herein shall survive for a period of eighteen (18) months from the Closing Date. The covenants and agreements of Seller and the Company contained herein and to be performed to any extent after the Closing Date shall survive until fully discharged and performed, and any claims for indemnification in respect of a breach of such covenants to be performed in any respect after the Closing Date must be made on or before such date. The covenants and agreements of Buyer contained herein to be performed in any respect after the Closing Date shall survive the Closing Date until fully discharged and performed. No Party has made or will make in connection with this Agreement any representation or warranty, express or implied, other than as set forth in this Agreement, the schedules hereto, and the certificates delivered pursuant hereto.

10.2 INDEMNIFICATION.

(a) By Seller and the Company. After the Closing, Seller and the Company shall, jointly and severally, indemnify Buyer and hold Buyer harmless from and against any loss, Liability, deficiency, damage, Tax or expense (including reasonable legal expenses and costs) and any cost or expense arising from or incurred in connection with any action, suit, proceeding, claim or judgment relating to any matter described in this clause, or in enforcing the indemnity provided by this Section 10.2 (any such amount, a "LOSS"), which Buyer may suffer, sustain or become subject to, as a result of:

(i) any breach by Seller or the Company of any representation or warranty set forth in this Agreement (including any representation or warranty deemed to be remade by Seller and the Company as of the Closing pursuant to the first paragraph of Article IV);

(ii) any litigation, investigation, proceeding, or other claim by any Governmental Entity or any Person not claiming by, through or under Buyer, to the extent that the same actually arises from or relates to the Business or any Asset prior to the Closing;

(iii) any Liability or obligation of Seller or related to the Business (including any indebtedness) which is not an Assumed Liability or Assumed Contract;

(iv) any breach by Seller of, or failure by Seller to perform, any covenant or obligation of Seller set forth herein or in any certificate, document or instrument prepared by Seller and delivered to Buyer hereunder;

(v) any liability under the WARN Act or any similar state or local Legal Requirement that may result from an "Employment Loss", as defined by 29 U.S.C. sect. 2101(a)(6), caused by any action of Seller prior to the Closing;

(vi) any Liability related to, derived from or imposed by any governmental entity on account of any employee benefit to which any employee or contractor of Seller was entitled prior to the Closing Date; or

(vii) the failure or alleged failure to obtain any Consent required by the terms of this Agreement;

provided that Seller and the Company will not be liable for any Loss described in clause (i) above (other than a Loss arising in respect of a breach of a representation or warranty contained in Sections 4.7, 4.12, 4.14, 4.17 and 4.18) until the aggregate amount of such Losses exceeds $25,000 (the "BASKET"), and provided further that Seller and the Company will not be liable for any Loss described in clause (i) above (other than a Loss arising in respect of a breach of a representation or warranty contained in Sections 4.7, 4.12, 4.14, 4.17 and 4.18) to the extent that the aggregate amount of such Losses exceeds the Purchase Price (the "CAP"); provided, further, that notwithstanding the foregoing, Seller will be liable for any Loss resulting from fraud, liability for any Tax or willful or intentional breach of any representation, warranty or covenant by Seller or the Company set forth herein and any such Loss shall not count toward the aggregate amount of all Losses being computed for purposes of the Cap or the Basket.

(b) By Buyer. After the Closing, Buyer will indemnify Seller and hold Seller harmless from and against any Loss which Seller may suffer, sustain or become subject to, as the result of:

(i) any breach by Buyer of any representation, warranty, covenant or agreement of Buyer set forth in this Agreement;

(ii) any litigation, investigation, proceeding, or other claim by any Governmental Entity or any Person not claiming by, through or under Seller or any Affiliate of Seller, to the extent that the same actually arises from or relates to the operation of the Business by Buyer or the Assets or Assumed Liabilities or Assumed Contract after the Closing;

(iii) any Assumed Liability; or

(iv) any failure by Buyer to perform any covenant or obligation of Buyer set forth herein or in any certificate, document or instrument prepared by Buyer and delivered to Seller hereunder;

provided that Buyer will not be liable for any Loss described above until the aggregate amount of such Losses exceeds $25,000 and provided further that Buyer will not be liable for any Losses in excess of the Purchase Price.

(c) Determination of Loss and Amount. For purposes of determining whether any Loss has occurred, or the amount of any such Loss, the representations, warranties, covenants and agreements of the Parties set forth in this Agreement and the other Transaction Documents will be considered without regard to any materiality qualification set forth therein.

(d) Knowledge No Effect. No knowledge of any breach, claim, Liability or other obligations, whether obtained by notice hereunder or otherwise, will affect any party's right to indemnification or other remedy provided for in this Agreement in respect to any such matter of which it obtains knowledge or receives such notice unless the relevant party expressly waives such right or remedy in writing.

10.3 INDEMNIFICATION PROCEDURES.

(a) Notice of Claim. Any Party making a claim for indemnification under Section 10.2 (the "INDEMNIFIED PARTY") will notify the Party from whom indemnification is claimed (the "INDEMNIFYING PARTY") of the claim in writing promptly after receiving written notice of any action, lawsuit, proceeding, investigation or other claim against it (if by a third party) or discovering the Liability, obligation or facts giving rise to such claim for indemnification. Such notice will describe the claim, the amount thereof (to the extent then known and quantifiable), and the basis therefor, in each case to the extent known to the Indemnified Party. The failure to so notify the Indemnifying Party will not relieve the Indemnifying Party of its obligations under Section 10.2, except to the extent that such failure actually prejudices the Indemnifying Party.

(b) Assumption of Defense. With respect to any third party claim which gives rise or is alleged to give rise to a claim for indemnity under Section 10.2 and which involves only the payment of money damages to such third party, the Indemnifying Party, at its option (subject to the limitations set forth below), will be entitled to assume responsibility for and control the defense of such claim and to appoint a competent and reputable counsel reasonably acceptable to the Indemnified Party to act as lead counsel of such defense. Prior to the Indemnifying Party assuming control of such defense, the Indemnifying Party must first furnish the Indemnified Party with evidence which, in the Indemnified Party's reasonable judgment, establishes that the Indemnifying Party is and will be able to satisfy any such Liability, and a written agreement by the Indemnifying Party agreeing to be liable for all related Losses, notwithstanding the provisions of Section 10.2.

(c) Limits of Assumption of Defense. An Indemnifying Party's rights under Section 10.3(b) will be subject to the following additional limitations:

(i) with respect to any claim the defense of which the Indemnifying Party has assumed, the Indemnified Party will be entitled to participate in the defense of such claim and to employ counsel of its choice for such purpose, and the fees and expenses of such separate counsel will be borne by the Indemnified Party (except that the reasonable fees and expenses of such separate counsel incurred with prior notice to the Indemnifying Party prior to the date the Indemnifying Party effectively assumes control of such defense will be borne by the Indemnifying Party);

(ii) the Indemnifying Party will not be entitled to assume control of such defense if (A) the claim for indemnification relates to or arises in connection with any criminal proceeding, action, indictment, allegation or investigation, (B) the Indemnified Party reasonably concludes that, in light of any actual or potential conflict of interest, it would be inappropriate for legal counsel selected by the Indemnifying Party to represent the Indemnified Party, (C) the Indemnified Party reasonably believes that an adverse determination with respect to the action, lawsuit, investigation, proceeding or other claim giving rise to such claim for indemnification would be detrimental to or injure the Indemnified Party's reputation or future business prospects, (D) upon petition by the Indemnified Party, an appropriate court rules that the Indemnifying Party failed or is failing to vigorously prosecute or defend such claim, or, (E) the Indemnifying Party does not give prompt notice of its intention to do so;

(iii) if the Indemnifying Party assumes control of the defense of any such claim, then the Indemnifying Party will obtain the prior written consent of the Indemnified Party before entering into any settlement of such claim, if such settlement does not expressly and unconditionally release the Indemnified Party from all Liabilities and obligations with respect to such claim, without prejudice; and

(iv) if the Indemnifying Party assumes control of the defense of any such claim, then the Indemnifying Party and its counsel will proceed diligently and in good faith with respect thereto. If the Indemnifying Party has the right to, but does not, assume control of the defense of any claim in accordance with this Section 10.3, then the Indemnifying Party may nonetheless participate (at its own expense) in the defense of such claim and the Indemnified Party will consult with the Indemnifying Party in respect of such defense. As used in this Article X, the term "settlement" refers to any settlement, compromise, consent or similar decree, or election to permit default judgment to be entered, in respect of any claim.

10.4 TREATMENT OF INDEMNIFICATION PAYMENTS. Each Party will treat all payments made pursuant to Section 10.2 as adjustments of the Purchase Price for all purposes.

10.5 EXCLUSIVE REMEDY. Buyer, Seller and the Company acknowledge and agree that the indemnification provisions in this Article X shall be the exclusive remedy of Buyer, Seller and the Company for the assertion of any Loss against, or the imposition of any liability on, any party or their respective officers, directors, and Affiliates for any breach of any representation or warranty under this Agreement. Notwithstanding the foregoing, no party hereto waives (i) any rights that may arise out of intentional or willful misconduct or fraud, (ii) any rights to obtain injunctive relief pursuant to Section 11.10, (iii) any rights that may arise out of the breach of a covenant or agreement by the other party, and the rights of Buyer and Seller under this Article X with respect to indemnification for any matters in clauses (i), (ii) or (iii) shall be cumulative and shall not exclude any other remedies to which a party may be entitled for such matters.

ARTICLE XI
MISCELLANEOUS

11.1 AMENDMENT AND WAIVER. This Agreement may be amended and any provision of this Agreement may be waived; provided, that any such amendment or waiver (a) will be binding upon Seller only if such amendment or waiver is set forth in a writing executed by Seller, (b) will be binding upon Company only if such amendment or waiver is set forth in a writing executed by Company and (c) will be binding upon Buyer only if such amendment or waiver is set forth in a writing executed by Buyer. No course of dealing between or among any Persons having any interest in this Agreement will be deemed effective to modify, amend or discharge any part of this Agreement or any rights or obligations of any Party under or by reason of this Agreement. No failure by any Party to insist upon the strict performance of any covenant, duty, agreement or condition of this Agreement or to exercise any right or remedy consequent upon a breach thereof will constitute a waiver of any such breach or any other covenant, duty, agreement or condition.

11.2 NOTICES. All notices, demands and other communications given or delivered under this Agreement will be in writing and will be deemed to have been given when personally delivered or delivered by express courier service. Notices, demands and communications to the Parties will, unless another address is specified in writing, be sent to the address indicated below:

To Seller:

Hanover Capital Partners 2, Ltd.
200 Metroplex Drive, Suite 100
Edison, NJ 08817
Telecopy: 732-548-0286
Attention: Irma N. Tavares, Senior Managing Director

with a copy to (which shall not constitute notice to Seller):

Hanover Capital Mortgage Holdings, Inc.
200 Metroplex Drive, Suite 100
Edison, NJ 08817
Telecopy: 732-548-0286
Attention: Suzette Berrios, Vice President and General Counsel

and with a copy to (which shall not constitute notice to Seller):

Thacher Proffitt & Wood LLP
Two World Financial Center
New York, NY 10281
Telecopy: 212-912-7751
Attention: Mark I. Sokolow, Esquire

To the Company:

Hanover Capital Mortgage Holdings, Inc.
200 Metroplex Drive, Suite 100
Edison, NJ 08817
Telecopy: 732-548-0286
Attention: John Burchett, President and CEO

with a copy to (which shall not constitute notice to the Company):

Hanover Capital Mortgage Holdings, Inc.
200 Metroplex Drive, Suite 100
Edison, NJ 08817
Telecopy: 732-548-0286
Attention: Suzette Berrios, Vice President and General Counsel

and with a copy to (which shall not constitute notice to Seller):

Thacher Proffitt & Wood LLP
Two World Financial Center
New York, NY 10281
Telecopy: 212-912-7751
Attention: Mark I. Sokolow, Esquire

To Buyer:

Terwin Acquisition I, LLC
45 Rockefeller Plaza, Suite 420
New York, NY 10111
Telecopy: 212-218-5875
Attention: Brian Flynn

with a copy to (which shall not constitute notice to Buyer):

Klehr, Harrison, Harvey, Branzburg & Ellers LLP
260 South Broad Street
Philadelphia, PA 19102

Telecopy: 215-568-6603
Attention: William W. Matthews, Esquire

11.3 BINDING AGREEMENT; ASSIGNMENT. This Agreement and all of the provisions hereof will be binding upon and inure to the benefit of the Parties and their respective successors and assigns; provided that neither this Agreement nor any of the rights, interests or obligations hereunder may be assigned by any Party without the prior written consent of the other Parties hereto; provided, further, that so long as Buyer does not assign its obligations hereunder, Buyer may assign its right and interests (but not its obligations) hereunder to an Affiliate of Buyer without the consent of any other Party hereto. Any assignment made in contravention of this Section 11.3 shall be null and void.

11.4 SEVERABILITY. Whenever possible, each provision of this Agreement will be interpreted in such a manner as to be effective and valid under applicable law, but if any provision of this Agreement is held to be prohibited by or invalid under applicable law, such provision will be ineffective only to the extent of such prohibition or invalidity, without invalidating the remainder of such provisions or the remaining provisions of this Agreement.

11.5 NO STRICT CONSTRUCTION. The language used in this Agreement will be deemed to be the language chosen by the Parties to express their mutual intent. In the event an ambiguity or question of intent or interpretation arises, this Agreement will be construed as if drafted jointly by the Parties, and no presumption or burden of proof will arise favoring or disfavoring any Person by virtue of the authorship of any of the provisions of this Agreement.

11.6 CAPTIONS. The captions used in this Agreement are for convenience of reference only and do not constitute a part of this Agreement and will not be deemed to limit, characterize or in any way affect any provision of this Agreement, and all provisions of this Agreement will be enforced and construed as if no caption had been used in this Agreement.

11.7 ENTIRE AGREEMENT. This Agreement and the documents referred to herein contain the entire agreement between the Parties and supersede any prior understandings, agreements or representations by or between the Parties, written or oral, which may have related to the subject matter hereof in any way.

11.8 COUNTERPARTS. This Agreement may be executed in one or more counterparts (including by means of facsimile), each of which will be deemed an original but all of which taken together will constitute one and the same instrument.

11.9 GOVERNING LAW. All questions concerning the construction, validity and interpretation of this Agreement will be governed by and construed in accordance with the internal laws of the State of New York, without giving effect to any choice of law or conflict of law provision that would cause the application of the laws of any jurisdiction other than the State of New York. In furtherance of the foregoing, the internal law of the

State of New York will control the interpretation and construction of this Agreement (and all schedules and exhibits hereto), even if under that jurisdiction's choice of law or conflict of law analysis, the substantive law of some other jurisdiction would ordinarily apply.

11.10 SPECIFIC PERFORMANCE. Seller and the Company acknowledge that the Business is unique, and recognizes and affirms that in the event of a breach of this Agreement by Seller or the Company, monetary damages may be inadequate and Buyer may have no adequate remedy at law. Accordingly, in the event of any such breach, Buyer and/or successors or assigns may, in addition to any other rights and remedies existing in their favor, enforce their rights and Seller's and the Company's obligations hereunder by an action or actions for specific performance, injunctive and/or other relief, without any requirement of proving actual damages or posting any bond or other security.

11.11 EXPENSES. Except as otherwise expressly provided herein, Seller, the Company and Buyer each will pay all of their own fees, costs and expenses (including fees, costs and expenses of legal counsel, investment bankers, accountants, brokers or other representatives and consultants and appraisal fees, costs and expenses). Seller will prepare and file, on or before the due dates thereof, any required Tax Returns or Tax forms with respect to any Transfer Taxes imposed by any Taxing jurisdiction by reason of the transactions contemplated by this Agreement. Buyer agrees to cooperate with Seller in connection with the preparation and filing thereof. Seller and the Company will be solely responsible for all Transfer Taxes imposed by reason of any transaction contemplated by this Agreement. If valuations of any property or leases are required to determine the amount of any Transfer Taxes, Seller and Buyer will reasonably determine such valuations, and the Parties agree that they will not take (or cause to be taken) any position inconsistent with such valuations in connection with any Tax Return or otherwise.

11.12 PARTIES IN INTEREST. Nothing in this Agreement, express or implied, is intended to confer on any Person other than the Parties and their respective successors and permitted assigns any rights or remedies under or by virtue of this Agreement.

11.13 GENERALLY ACCEPTED ACCOUNTING PRINCIPLES. Where any accounting determination or calculation is required to be made under this Agreement, such determination or calculation (unless otherwise provided) will be made in accordance with GAAP.

11.14 WAIVER OF JURY TRIAL. AS A SPECIFICALLY BARGAINED INDUCEMENT FOR EACH OF THE PARTIES TO ENTER INTO THIS AGREEMENT (EACH PARTY HAVING HAD OPPORTUNITY TO CONSULT COUNSEL), EACH PARTY EXPRESSLY WAIVES THE RIGHT TO TRIAL BY JURY IN ANY LAWSUIT OR PROCEEDING RELATING TO OR ARISING IN ANY WAY FROM THIS AGREEMENT OR THE TRANSACTIONS CONTEMPLATED HEREIN.

[SIGNATURE PAGE TO FOLLOW]

IN WITNESS WHEREOF, the Parties have executed this Asset Purchase Agreement as of the date first written above.

HANOVER CAPITAL PARTNERS 2, LTD.

By: /s/ John A. Burchett
Name: John A. Burchett
Title: Chairman of the Board

HANOVER CAPITAL MORTGAGE HOLDINGS, INC.

BY: /s/ John A. Burchett
NAME: JOHN A. BURCHETT
TITLE: PRESIDENT AND CEO

TERWIN ACQUISITION I, LLC

By: /s/ Thomas K. Guba
Name: Thomas K. Guba
Title: President

EXHIBIT A

REVENUE

Net interest income after loan loss reserve
Due diligence fees & Assignments
Out-of-pocket reimbursables
Other income

DIRECT EXPENSES

Subcontractor expense
Out-of-pocket reimburseables
Appraisals
Credit reports
Travel & Entertainment
Other

INDIRECT EXPENSES

Personnel
Legal and professional
Insurance
General & Administrative
Financing fees
Depreciation and amortization
Dataprocessing
Travel and entertainment
Interest
Occupancy

NJ02 office (67115)
IL01 Office (67160)

EXHIBIT B

BILL OF SALE

See Tab 5

EXHIBIT C

ESCROW AGREEMENT

See Tab 13

EXHIBIT D

PERPETUAL SOFTWARE LICENSE AGREEMENT

EXHIBIT E

NONCOMPETITION AGREEMENT

See Tab 8

EXHIBIT F

ASSIGNMENT AND ASSUMPTION AGREEMENT

See Tab 6

EXHIBIT G

TRANSITIONAL SERVICES AGREEMENT

See Tab 9

EXHIBIT H

ESTOPPEL CERTIFICATE

See Tab 14

EXHIBIT I

OPINION OF COUNSEL TO SELLER

See Tab 15

EXHIBIT 21

Consolidated Subsidiaries of Hanover Capital Mortgage Holdings, Inc.

Subsidiary	Jurisdiction	d/b/a
Hanover Capital Partners 2, Ltd.	Delaware	None
Hanover Capital Securities, Inc. (1)	New York	None
Hanover SPC-A, Inc.	Delaware	None
Pedestal Capital Markets, Inc.(1)	Delaware	None
HDMF-I LLC	Delaware	None
HDMF-II LLC (2)	Delaware	None
HDMF-II Realty Corp. (3)	Delaware	None

Unconsolidated Subsidiaries of Hanover Capital Mortgage Holdings, Inc.

Subsidiary	Jurisdiction	d/b/a
Hanover Statutory Trust I	Delaware	None
Hanover Statutory Trust II	Delaware	None

(1) Subsidiary of Hanover Capital Partners 2, Ltd.

(2) Subsidiary of HDMF-I LLC

(3) Subsidiary of HDMF-II LLC

Exhibit 23.1

CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

We have issued our reports dated March 13, 2007, accompanying the consolidated financial statements and management's assessment of the effectiveness of internal control over financial reporting included in the Annual Report of Hanover Capital Mortgage Holdings, Inc. on Form 10-K for the year ended December 31, 2006. We hereby consent to the incorporation by reference of said reports in the Registration Statements of Hanover Capital Mortgage Holdings, Inc. on Forms S-3 (File No. 333-512914, effective February 18, 2004) and on Forms S-8 (File No. 333-84290, effective March 14, 2002 and File No. 333-99483, effective September 13, 2002)

GRANT THORNTON LLP

New York, New York
March 13, 2007

EXHIBIT 31.1

CERTIFICATION BY JOHN A. BURCHETT PURSUANT TO SECURITIES EXCHANGE ACT
RULE 13A-14(A), AS ADOPTED PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY
ACT OF 2002

I, John A. Burchett, certify that:

1. I have reviewed this Annual Report on Form 10-K of Hanover Capital Mortgage Holdings, Inc.;

2. Based on my knowledge, this Annual Report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this Annual Report;

3. Based on my knowledge, the financial statements, and other financial information included in this Annual Report, fairly present in all material respects the financial condition, results of operations and cash flows of the Registrant as of, and for, the periods presented in this Annual Report;

4. The Registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the Registrant and have:

(a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this Annual Report is being prepared; and

(b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles; and

(c) evaluated the effectiveness of the Registrant's disclosure controls and procedures and presented in this Annual Report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this Annual Report based on such evaluation; and

(d) disclosed in this Annual Report any change in the Registrant's internal control over financial reporting that occurred during the Registrant's most recent fiscal quarter (the Registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the Registrant's internal control over financial reporting.

5. The Registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Registrant's auditors and the audit committee of the Registrant's Board of Directors (or persons performing the equivalent functions):

(a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Registrant's ability to record, process, summarize and report financial information; and

(b) any fraud, whether or not material, that involves management or other employees who have a significant role in the Registrant's internal control over financial reporting.

/s/ John A. Burchett
John A. Burchett
President and Chief Executive Officer

Date: March 16, 2007

EXHIBIT 31.2

CERTIFICATION BY HAROLD F. MCELRAFT PURSUANT TO SECURITIES EXCHANGE ACT RULE 13A-14(A), AS ADOPTED PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, Harold F. McElraft, certify that:

1. I have reviewed this Annual Report on Form 10-K of Hanover Capital Mortgage Holdings, Inc.;

2. Based on my knowledge, this Annual Report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this Annual Report;

3. Based on my knowledge, the financial statements, and other financial information included in this Annual Report, fairly present in all material respects the financial condition, results of operations and cash flows of the Registrant as of, and for, the periods presented in this Annual Report;

4. The Registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the Registrant and have:

(a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this Annual Report is being prepared; and

(b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles; and

(c) evaluated the effectiveness of the Registrant's disclosure controls and procedures and presented in this Annual Report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this Annual Report based on such evaluation; and

(d) disclosed in this Annual Report any change in the Registrant's internal control over financial reporting that occurred during the Registrant's most recent fiscal quarter (the Registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the Registrant's internal control over financial reporting.

5. The Registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Registrant's auditors and the audit committee of the Registrant's Board of Directors (or persons performing the equivalent functions):

(a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Registrant's ability to record, process, summarize and report financial information; and

(b) any fraud, whether or not material, that involves management or other employees who have a significant role in the Registrant's internal control over financial reporting.

/s/ Harold F. McElraft
Harold F. McElraft
Chief Financial Officer

Date: March 16, 2007

Exhibit 32.1

CERTIFICATION BY JOHN A. BURCHETT PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Annual Report of Hanover Capital Mortgage Holdings, Inc. (the "Company") on Form 10-K for the period ended December 31, 2006, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, John A. Burchett, President and Chief Executive Officer of the Company, certify pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, to the best of my knowledge:

(1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ JOHN A. BURCHETT
John A. Burchett
President and Chief Executive Officer

Date: March 16, 2007

Exhibit 32.2

CERTIFICATION BY HAROLD F. McELRAFT PURSUANT TO 18 U.S.C. SECTION 1350
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Annual Report of Hanover Capital Mortgage Holdings, Inc. (the "Company") on Form 10-K for the period ended December 31, 2006, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Harold F. Mc Elraft, Chief Financial Officer of the Company, certify pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, to the best of my knowledge:

(1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ HAROLD F. McELRAFT
HAROLD F. McELRAFT
Chief Financial Officer

Date: March 16, 2007